TAX POLICY:

Executive Compensation, Tax Policy and the Public Good

"Creating an effective tax penalty for executives choosing to liquidate shares prior to retirement achieves a sensible balance for executive risk-taking and provides greater long-term skin-in-the-game"

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There is substantial agreement between academics, policy makers and behavioral experts that executive ownership of company shares, particularly when those shares are held for an entire career (e.g., retirement plus 2 years for successor transition), is good for investors and the public. Long-term equity ownership on the part of executives is viewed as a mitigant for excessive risk taking, providing financial accountability for risks taken over the course of a career that may not be reflected in annual bonus or salary decisions. However, current tax law does not effectively extend to executives the same tax treatment afforded investors, nor does it encourage the type of ownership that can retard events such as those leading up to the recent financial crisis.

Gaps and inconsistencies in tax policy have contributed to much of the complication, obfuscation and negative unintended consequences in current executive pay arrangements. Companies seek, often through overly-complex arrangements, to provide executives with the same tax treatment afforded investors.

The IRS Code has provided some opportunity for alignment between tax policy and good governance dating back to 1964 through employee stock purchase plans (ESPP's)[1] and since 1981 with Incentive Stock Options (ISO's)[2]. These provisions allowed, in certain circumstances, for employee equity to be treated consistent with investors with respect to capital gains treatment. An Incentive Stock Option (ISO), established in 1981, provides employees with capital gains treatment for the gain on any qualifying option award under certain exercise and holding period requirements. Unfortunately, the original $100,000 award limitation remains unchanged from 1981. On a pay-inflation-adjusted basis alone, this limit would need to be over $1M in 2013[3].

We propose that through minor modification to the existing tax code we can increase the transparency of executive equity/compensation arrangements, provide greater alignment of executive rewards with societal goals of balanced risk taking, and increase the actual net revenue to Treasury. We propose the following simple changes to existing tax code:

- Eliminate the $100,000 limit on Incentive Stock Option awards. The definition of a qualified award would include full-value shares as well as stock options.
- Where there is a discount element (e.g., restricted or performance shares), the discount at grant would be treated as ordinary income to the executive, taxed upon sale of the shares. The corresponding employer tax deduction would also be deferred until sale.
- To qualify for capital gains treatment, shares must be held for the longer of ten years from the date of grant 2 years following termination of employment. Shares sold prior to the time limit would be disqualified and subject to immediate ordinary income taxation of the entire amount.

[1] The Revenue Act of 1964 provided the tax treatment for options contained in ESPPs through IRC Section 421(a)(1), providing that "no income shall result at the time of the transfer of such share to the individual upon his exercise of the option with respect to such share."

[2] The Economic Recovery Tax Act of 1981 established ISOs. P.L. 97-34. Senate Report 97-144 states the intended tax treatment for ISOs: The bill provides for "incentive stock options" where there are no tax consequences when an incentive stock option is granted or when the option is exercised, and the employee will be taxed at capital gains rates when the stock received on exercise of the option is sold. Similarly, no business expense deduction will be allowed to the employer with respect to an incentive stock option.

[3] IRC Section 422(d)(1). The $100,000 limit on ISO value was established in 1981 and has not changed. Based on compound growth rate of executive pay for S&P 500 CEOs from the period 1989 through 2011, the $100,000 limit established in 1981 would need to be over $1M for 2013 based on the average growth rate in S&P 500 CEO compensation of roughly 7.5% per year.

These proposed tax rules create a strong incentive for executives and Boards to design equity plans utilizing hold–till-retirement provisions. This will result in more net shares remaining in the hands of executives, presumably providing a more significant incentive for delivering long-term results for investors and the public at large.

Curiously, although the executive would receive favorable tax treatment, the tax revenue gains to the government would actually increase. Currently, upon share vesting or option exercise, income tax paid by the executive is generally offset by the compensation deduction of the employer. On a net basis, the only revenue received by Treasury now is the capital gains tax received upon sale of the shares. Under our scenario, the employer loses the tax deduction for gains from grant through exercise/vesting (further delineating between income and investment), leaving the government with effective taxation, albeit at a lower rate, of a greater portion of the award.

Under our proposed approach[4], the executive's capital gains would be measured from the grant date price – as is the case with an investor purchase – with no offsetting tax deduction by the corporation for subsequent gains. While this results in a lower tax rate for the executive, the effective Treasury revenue is increased by elimination of the employer's tax deduction. Furthermore, the combination of hold-till-retirement covenants and supporting tax policy better aligns the executive performance incentive with the interests of investors and the public over time, rather than allowing an executive group to be rewarded for short term results. With a broad definition of equity incentive plans (i.e., including nonpublic company equity and equity-like vehicles), this approach can successfully apply regardless of company size or ownership structure (e.g., small businesses, joint ventures, subsidiaries, private equity and start-ups).

The individual & corporate taxation, as well as federal revenue, can be summarized in the following example where an executive is granted 3,000 restricted shares at $10 per share, vesting in entirety at the end of three years, with the shares eventually sold at the end of 10 years, assuming a constant 10% CAGR in share price.

Current Treatment of Executive Equity

	Grant Date 1/1/2013	Vesting 1/1/2016	Sale 1/1/2023	Total
Executive Gain	-	39,930	37,882	77,812
Executive Tax	-	15,972	7,576	23,548
Company Deduction Value	-	15,972	0	15,972
Net Taxation		-	7,576	7,576

Proposed Section 422 Modified Treatment of Executive Equity

	Grant Date 1/1/2013	Vesting 1/1/2016	Sale 1/1/2023	Total
Executive Gain	-	-	77,812	77,812
Executive Tax	-	-	21,562	21,562
Company Deduction Value	-	-	12,000	12,000
Net Taxation		-	9,562	9,562

Treating executive pay consistent with investors is good public policy. Creating an effective tax penalty for executives choosing to liquidate shares prior to retirement achieves a sensible balance for executive risk-taking and provides greater long-term skin-in-the-game that provides additional accountability for executives and corporations within our economy. We believe this is an easily-achievable step toward aligning federal tax policy with public policy interests, and can immediately provide increased federal tax revenues through improved public policy. Lastly, it would eliminate the need for complex plans, where any benefits to investors or the public are negligible at best.

[4] See Aligning Tax Policy with Sound Executive Pay Practices, Board Advisory, LLC, (Issue 3, 2009).