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COMMENT

Taxing Unreasonable Compensation: § 162(a)(1) and Managerial Power

In March 2009, the American International Group provoked a firestorm by releasing compensation data for executives in the company's failed derivatives trading group.[1] These bonuses were quickly derided as "most outrageous" and "unreasonable."[2] The House of Representatives subsequently passed legislation attempting to recoup a large portion of the bonuses via the tax code, reflecting the argument that taxpayer money should not be used to subsidize excessive executive compensation.[3]

However, taxpayer subsidization of unreasonable compensation is hardly limited to AIG.[4] Section 162(a)(1) of the Internal Revenue Code,[5] as construed by the IRS, effectively allows publicly traded businesses to deduct an unlimited amount of executive compensation for corporate tax purposes, since salaries are presumably negotiated at arm's length by an independent, profit-maximizing

1. Edmund L. Andrews & Peter Baker, *A.I.G., Huge Bonuses After $170 Billion Bailout*, N.Y. TIMES, Mar. 15, 2009, at A1.

2. Edmund L. Andrews & Peter Baker, *Bonus Money at Troubled AIG Draws Heavy Criticism*, N.Y. TIMES, Mar. 15, 2009, http://www.nytimes.com/2009/03/16/business/16aig.html.

3. Greg Hitt & Aaron Lucchetti, *House Passes Bonus Tax Bill*, WALL ST. J., Mar. 20, 2009, at A1. At the time, I noted that these bonuses could, potentially, be classified as unreasonable compensation under § 162(a)(1). Aaron Zelinsky, *Larry Summers: Stop the AIG Bonuses. Yes You Can*, HUFFINGTON POST, Mar. 15, 2009, http://www.huffingtonpost.com/aaron-zelinsky/larry-summers-stop-the-ai_b_175151.html. For more on the tax implications of voluntary repayment, see Robert W. Wood, *Giving Back Bonuses: Easy; Getting Tax Deductions: Priceless*, 2009 TAX NOTES TODAY 185 (2009).

4. U.S. CEOs earn, on average, twice as much as their foreign counterparts. Randall S. Thomas, *Explaining the International CEO Pay Gap: Board Capture or Market Driven?*, 57 VAND. L. REV. 1171, 1183 (2004).

5. 26 U.S.C. § 162(a)(1) (2006).

board. In contrast, the IRS has consistently used § 162(a)(1) to limit corporate deductions for executive compensation paid by closely held corporations, since closely held corporations lack the commercial checks and balances of their publicly traded brethren.[6] This Comment proposes that, in light of recent scholarship, the IRS has misapplied § 162(a)(1), since publicly traded corporations may lack the appropriate oversight and incentive infrastructure to set executive compensation reasonably. Therefore, this Comment proposes that the IRS should use § 162(a)(1) to render such compensation nondeductible, just as the Service examines the deductibility of compensation paid by privately held corporations. There are two potential means for the IRS to accomplish the goal of treating equitably the compensation paid by closely held and publicly traded corporations. First, the IRS could examine the compensation paid by publicly held corporations in an identical fashion to privately held corporations. Second, the Service could employ an additional factor in the context of publicly held corporations to assess the traits of the CEO-board relationship, and determine whether an arm's-length relationship actually exists when executive compensation levels are established.

This Comment proceeds in three Parts. The first Part describes § 162(a)(1) and the IRS's longstanding interpretation of the statute as limited to only closely held corporations. The second Part examines this interpretation in light of recent scholarship on managerial power and board control, and concludes that the IRS's policy of effectively exempting publicly traded corporations from § 162(a)(1) is flawed in light of this scholarship. The third Part explores the new proposed interpretation of § 162(a)(1), whereby the IRS would analyze and challenge the deductibility of excessive compensation paid by publicly traded corporations. The IRS could employ the same test for compensation paid by publicly traded corporations as for the compensation paid by their privately traded brethren. Alternatively, the IRS could consider an additional factor which measures the propensity for management influence and capture of the board process of setting executive compensation.

I. THE TRADITIONAL IRS APPROACH TO § 162(a)(1)

Section 162(a) of the Internal Revenue Code declares:

6. Michael P. Watters & Daryl Burckel, *Establishing Reasonableness of Compensation Difficult in IRS Attacks*, 8 AKRON TAX J. 147, 147 (1991).

> There shall be allowed as a deduction all the ordinary and necessary expenses paid or incurred during the taxable year in carrying on any trade or business, including . . . a reasonable allowance for salaries or other compensation for personal services actually rendered.[7]

Neither the tax code nor the Treasury regulations define "reasonable allowance for salaries."[8] Nevertheless, the IRS has systematically interpreted § 162(a)(1) to apply only to closely held corporations, effectively concluding that "any amount of compensation paid by a publicly held corporation should be per se reasonable,"[9] even though § 162(a)(1) does not differentiate between the reasonableness of publicly owned and privately held corporations. The original revenue regulations proposed by the Treasury Department immediately following the codification of § 162(a)(1)'s predecessor statute disallowed the deduction of compensation which constituted "waste or appropriation of assets of the corporation."[10] However, no subsequent regulations included such a provision, and there appear to have been no enforcement actions taken under those regulations.

The IRS apparently differentiates between public and private corporations because, with publicly held corporations, "the operation of the normal system of commercial checks and balances arguably is adequate to ensure a proper result so that review by the IRS generally is unnecessary."[11] Such analysis begs the question of what constitutes a "proper result" under § 162(a)(1). The "proper result" may be one in which the level of compensation is not motivated by tax avoidance.[12] Alternatively, for § 162 purposes, the "proper result" may be

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7. 26 U.S.C. § 162(a).

8. *Id.*; Meredith R. Conway, *Money for Nothing and the Stocks for Free: Taxing Executive Compensation*, 17 CORNELL J.L. & PUB. POL'Y 383, 391 (2008) ("The term 'reasonable compensation' is not defined by the tax code or the Treasury regulations.").

9. Anne E. Moran, *Reasonable Compensation*, 390-4th Tax Mgmt. Portfolio (BNA), at III.B. (2009), http://taxandaccounting.bna.com/btac/T400/doc_display.adp?fedfid=4275597&vname=tmcppor; *see also* Conway, *supra* note 8, at 392 ("[Courts] have applied the [§ 162(a)(1)] standard primarily to limit payments by closely held companies where those companies have tried to disguise nondeductible dividends as compensation which would be deductive."); Andrew W. Stumpff, *The Reasonable Compensation Rule*, 19 VA. TAX REV. 371, 377 (1999) ("Reasonable compensation cases virtually always involve a fact pattern . . . [with] . . . payments to an employee who is also a shareholder of a closely-held corporation.").

10. *See* Moran, *supra* note 9, at III.B.4. (internal quotation marks omitted).

11. *Id.*

12. *See, e.g.*, Anthony P. Polito, *Advancing to Corporate Tax Integration: A Laissez-Faire Approach*, 55 S.C. L. REV. 1, 37 (2003); Stumpff, *supra* note 9, at 383 ("Where, on the other hand, there one that preserves the corporate tax base from erosion by self-rewarding managers.[13]

Available authority lends little support to the tax-avoidance rationale for the nondeductibility of unreasonable compensation. The scant legislative history of § 162(a)(1) contains no evidence that tax motivation was intended to play any role in determining reasonableness.[14] Similarly, neither judicial decisions nor the Treasury regulations indicate that the intent behind the compensation is a critical factor in determining whether such compensation qualifies as excessive.[15] Moreover, motivation is not a touchstone for other determinations made under § 162(a), which focus upon objective factors such as ordinariness and necessity.[16] There is accordingly no persuasive argument for considering motivation as a controlling factor in determining when a

is no relationship between the parties other than that of employer-employee, the payment of excessive compensation does not result in avoidance of tax.").

13. *See, e.g.*, Edward A. Zelinsky, *The Tax Policy Case for Denying Deductibility to Excessive Executive Compensation: Disguised Dividends, Reasonable Compensation, and the Protection of the Corporate Income Tax Base*, 58 TAX NOTES 1123, 1124 (1993) ("[E]liminating the deductibility of extravagant managerial remuneration will, in the aggregate, protect the base of the tax . . . ."). Filial deference aside, this Comment differs from the above article by incorporating recent developments in the managerial power hypothesis into interpretations of § 162(a)(1), and by proposing a modification of the IRS and the Court's decisionmaking processes to incorporate the managerial power hypothesis. Moreover, in the optimism of youth, I call for enforcement of § 162(a)(1) against publicly traded corporations, rather than exemption for privately held companies. *See* Edward A. Zelinsky, *Is Martha Stewart Reasonably Compensated?*, 99 TAX NOTES TODAY 919, 923 (2003) ("I once believed that the tax system could and would scrutinize the reasonability of compensation granted by publicly traded corporations to their managers. I believe this no more. Thus, if the double standard is to be eliminated, it must, at least in the short run, be dispelled by greater IRS restraint in bringing reasonable compensation cases against closely held corporations . . . .").

14. *See* [Erwin N. Griswold], Note, *The Deduction of "A Reasonable Allowance for Salaries"—The Undefined Power of the Commissioner*, 56 HARV. L. REV. 997, 997 (1943) (stating that the statutory predecessor to § 162(a)(1) "ha[s] no legislative history"). *But see* [Erwin N. Griswold], Note, *New Light on "A Reasonable Allowance for Salaries*,*"* 59 HARV. L. REV. 286, 287 (1945) ("There is in fact a clear basis for showing that the purpose of Congress in adding the 'reasonable allowance for salaries' clause was to enlarge the preceding language of the section, and to permit the deduction of an allowance for salaries although no salaries were in fact paid."). Although Professor Griswold's account has become "standard," it does not provide a convincing rationale for current IRS examination of any compensation paid by closely held corporations.

15. The courts generally look to at least nine factors in determining the reasonableness of compensation, while the IRS uses twelve factors. Conway, *supra* note 8, at 392-93. Notably, none of these factors involves the motivation for the compensation arrangement.

16. For example, most individuals are more familiar with determinations made under § 162(a)(2), which covers travel expenses incurred when away from home in the pursuit of a trade or business. 26 U.S.C. § 162(a)(2) (2006).

"proper result" has been reached for reasonable compensation purposes. Rather, the tax statute, which calls for "ordinary and necessary" expenses to be deducted, provides the context in which determinations of reasonableness should be made: § 162(a)(1) is best understood as an attempt to preserve the corporate tax base from erosion, regardless of motivation. Compensation is "unreasonable" regardless of the motivation for the payment.[17]

In this context, the IRS's reliance on the interplay between an executive and a profit-maximizing independent board with fiduciary obligations to its public shareholders assumes that such interplay is at arm's length in an efficient market for executive talent. Under this theory, a publicly traded corporation automatically sets compensation "reasonably." In contrast, the IRS has frequently examined the compensation paid by closely held corporations, analyzing a variety of factors, including the nature of the work provided,[18] the education level of the employee,[19] and how many hours the employee actually works for the business.[20]

II. RE-EXAMINING § 162(a)(1) IN LIGHT OF THE MANAGERIAL POWER APPROACH

The past twenty years have seen a vast growth in the scholarship related to executive compensation.[21] In recent times, there has been increased focus on the reasonableness of such compensation. In one line of scholarship, the market for executive labor clears with near perfection, and CEOs are paid efficient market wages.[22] Supporters of optimal contracting theory thus believe

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17. Consider two identical businesses: Corporation A and Corporation B. In Corporation A, compensation is determined by finding the optimal tax-avoidance mechanisms. In Corporation B, the same compensation arrangement is reached, but by throwing darts at a board. There is no objective reason why the compensation paid by Corporation A is more "reasonable" than the compensation paid by Corporation B.

18. Charles E. Smith & Sons Co. v. Comm'r, 184 F.2d 1011 (6th Cir. 1950).

19. Tumwater Lumber Mills Co. v. Comm'r, 65 F.2d 675 (9th Cir. 1933).

20. Am-Plus Storage Battery Co. v. Comm'r, 35 F.2d 167 (7th Cir. 1929).

21. *See, e.g.*, LUCIAN BEBCHUK & JESSE FRIED, PAY WITHOUT PERFORMANCE: THE UNFULFILLED PROMISE OF EXECUTIVE COMPENSATION (2004) (exploring how executive compensation has failed to achieve intended results in the United States over the recent decades); Michael C. Jensen & Kevin J. Murphy, *CEO Incentives: It's Not How Much You Pay, but How*, HARV. BUS. REV., May-June 1990, at 138 (examining the structure of executive payments and arguing that the current system is efficient).

22. *See* Frank H. Easterbrook, *Managers' Discretion and Investors' Welfare: Theories and Evidence*, 9 DEL. J. CORP. L. 540 (1984); Michael C. Jensen & Kevin J. Murphy, *Performance Pay and Top-Management Incentives*, 98 J. POL. ECON. 225 (1990).

any size payment approved by a publicly traded corporation's board is prima facie reasonable.[23] This logic comports with the IRS interpretation of § 162(a)(1) as inapplicable to publicly traded employers.[24]

However, there is an alternative trend in executive compensation scholarship. Under the "managerial power" approach, executives exercise influence over the board to set their own compensation levels in a manner inconsistent with shareholder preferences.[25] Under this theory, at least five factors enable executives to thwart the independence of boards' compensation committees. First, although compensation committees are nominally independent, executives can still have "significant control over who will serve on the board from which [compensation] committee members will be drawn."[26] Thus, executives can load the board with individuals who have benefited from executive largesse in the past and consequently are unlikely to curb future executive compensation.[27] Second, executives can steer opportunities to board members, such as positions on other boards or positions at the company at a later time. This possibility makes board members less likely to take action which could make the executives unhappy.[28] Third, "social and psychological factors discourage board members from bargaining aggressively with CEOs over compensation."[29] Fourth, board members have little financial interest in the impact of their compensation decisions, since the

23. Michael B. Dorff, *The Group Dynamics of Executive Compensation*, 28 CARDOZO L. REV. 2025, 2029 (2007).

24. *See supra* note 9 and accompanying text.

25. BEBCHUK & FRIED, *supra* note 21, at 61-62 ("The managerial power approach . . . does not view executive compensation primarily as a remedy for this agency problem; on the contrary, the pay-setting process is itself seen as a major part of the problem . . . . [T]he managerial power approach does not assume that the board focuses solely on shareholders' interests when negotiating executive pay arrangements."); *see also* Lawton W. Hawkins, *Compensation Representatives: A Prudent Solution to Excessive CEO Pay*, 72 BROOK. L. REV. 449 (2007) (discussing and evaluating potential objections to Bebchuk and Fried's hypothesis). While Bebchuk and Fried present the central theoretical critique, there are other theories regarding why executive compensation is not adequately set. *See, e.g.*, Dorff, *supra* note 23, at 2029 ("CEO compensation in public corporations may be caused at least in part by the decision-making flaws rooted in group dynamics."). This Comment focuses on the arguments of Bebchuk and Fried because they are the most compelling and largely occupy the field in executive compensation. Nevertheless, any mechanism which frustrates optimal contracting theory supports a more skeptical view of executive compensation.

26. Hawkins, *supra* note 25, at 453.

27. *See id.*

28. *Id.* at 454; BEBCHUK & FRIED, *supra* note 21, at 17-18.

29. Hawkins, *supra* note 25, at 454.

burden of executive compensation is spread widely over many shareholders.[30] Fifth, board members often "rely on the advice provided by the company's human resources department," which frequently answers to the executives in question.[31]

The "managerial power" approach has not gone unchallenged. Some argue that there is no problem with executive compensation because the vast scope and complexity of modern corporations justifies the high pay executives receive.[32] Others justify executive compensation based on the returns executives create for their businesses.[33] Some propose that the market for corporate executives in the United States is more demanding and efficient than in other nations, and thus the winners are able to reap more compensatory rewards than their foreign counterparts.[34] These arguments reinforce the optimal contract theory approach, and thus implicitly support the blanket approval by the IRS of executive compensation practices under § 162(a)(1) for publicly traded corporations.[35]

Even if the optimal contract theory were largely true, there is sufficient evidence of managerial power to suggest that board capture has an independent distortion effect at the margin of executive compensation decisions. This distortion should invite the IRS to question in particular cases whether determination of executive compensation is actually at arm's length. Indeed, the IRS somnolence as to all of executive compensation for publicly traded corporations is the classic dog which did not bark[36]: it is improbable that there have been thousands of instances of unreasonable compensation in the context of closely held corporations, without a single breakdown of optimal

30. BEBCHUK & FRIED, *supra* note 21, at 34-36.

31. Hawkins, *supra* note 25, at 454.

32. Joseph E. Bachelder, *Comments on* Pay Without Performance, 30 J. CORP. L. 777, 781 (2005).

33. John E. Core et al., *Is U.S. CEO Compensation Inefficient Pay Without Performance?*, 103 MICH. L. REV. 1142, 1165-66 (2005) (reviewing BEBCHUK & FRIED, *supra* note 21); *see also* Hawkins, *supra* note 25, at 463 (discussing, in addition to those arguments raised above, other arguments against "managerial power," including "the 'tournament' to become a U.S. CEO" and the comparable pay of asset managers).

34. Iman Anabtawi, *Explaining Pay Without Performance: The Tournament Alternative*, 54 EMORY L.J. 1557 (2005).

35. There is, of course, the possibility that even under optimal contract theory executive malfeasance (such as bribery) would disrupt the independent board setup. However, I suspect that even the strongest adherents of a narrow § 162(a)(1) analysis would support action in those circumstances.

36. *See* ARTHUR CONAN DOYLE, *Silver Blaze*, *in* THE ADVENTURES AND MEMOIRS OF SHERLOCK HOLMES 255, 275 (Modern Library 2001) (1893).

contracting theory in the privately held sector. That, however, is the only way the IRS's approach to § 162(a)(1) can be understood.

Thus, in the "managerial power" world, the transactions between executives and their boards are not at arm's length. In this world, the Service's underlying rationale for exempting all publicly traded corporations from § 162(a)(1) crumbles, as corporate board decisions no longer provide prima facie reasonableness. Once the possibility of managerial influence over board decisions is recognized, the IRS cannot invoke the argument that "the operation of the normal system of commercial checks and balances arguably is adequate to ensure a proper result so that review by the IRS generally is unnecessary."[37] Rather, executive compensation at both public and private corporations is open to scrutiny. Through board capture, CEOs of publicly traded corporations can receive compensation which is "unreasonable" and therefore nondeductible.

In this world, § 162(a)(1) would be enforced against both publicly traded and privately held corporations. While the managerial power hypothesis may not describe every CEO-board relationship, the possibility of such a relationship undermines the Service's underlying logic for the unequal treatment of publicly traded and privately held corporations under § 162(a)(1), and supports a reading of § 162(a)(1) which requires scrutiny of the executive compensation of public CEOs just as it does the compensation of CEOs of privately held corporations.

III. THE PRACTICAL APPLICATION OF § 162(a)(1) TO PUBLICLY TRADED CORPORATIONS

What would a world of equal enforcement of § 162(a)(1) look like? Three important caveats are necessary:

First, the proposed changes to the interpretation of § 162(a)(1) would not mandate levels of pay for corporate CEOs. Rather, a new interpretation would merely stop corporations from deducting portions of executive compensation determined to be excessive, thus stopping taxpayer subsidies of economically inefficient behavior. Corporations could still pay executives what the board wants, but they would lose the income tax deduction for doing so. As described below, there are further potential impacts to doing so, but the board would always have the option of deciding to risk adverse publicity and potential shareholder action to pay a large, nondeductible bonus to an executive.

37. Moran, *supra* note 9, at III.B.4.

Second, applying § 162(a)(1) to publicly traded corporations would harmonize the tax treatment of public and private corporations with respect to excessive executive compensation. At present, there is a normatively unjust asymmetry between corporations: small fry at privately held companies, earning relatively small sums of money, can lose the corporate deductions for excessive executive compensation, while CEOs of much larger corporations face no similar rules or penalties for their publicly held employers.

Third, public litigation by the IRS and judicial determinations of excessive executive compensation have the potential to reduce such excesses through shaming and potential derivative suits. Corporations, and the individuals who sit on their boards, may seek to avoid the negative publicity associated with government suits alleging excessive compensation for income tax purposes. If so, they will be less likely to pay excessive salaries. This will lead to more economically efficient outcomes, as money, which would otherwise be handed over to corporate executives because of their managerial power over directors' decisionmaking, would instead be retained by the firms or distributed to the shareholders. Moreover, the threat of future derivative action will provide a further check on excessive compensation. Once the IRS and the courts have made a determination that particular compensation is excessive under § 162, shareholders could potentially use that determination to substantiate derivative suits for recovery against the board for corporate waste.[38]

This Comment does not advocate IRS oversight as the lead mechanism for purifying the muddled world of executive compensation: addressing the issues raised by the managerial power hypothesis will likely require coordinated action by a variety of governmental and nongovernmental actors. Nevertheless, if the IRS focuses on ensuring that the corporate tax base is protected against deduction of unreasonable compensation paid by publicly traded corporations, shareholders and shareholder activists are likely to be emboldened by the IRS's enforcement activities.

There are two ways the IRS could determine whether executive compensation is unreasonable in the context of publicly traded corporations. The IRS and the courts could employ the same factors they currently use for privately held corporations[39] to determine if the compensation paid to publicly held corporations' executives is reasonable. This approach has the advantage of providing clear guidance to public boards, as there is a large body of case law

38. It is important to note that the IRS determination will be binding only in the tax context: the board would still be free to set the compensation higher and pay the tax. The IRS determination will merely be one factor among others in the derivative suit context.

39. *See supra* notes 18-20 and accompanying text.

regarding privately held corporations and reasonable compensation, providing effective illumination of reasonable compensation. Central to this approach is the marshalling of comparable businesses and examining their respective executive compensation levels to determine the reasonableness of challenged compensation. This approach provides for normatively attractive parity between publicly and privately held corporations.

However, such an analysis might not address the systemic problems which result from managerial power over board decisions in the public corporate context. If unreasonable compensation and board capture are widespread phenomena, the use of comparables could actually hurt, rather than help, preserve the corporate tax base, as salaries could be increased in tandem by opportunistic executives. Alternatively, CEO-board relationships may vary: some relationships may be perfectly arm's-length, others not at all, and many likely somewhere in between. Accordingly, a second approach emerges: when assessing the reasonability of a particular corporate taxpayer's compensation payments, the IRS could assess the objective traits of the corporation's CEO-board relationship for determining when compensation is reasonable, and could petition the courts to do the same. Greater board independence would indicate a stronger presumption that compensation is reasonable.

Stressing board independence in this fashion would provide strong incentives to corporations on how best to structure their boards to avoid running afoul of § 162(a)(1). However, this approach would also have the potentially negative impact of inserting the Service into corporate governance. Nevertheless, given the reality of managerial power and the resulting degradation of the corporate tax base through unreasonable compensation payments to the executives of publicly held businesses, one of these solutions is appropriate.

CONCLUSION

The IRS's traditional approach to § 162(a)(1) rests on a fundamentally flawed premise since corporate boards do not invariably embody arm's-length standards in setting executive compensation for the executives of publicly held corporations. Publicly traded corporations have the potential to arrive at equally unreasonable compensation arrangements as their privately held brethren. The Service should recognize this fact and should apply § 162(a)(1) equally to public and private firms alike. The courts should follow and recognize that unreasonable compensation is not limited to payments by closely held corporations.

AARON S.J. ZELINSKY