

BOARD ADVISORY LLC

Aligning Tax Policy with Sound Executive Pay Practices

If we want executives to act and be rewarded like investors, we should tax them like investors.

As the chorus of public outrage over executive compensation rises to a new crescendo, it is understandable why the populist approach to “solve” executive pay is through regulatory pay limits. However, pay experts and investor representatives alike agree that rather than limiting pay, the best thinking on the subject is focused on creating plans where executive wealth is tied to that of long-term investors – where they are unable to profit (or limit losses) from short-term changes in company performance or company stock price. There is much agreement that this linkage is best accomplished through executive equity arrangements with provisions such as “hold-till-retirement” requirements. However, in implementing these provisions boards of directors are now finding that federal tax policy is not aligned with what is arguably in the best interest of the public, not to mention shareholders.

We believe that minor changes to the tax code could facilitate these ownership provisions, thus providing greater alignment of executive pay with public interests. Further, these changes will also increase federal revenues by increasing the effective tax on executive pay without the adverse economic effect of broad rate increases. Simply put, we recommend that the tax code cease treating certain long-term executive equity incentives as annual “compensation”, and instead treat it like an investment.

Current Tax Law Rewards an Early Exit

The table below shows the current taxation of various popular executive equity compensation vehicles:

Vehicle	Form of Income	Timing
Restricted Stock or Performance Shares	Full value is Compensation	Vesting
Nonqualified Stock Option (NQSO)	Gain is Compensation	Exercise
Incentive Stock Option (ISO)	Gain is Capital Gains	Sale of shares

Any compensation value from an executive equity grant is also deductible to the employer (subject to the limits and performance rules of section 162(m)) and is subject to Medicare taxes (1.45% rate) from both the executive and the employer.

The net effect of this approach is that today's executives have a powerful incentive to exercise stock options during favorable market cycles, then liquidate their positions to provide cash flow to execute the exercise, including withholding taxes. Since there is

no further tax liability and typically little obligation beyond perhaps modest stock holding requirements, a rational executive/investor would clearly sell their ownership position and interests to diversify their overall portfolio. The existing tax treatment does not encourage long-term executive ownership nor penalize sale of stock during the executive's career.

Alternative Tax Approach Creates Value from Holding to Retirement

An alternative approach is to treat executive equity awards as a sale of company stock on the date of grant, similar to any other investor purchasing shares for cash. Where there is a discount element (e.g., restricted stock or performance shares), the discount at grant would be treated as compensation to the executive and deductible to the company (subject to 162(m)). However, the tax on this compensation would not be due until it was both vested and sold. Thus a company could create a very favorable tax situation for its executives (and an incentive benefiting investors and the public alike) by requiring that they hold the stock until after they leave the company. Like other investors, any post-grant gain (or loss) would be taxed as a capital gain at the time of sale. Similarly, any dividends paid would be taxed at the 15% rate (under current law).

Vehicle	Form of Income	Timing
Restricted Stock or Performance Shares	Value at grant is Compensation, any post-grant change is Capital Gain (Loss)	Sale of Shares
Stock Options ¹	Gain is Capital Gains	Sale of shares

These proposed tax rules create a strong incentive for executives and Boards to design equity plans utilizing hold-till-retirement provisions. For example, without a hold-till-retirement provision a performance share grant would trigger immediate taxation for the full value at vesting. The executive would typically then sell shares to satisfy the withholding tax. With the benefit of a hold-till-retirement provision, the executive would not be liable for any tax until the shares were sold - at some point after retirement. 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 be significant. Currently, the executive's ordinary income tax and the corporate deduction largely offset each other. As a result, the executive's basis in the stock is stepped up to the price at the date of vesting (for full value shares) or exercise (in the case of an option). Thus the net tax received by the federal government is limited to the capital gains tax calculated on any stock

¹ The tax code changes proposed in this article could be achieved by simply modifying existing ISO provisions in IRC sections 421 through 424, to reflect contemporary executive pay programs and hold-till-retirement obligations.

appreciation subsequent to vesting/exercise – and there is little incentive for executives to hold shares after vesting/exercise.

Under the proposed approach, 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. While this results in a lower tax rate for the executive, the effective taxation is increased by eliminating 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 non-public 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).

We believe this is an easily achievable first step toward aligning federal tax policy with public policy interests regarding executive compensation and corporation accountability. If we want executives to act and be rewarded like investors, we should tax them like investors.

- Paul McConnell

Paul McConnell works with a number of Board Advisory clients within the banking and related financial services arena on executive pay alignment, performance measurement, and executive performance issues. Mr. McConnell's bio is available at <http://www.board-advisory.com/team.php>. If you have any question or comments on this article, or want to speak with Paul about any executive rewards, performance, or succession issue, he can be reached at pmcconnell@board-advisory.com, or at (407)876-7249.
