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Beyond the AIG Bonuses

The Taxpayer Subsidies for Executive Excess that Haven't Yet Hit the Headlines

The incredible firestorm over the \$165 million bonus payout at failed insurance giant AIG has dramatically revealed the depth of the public anger at private companies that enrich themselves at taxpayer expense.

Ideally, Congress would have prevented this scandal by placing strict limits on compensation in the bailout plans. Nevertheless, Congressional action to recoup these bonuses through taxes would be a positive step towards ending bailout profiteering. But merely undoing the AIG bonuses, note analysts at the Institute for Policy Studies, will leave in place tens of billions of dollars in taxpayer subsidies for banks and corporations that routinely overcompensate their executives.

"Year in and year out," notes the Institute's Sarah Anderson, the lead author on the annual IPS *Executive Excess* report, "average U.S. taxpayers are subsidizing excessive executive compensation via a variety of tax, contracting, and accounting loopholes that lawmakers in Congress, if they so chose, could shut in a minute."

"Under current law," adds IPS associate fellow Sam Pizzigati, "the federal government is actually rewarding companies that overpay their top execs."

The loopholes and tax code provisions that make these rewards possible range from the unlimited tax deductibility of executive compensation to the absence of meaningful executive pay strings in the federal procurement process. Few of these taxpayer subsidies for outrageous executive pay have ever drawn much public or political attention.

To help shine more light on the current executive pay subsidy situation, IPS analysts have prepared a summary chart that pinpoints the basic problem areas and the various reforms now pending in Congress that speak to these problems. This reference chart starts with the specific problem the AIG scandal suggests: the lack of effective restrictions on compensation in the federal bailouts put in place since last September.

Tax Reforms

Problem	Description	Legislative status
<p>Bailouts do not include effective restrictions on employee compensation</p>	<p>The bailout deals approved since last September have included only weak restrictions on executive compensation. In January, a glaring sign that firms had taken advantage of huge loopholes in the bailouts was revealed in a report that Wall Street firms as a whole had doled out more than \$18 billion in employee bonuses. Since then, there have been numerous revelations of bonus largesse among individual bailout recipients. For example, Merrill Lynch, which had a net loss of \$27.6 billion in 2008, handed out bonuses of more than \$10 million to each of the bank's top executives late last year. Bank of America received \$20 billion in taxpayer money for its acquisition of Merrill Lynch.</p> <p>In the aftermath of the AIG bonus scandal, members of Congress have rushed to put forward proposals for recouping the bonuses awarded to AIG employees and those of other bailout recipients through various tax code reforms.</p>	<p>House: On March 19, the House voted 328-93 to approve H.R. 1586, which would impose a 90% tax on any bonuses given to employees at firms that received more than \$5 billion in federal assistance under the Troubled Asset Relief Program (TARP). The legislation only applies to individuals working in the United States whose total family income exceeds \$250,000 per year. It also only affects bonuses received after December 31, 2008. Thus, for example, the Merrill Lynch bonuses paid out in December would not be affected. And foreign employees, such as AIG's London-based credit default swap unit, would be off the hook.</p> <p>Senate: Senate Finance Committee leaders released legislative language on March 19 that would place a 35% excise tax on companies for all retention bonuses and all other bonuses above \$50,000, as well as a 35% excise tax on the individual recipients of those bonuses (for a total 70% tax rate). All recipients of TARP, as well as companies in which the government holds an equity interest, would be covered. Senate lawmakers are aiming to extend the individual tax to foreign employees by holding their employer responsible if tax treaties do not allow normal withholding. Like the House version, this bill would also apply to bonuses received after December 31, 2008. Legislative action appears stalled until after the April recess.</p>
<p>Unlimited tax deductibility of executive compensation</p>	<p>Currently there are no meaningful limits on how much corporations can deduct from their income taxes for the expense of executive compensation. A 1993 law designed to cap executive pay deductions at \$1 million has been ineffective because it allows an exception for "performance-based" pay.</p> <p>The Troubled Asset Relief Program (the financial bailout known as the TARP) set an important precedent for closing this loophole by limiting the deductibility of compensation for executives of TARP recipient firms to no more than \$500,000, with no exceptions for "performance-based" pay.</p> <p>In his confirmation hearing, Treasury Secretary Timothy Geithner stated that he would "consider extending at least some of the TARP provisions and features of the \$500,000 cap to U.S. companies generally."</p> <p>Estimated annual cost to taxpayers of this loophole: \$5,249,475,000¹</p>	<p>On March 18, Rep. Barbara Lee re-introduced the Income Equity Act (H.R.1594), which would cap the amount of pay that all corporations can deduct off their taxes for the expense of executive compensation.</p> <p>The version introduced in the 110th Congress (H.R. 3876) had a deductibility cap of no more than 25 times the pay of the firm's lowest-paid worker. This has been expanded to offer either the 25-to-1 option or a flat cap of \$500,000, whichever is greater. The bill would also require corporations to annually reveal the pay gap between their highest- and lowest-paid workers.</p>

<p>Preferential capital gains treatment of carried interest</p>	<p>Under the current tax code, private investment fund managers pay a 15 percent capital gains rate on the profit share (i.e., "carried interest" income) they get paid to manage investment funds they do not own, rather than the 35 percent rate they'd pay under normal income tax schedules.</p> <p>Estimated annual cost to taxpayers of this loophole: \$2,661,000,000²</p>	<p>The House passed a tax reform bill in November 2007 that would have closed the carried interest loophole (H.R. 3996). No bill in the Senate.</p>
<p>Stock option accounting double standard</p>	<p>Current accounting rules value stock options on their grant date. The current tax code values stock options on the day that executives decide to cash them in. The two numbers rarely match, and in recent years, the actual "in-the-pocket" value has been significantly higher than the grant date estimate. As a result, companies can lower their tax bill by claiming deductions for options-related costs that are much higher than what they report in their financial statements.</p> <p>Estimated annual cost to taxpayers: \$10,000,000,000³</p>	<p>Sen. Carl Levin introduced a bill (S. 2116) in 2007 that would require the federal corporate tax deduction for stock option compensation to be the same as the expense shown on corporate financial reports filed with the SEC.</p>
<p>Unlimited deferred compensation</p>	<p>The vast majority of CEOs at large companies now legally shield unlimited amounts of compensation from taxes through special deferred accounts set up by their employers. By contrast, ordinary taxpayers face strict limits on how much income they can defer from taxes via 401(k) plans — \$15,500 max per year for most workers.</p> <p>Estimated annual cost to taxpayers: \$80,600,000⁴</p>	<p>The Senate passed a bill (S. 349) in 2007 that would have limited annual executive pay deferrals to \$1 million but it was dropped in conference committee.</p> <p>The legislative language published on March 19, 2009, by the Senate Finance Committee to tax back bailout bonuses also includes a \$1 million cap on deferred compensation for employees of all federal bailout recipients.</p>

Procurement Reform

Procurement loophole	Description	Legislative status
<p>Government contracts do not reward responsible pay practices.</p>	<p>Congress recently acted to place some limits on executive pay for firms receiving taxpayer assistance through the TARP. However, many firms that rely heavily on government subsidies, contracts, and other forms of support continue to face no meaningful restraints on pay.</p> <p>Every year, the Office of Management and Budget does establish a maximum benchmark for contractor compensation, \$612,196 in FY 2008. But this benchmark only limits the executive pay a company can directly bill the government for reimbursement. The benchmark in no way curbs windfalls that contracts generate for companies and their top executives.</p> <p>By law, the U.S. government denies contracts to companies that discriminate, in their employment practices, by race or gender. Our tax dollars, Americans agree, should not subsidize racial or gender inequality. But billions of taxpayer dollars flow annually to companies that increase economic inequality — by paying CEOs hundreds of times more than their workers.</p>	<p>The Patriot Corporations of America Act of 2007, sponsored by Rep. Schakowsky, would extend tax breaks and federal contracting preferences to companies that meet benchmarks for good corporate behavior. Among the benchmarks: not compensating any executive at more than \$10,000 percent — 100 times — the income of the company's lowest-paid worker.</p>

Contacts:

Sarah Anderson is the Director of the Global Economy Project at the Institute for Policy Studies and a co-author of 15 IPS annual reports on executive compensation. Contact: saraha@igc.org, 202 234 9382 x 227.

Chuck Collins is a senior scholar at the Institute for Policy Studies where he directs the Program on Inequality and the Common Good. A co-founder of United for a Fair Economy, his most recent book is *The Moral Measure of the Economy*. Contact: chuckcollins7@mac.com, 617 308 4433.

Sam Pizzigati is an Associate Fellow of the Institute for Policy Studies and the author of *Greed and Good: Understanding and Overcoming the Inequality That Limits Our Lives* (Apex Press, 2004). He edits *Too Much*, an online weekly on excess and inequality. Contact: editor@toomuchonline.org, 301 933 2710.

About IPS

The Institute for Policy Studies, founded in 1963, turns ideas into action for peace, justice, and the environment. IPS has published 15 widely publicized annual reports on executive pay. The latest, [Executive Excess 2008](#), released August 25, 2008, finds that five tax loopholes that benefit top executives cost taxpayers more than \$20 billion per year. For additional analyses of executive compensation issues, including detailed critiques of pay-related provisions in the stimulus bill and the TARP, see: www.ips-dc.org.

Notes

¹ Calculated by the Institute for Policy Studies, based on a limited sample of the top five executives at 1,500 small, medium, and large companies. Methodology: \$5.2 billion is the additional revenue that the federal government would have received if a deductibility cap of no more than 25 times a company's lowest-paid worker pay had been in place in 2003 for the companies that comprise the S&P 500, MidCap400, and SmallCap600. Pay figures for the top five executives in each of these groups drawn from Bebchuk and Grinstein, "The Growth of Executive Pay" (2005). Formula: \$12,168 (annual pay for full-time minimum wage workers) X 25 = \$304,200 (amount above which corporations could not claim a deduction under the proposed Income Equity Act). \$4,280,000 (average pay for top 5 execs in S&P 500) - \$304,200 (amount above which corporations could not claim a deduction under the proposed law) = \$3,975,800 (unallowable corporate deduction) X 35 percent (maximum corporate tax rate) = \$1,391,530 (taxpayer savings per executive) X 2,500 (5 execs in 500 companies = \$3,478,825,000 in total taxpayer savings. (repeated for MidCap400 and SmallCap600). Note: This calculation uses the minimum wage as the lowest-pay rate but the estimate is conservative in that it only applies to 1,500 companies of varying sizes.

² [Joint Committee on Taxation, JCX-105-07, October 31, 2007. See: http://www.house.gov/jct/x-105-07.pdf \(see p. 5, line for "income of partners for performing investment management services treated as ordinary income received for performance of services"\)](http://www.house.gov/jct/x-105-07.pdf)

³ Senate Committee on Homeland Security and Governmental Affairs (press release), September 28, 2007. Note: Levin based his estimate on partial-year numbers for 2004 that were considerably lower than the IRS findings for 2005. This report uses the high-end estimate. See: http://hsgac.senate.gov/public/index.cfm?Fuseaction=PressReleases.View&PressRelease_id=661bf7cc-b067-4cf4-a02a-136ed7ed9160&Affiliation=R

⁴ [Democratic Policy Committee \(press release\) January 23, 2007. see: http://dpc.senate.gov/dpc-new.cfm?doc_name=lb-110-1-11. Note: Note: IPS divided the 10-year projected revenue by 10 to obtain an annual cost to taxpayers.](http://dpc.senate.gov/dpc-new.cfm?doc_name=lb-110-1-11)