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Focus on Tax Policy: An Introduction

By: Professor Annette Nellen, *SJSU MST Program Director*

This section of The Contemporary Tax Journal includes tax policy work of SJSU MST students. We offer it here and on the journal website to showcase the range of tax knowledge the students gain from the program and to provide a public service. We think the analysis of existing tax rules and proposals using objective tax policy criteria will be of interest to lawmakers and their staff, and individuals interested in better understanding taxation.

One of the learning objectives of the SJSU MST Program is: *To develop an appreciation for tax policy issues that underpin our tax laws.*

Students learn about principles of good tax policy starting in their first MST class - Tax Research and Decision-making. The AICPA's tax policy tool, issued in 2001,¹ which lays out ten principles of good tax policy, is used to analyze existing tax rules as well as proposals for change.

Beyond their initial tax course, SJSU MST students examine the principles and policies that underlie and shape tax systems and rules in the Tax Policy Capstone course. In other courses, such as taxation of business entities and accounting methods, students learn the policy underlying the rules and concepts of the technical subject matter in order to better understand the rules and to learn more about the structure and design theory of tax systems.

The seven tax policy analyses included in this section join the growing archive of such analyses on the journal website (under "[Focus on Tax Policy](#)").

- 1) Transferability of the Research Tax Credit.
- 2) Return of the 20% Capital Gains Rate for Certain High Income Individuals.
- 3) Surtax on Millionaires.
- 4) Excessive Compensation – How Much is Too Much?
- 5) Increase and Make Permanent the Research Tax Credit.
- 6) Preferential Treatment of Capital Gains.
- 7) Repeal of the Inclusion of Social Security Benefits in Gross Income.

¹ AICPA. (2001) Tax Policy Concept Statement 1 – Guiding Principles of Good Tax Policy: A Framework for Evaluating Tax Proposals. Available [here](#). Professor Nellen was the lead author of this AICPA document.

Excessive Compensation – How Much is Too Much?

By: Lisa Pan, *MST Student*

Marissa Mayer is not your normal Silicon Valley executive. Aside from heading the multinational Yahoo, Inc. at age 37, she is also among the highest compensated individuals. Her first year compensation package at Yahoo totaled \$60 million, consisting of salary, bonus, restricted stock, and stock options vesting over several years.¹ One might presume a package of this size would surely produce some unfavorable tax consequences for Yahoo if one knows that the law includes a deduction limit for executive compensation. Yet Marissa's salary of exactly \$1 million falls safely under the current limitation of executive compensation, which disallows a publicly traded company from deducting its chief executive officer's remuneration in excess of \$1 million.² However, current law does not limit performance-based bonuses and certain deferred compensation.³ As a result, public companies can often deduct executive compensation far exceeding the apparent statutory limit.

On January 4, 2013, U.S. House Representative Barbara Lee (CA-13) introduced H.R. 199 to target excessive compensation. H.R. 199, the "Income Equity Act of 2013," amends IRC §162 to add a new limit on the deduction of any full time employee's compensation to the greater of \$500,000 or 25 times the salary of the lowest-paid fulltime employee. More importantly, the proposed bill defines compensation broadly to include "wage, salary, deferred compensation, retirement contribution, options, bonuses, property," and any other form deemed appropriate by the U.S. Treasury Department. In addition, unlike IRC §163(m), H.R. 199 does not restrict its application to only publicly traded companies as defined by the Security and Exchange Act.⁴ The body of the bill does not specifically define the term employer, but it does treat a controlled group of corporations, partnerships, or service organizations as one employer.⁵ This means the lowest-paid employee's salary in one entity can affect the deduction limitation on all entities in a closely related group.

People concerned with the income spread between certain corporate executives and

¹ Strauss, G. (2012, Jul. 20). Marissa Mayer's Yahoo CEO Compensation Nearly \$60 Million. USA Today. Retrieved from <http://usatoday30.usatoday.com/money/industries/technology/story/2012-07-19/Yahoo-Ceo-compensation-Marissa-Mayer/56341912/1>

² IRC §162(m)(1). [also note that the rule applies to the other top 4 paid execs]

³ IRC §162(m)(4).

⁴ Income Equity Act of 2013, H.R. 199, 113th Congress, 1st Session (2013).

⁵ IRC §52(1) & (2), and IRC §414(o).

rank-and-file workers may argue that this proposal is a much needed update to the U.S. tax system. After all, average workers do not receive creative forms of compensation that are common at the upper level. According to Representative Lee's press release, this bill targets the various forms of compensation not currently covered by IRC §163(m), such as private jets for executives. By making these expenses nondeductible for tax purposes, taxpayers would, as described by Congresswomen Lee, no longer subsidize excessive forms of compensation⁶. Opponents of H.R. 199 may argue that employers, not government, should decide the appropriate amount of compensation. Nevertheless, both liberals and conservatives would agree that neither IRC §163(m) nor H.R. 199 prevents a company from paying any amount to its employees; they merely take away some tax benefits with regards to high levels of compensation. Moreover, it is readily apparent that existing law only limits certain kinds of compensation, and a more comprehensive system should be considered.

The following discussion based on AICPA's Ten Principles of Good Tax Policy provides an objective analysis on the fairness, operability, and appropriate purposes of H.R. 199. Given the existing salary limitation in the tax law, it does not analyze the use of such a limitation.

⁶ Williams, N. (2009, Mar. 20). Congresswoman Barbara Lee Introduces Income Equity Act. <http://lee.house.gov/press-release/congresswoman-barbara-lee-introduces-income-equity-act>

Principles of Good Tax Policy Evaluation

Equity and Fairness

Similarly situated taxpayers should be taxed similarly.

This proposal is designed to address existing inequality in compensation. It allows for more horizontal as well as vertical fairness among taxpayers. Under the current system, a corporation paying an employee \$10 million in annual salary can only deduct \$1 million as expense, but another corporation paying its employee \$10 million in performance bonuses is not subject to the \$1 million limitation. In both situations, the employee receives the same amount of compensation and the employer has paid the same dollar amount. Even if a bonus is inherently more uncertain than salary, the uncertainty does not make up for \$9 million of tax deductions (a potential saving of \$3 million based on 35% corporate tax rate). By subjecting various forms of compensation to the same limitation, this proposal provides horizontal equity to employers in similar situations.

Furthermore, the proposal also enhances vertical equity because smaller companies often lack the resource to structure complex compensation packages. By treating all forms of compensation equally, smaller companies are not punished for lacking tax planning resources.

Certainty

The tax rules should clearly specify when the tax is to be paid, how it is to be paid, and how the amount to be paid is to be determined.

Overall, the proposal makes the limitation on excessive compensation more certain. Instead of going through hundreds of pages of code, regulation, and judicial decisions to find what can be excluded from the \$1 million limit, companies simply cannot deduct more than \$500,000 or 25 times the salary of the lowest paid full time employee, regardless of the compensation form. In the case of Yahoo, there will be no question on the disallowance of Marissa Meyer's performance based bonuses and most of her stock options.

The one drawback on certainty is that the basis for measuring the limit—salary of the lowest-paid employees—may not be as certain. Is compensation defined in the same way for the lowest-paid employee as for the executive, or is it simply the amount reported on Form W-2? Regulations and administrative guidance are needed to further clarify the rules.

Convenience of payment

TA tax should be due at a time or in a manner that is most likely to be convenient for the taxpayer.

H.R. 199 does not have a direct effect on the convenience of payment. Because the deduction for compensation is reported along with other trade or business deductions, the additional tax liability will be paid via regular estimate payments.

Economy of Collection

The costs to collect a tax should be kept to a minimum for both the government and taxpayers.

Again, because the proposal makes tax liability more certain, it increases the economy of collection. Companies would not have to spend additional resources on structuring compensation packages. Similarly, the government can also save some resources when auditing these areas.

However, under existing rules the compensation limitation only applies to covered employees at publicly traded companies.⁷ H.R. 199 would likely include both public and private companies as well as non-corporate entities. The IRS would need to put tremendous resources in writing interpretations, educating its own staff, and providing taxpayer assistance. Due to unfamiliarity, there would likely be many cases of non-compliance in initial years. All of this will increase compliance and administrative costs.

Simplicity

The tax law should be simple so that taxpayers can understand the rules and comply with them correctly and in a cost-efficient manner.

The proposal creates additional compliance burden for taxpayers. It requires companies to file a report containing compensation information for the top five employees, an average of all non-managerial and executive employees, and the lowest-paid full time employee.⁸ For publicly traded companies that already report this in their SEC filings, the information may be readily available.

However, for the vast number of employers not filing with the SEC but is covered under H.R. 199, the rules create additional compliance requirement. The information gathering process can be challenging because personnel and compensation level often change multiple times in a year. Because the rule affects not just publicly traded companies, smaller businesses may lack the resources to keep track of the required information.

Furthermore, H.R. 199 also creates administrative tasks for the government to process the new information. The benefits of such tasks cannot be easily identified.

Depending on how “lowest compensation” is defined, businesses may have an incentive to adjust employees’ compensation package to make all forms of earnings more apparent. For example, reporting health insurance premium paid by the employer on Form W-2 allows

taxpayers and government to gain a better understanding of the entire compensation package, as opposed to just taxable income. However, these additional reporting also adds to _____ existing complexity.

Neutrality

The effect of the tax law on a taxpayer’s decisions as to how to carry out a particular transaction or whether to engage in a transaction should be kept to a minimum.

The existing law is not neutral with respect to taxpayer behavior. Likewise, the new proposal will probably result in behavioral changes. First, it may affect the labor structure of a company. For example, one way to get around the limitation is to reduce or outsource the low paying positions, such as janitorial services and administrative personnel. There is also an incentive to hire part-time or contract workers to perform the low-paid tasks so their pay does not count towards the deduction limit.

As Representative Lee’s press release states, this bill would “encourage companies to raise the pay of workers at the bottom.”⁹In other words, its goal is not merely raising revenue but also influencing taxpayer behavior. This incentive tends to favor investment in labor – higher paid labor translates to higher deduction limit – as opposed to investment in machinery.

Nevertheless, the effect of H.R. 199 on excessive compensation is still limited because it does not, and cannot, prevent companies from paying employees high salaries; it merely limits the deductibility of these payouts. Clearly, many companies have legitimate reasons to, and will continue to, pay millions in compensation to their most valuable employees.

Economic Growth and Efficiency

The tax system should not impede or reduce the productive capacity of the economy.

H.R. 199 can impact economic growth and efficiency in two major ways. First, pay increase among the lowest-paid workers can lead to increase in overall consumption. Second, H.R.199 has the potential to shift private investment from machinery to labor.

As mentioned in the Neutrality principle, this bill creates incentive for companies to increase salary for the lowest-paid employees, which could produce a broader economic benefit. For instance, when 100 workers making \$30,000 each receive a 10% pay increase, they are likely to spend most of the increase (a total of \$300,000) on goods and services, thus encouraging economic activities. In contrast, an executive making \$3 million may spend only a portion of his 10% pay raises (also a total of \$300,000) on consumption because one household can only consume so much.

Also related to the neutrality principle, this bill tends to encourage spending on labor rather than machinery. When companies invest in labor training that increases the overall skill of the labor force, it increases productivity and promotes innovation. However, when it makes the most economic sense to replace expensive labor with machines operated by low-paid labors, companies may be reluctant to do so due to loss of tax benefits.

⁸ “Income Equity Act of 2013”, 2013.

<https://scholarworks.sjsu.edu/sjsumstjournal/vol3/iss1/13>

⁹ Williams, 2009

Transparency and Visibility

Taxpayers should know that a tax exists and how and when it is imposed upon them and others.

Even though the public may not be aware of the nuances of tax law, the continuous widening of income gap in the U.S. is alarming to many. Recent publicity on the effective tax rates of the wealthiest Americans (average of 18% for the richest 400¹⁰) led to much public debate on income equality. The proponents of this bill will likely spend a lot of effort publicizing its equality component. At the same time, H.R. 199 directly targets some of the biggest corporations, whose executive compensation often receives negative news coverage.

For employers, the effect of H.R. 199 is easily visible because they are already calculating the deductible amounts of compensation on their tax returns every year. As some previously deductible payouts now become nondeductible, they can easily see the true cost of this proposal.

Minimum Tax Gap

A tax should be structured to minimize non-compliance.

The tax gap will likely be small because this proposal is very inclusive on the types of compensation disallowed for deduction. In other words, there are fewer ways to structure deductible compensation in excess of the statutory limit.

However, the likelihood of noncompliance also depends on the clarity of the law. H.R. 199 leaves some crucial terms undefined, such as “employer” and “salary of the lowest paid employee.” A lack of uniform understanding will create inconsistency and loopholes in the rule, which may be costly to resolve (such as using multiple lawsuits) if not addressed early on.

Appropriate Government Revenue

The tax system should enable the government to determine how much tax revenue will likely be collected and when.

The government can predict some, but not all, additional revenue to be collected from this proposal. For the more subtle forms of compensation, such as luxury auto and personal service, the government will need to dig deeper into the financial statements of companies to find out exactly how much benefit is provided to the employees.

One way to help with the revenue prediction is to require more reporting, but this also conflicts with the principle of simplicity. This demonstrates that a tax proposal may not be able to satisfy all principles of good tax policy at once.

According to an Economic Policy Institute report, roughly \$121.5 billion in executive compensation was deducted from 2007-2010, and roughly 55% of which was for performance based bonuses.¹¹ If all of the performance-based bonuses had been nondeductible, it would have raised an additional \$20 billion in revenue from 2007-2010.

This number is not a precise indication of revenue in the future, however, because taxpayer behavior often changes with the change of law. This makes accurate estimation difficult because it's not all clear what actions taxpayers may take to reduce tax liability.

¹⁰ Lenzner, R. (2011, Jul. 25). The 400 Richest Americans Pay An 18% Tax Rate. *Forbes*. Retrieved from <http://www.forbes.com/sites/robertlenzner/2011/07/25/the-400-richest-americans-pay-an-18-tax-rate/>

¹¹ Balsam, S. (2012, Aug. 14). Taxes and Executive Compensation. *Economic Policy Institute*. Retrieved from <http://www.epi.org/publication/taxes-executive-compensation/>

Rating Summary

Equity and Fairness	+
Certainty	+
Convenience of Payment	N/A
Economy in Collection	+/-
Simplicity	-
Neutrality	-
Economic Growth and Efficiency	+/-
Transparency and Visibility	+
Minimum Tax Gap	+/-
Appropriate Government	-

Conclusion

H.R. 199 intends to introduce more fairness and certainty to the existing tax system, and it does so by treating all forms of compensation equitably. It falls short on operability because the reporting requirements put additional compliance burden on taxpayers. Similarly, government also has to invest additional resources in administering this rule. H.R. 199 will unavoidably influence taxpayer behavior, which violates the neutrality principle, but it may also help promote some degree of economic efficiency. If H.R. 199 does become law, it will need clear definitions on key terminology to strengthen compliance. Clarity will also help taxpayers understand its impact better and allow government to make more accurate revenue estimation.

As the analysis of H.R. 199 shows, it's often unlikely for a law to meet all ten principles of good tax policy. Policymakers face a difficult task of weighing the importance of one principle against another.



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