CEO Bonus Loophole

Under current law, the more corporations pay their executives, the less they pay in federal taxes. This is the result of a loophole that allows corporations to deduct unlimited amounts of executive compensation from their taxable income— as long as the pay is "performance-based."

What is the origin of this loophole?

This perverse loophole stems from a Clinton administration reform that was meant to address widespread public outrage over runaway CEO pay. Section 162(m) of the tax code imposed a $1 million cap on the deductibility of compensation to a company's CEO and its three other highest-paid executive officers (excluding the CFO). However, by exempting "performance-based pay," this reform led instead to an explosion of executive compensation in the form of deductible stock options, performance shares, and other bonuses with performance triggers. Between 1995 and 2014, average compensation for large company CEOs jumped from $3.7 million to $13.5 million—largely as the result of huge payouts from stock-based "performance pay."

While this loophole applies to all corporations, it is particularly problematic for financial firms. Wall Street executives routinely rank at the top of highest-paid lists and this industry's reckless "bonus culture" was a factor in the financial crisis. Today, this bonus culture continues to thrive. Wells Fargo CEO John Stumpf, for example, raked in fully deductible bonuses and stock options gains worth more than $40 million in 2014, which translated into a $14 million tax break for the bank.

How does this loophole contribute to inequality?

Runaway executive pay is a major factor in the trend towards extreme inequality in this country. Corporate executives account for roughly 40 percent of the income growth of the top 1 percent in recent decades. This loophole is a key driver of inequality in that it gives corporations an incentive to hand out excessive executive compensation. When large corporations and banks are allowed to deduct massive sums from their federal taxes for the expense of CEO bonuses, small businesses and working families have to pick up the tab.

The stock-based pay incentives created by this loophole have also played a powerful role in deepening wealth inequality. Twenty CEOs who are not company founders hold more than $300 million worth of stock in their corporations. In contrast, American households' median net worth (including stock as well as property and other assets) is only $81,400. Among these 20 CEOs are JPMorgan Chase CEO Jamie Dimon, who held about $660 million in his bank's stock at the end of 2015, and Lloyd Blankfein, CEO of Goldman Sachs, with about $570 million.

How does this loophole contribute to financial instability?

The 2008 financial crisis is only the most severe example of how huge performance bonuses can encourage risky activities that endanger individual companies and the broader economy. Executive compensation experts have found that pay arrangements relying heavily on "performance pay" encourage managers to focus on boosting share prices in the short-term at the expense of long-term value.

How much money could be raised by eliminating this loophole?

The Joint Committee on Taxation estimates that eliminating this loophole for all companies would generate $50 billion in revenue over 10 years.

Are there precedents for closing this loophole?

In 2008, the Trouble Asset Relief Program (TARP) eliminated the CEO Bonus Loophole for banks as long as they participated in this bailout program. Lawmakers wanted to stem the flow of taxpayer dollars into the pockets of financial executives. For similar reasons, the Affordable Care Act (eliminated the loophole for health insurance corporations. But taxpayers should not be asked to subsidize excessive compensation for executives at any corporation. And the impact of these two important precedents in terms of reducing executive pay has been limited because of recruitment competition with other corporations that can still take advantage of the loophole.

What do the polls say?

Sixty-three percent of Americans want to eliminate this loophole. This is a reflection of broader public concerns about CEO pay. A Harvard University study found that Americans felt that the ideal ratio between CEO and average worker pay is 6.7-to-1. The actual current ratio is 354-to-1.

Proposed legislation:

The Stop Subsidizing Multimillion Dollar Corporate Bonuses Act (S. 1127 and HR 2103) would eliminate the “performance pay” exemption. Several additional bills have been introduced that would use revenue from the elimination of the CEO Bonus Loophole to pay for urgent needs, including expanding Social Security and the Earned Income Tax Credit.