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EpiPen Executive Pay Skyrocketed Too; Should It Be Tax Deductible?

Companies are in business to make money, but some price hikes can have a backlash. The skyrocketing prices for Mylan EpiPens is that way. As the public and Congress have reacted, perhaps the taxman should too. After all, it appears that Mylan's CEO saw a pay raise of over 600% while EpiPen prices rose 400%. The market isn't exactly happy that as lifesaving EpiPens were increasingly being priced out of reach, the EpiPen maker was dispensing outsize pay.

In fact, the company had the second-highest executive compensation among all U.S. drug and biotech firms over the past five years. According to a Wall Street Journal analysis, Mylan paid a staggering $292.1 million in pay for its top five executives over the five years ended last December. That outpaced industry rivals several times its size, including Johnson & Johnson, Pfizer Inc., Bristol-Myers Squibb Co. and Eli Lilly & Co. Since tax laws are often used to alter behavior, you might wonder where the tax law is in all of this.

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Should all of this be tax deductible? It isn't a silly question. The main qualifier for tax deductible pay is that the pay has to be "reasonable." But what does that mean anyhow? These days, no one talks much about reasonable compensation. It can seem like an oxymoron for judging tax deductions. But it turns out that there's a special language with public companies. Thus, Section 162(m) of the tax code generally limits tax deductible compensation to $1 million. This section applies only to public companies.

It denies a deduction for any compensation paid in excess of $1 million in any tax year to a company's top five employees (as listed in the annual proxy summary compensation table). Well then, how on earth can Mylan get away with deducting these vastly larger sums on its taxes? It turns out there is an exception that eats up the rule. Compensation arrangements that satisfy standards for "qualified performance-based compensation" are not subject to the $1M cap. The standards are less demanding than you might think.

Typically, a compensation committee of the board of directors will establish performance goals that are approved by shareholders. The compensation committee will then have responsibility to ensure that particular executives meet these goals prior to a payment or vesting event. With these relatively simple safeguards, the award is likely to be tax deductible, whatever the amount.

Not unlike the amorphous standards for "reasonableness," the overall question is whether the performance-based compensation met the criteria. Almost by definition, performance-based compensation must be set up in advance by looking at benchmarks. In a sense, the mere fact that the executive ended up with outsize payments—which might not be viewed as reasonable in the overall scheme of things—may not really matter.

The IRS regulations indicate that compensation does not lose its performance-based halo if it is payable prior to the attainment of performance goals upon one of three events: death, disability or a change in control. Note, however, that these three blessed circumstances (in which payments can be made under a performance based plan notwithstanding failure to perform) must still be tested against the $1 million limit.

With most corporations, all pay (to executives as well as rank-and-file workers) is deducted by the corporation as a business expense. That means no corporate tax is paid on the money. It is deducted, and tax is paid only by the recipients. What happens if the corporation pays out $10 million for the CEO when he's really only worth $3 million? The answer can complicated and depends on many variables.

But in practice, many things can be brought within the pretty large net of performance-based pay. And that should make it tax deductible by the company. Of course, the situation is trickier if the business is closely-held. To take an example, what if Joe owns 100% of the corporation's stock and is the CEO? If Joe will receive all the money in any event, Joe might have the company pay him deductible salary and bonus. That way, he only pays tax as an individual–the corporation would deduct all that compensation as a business expense.

If the company paid Joe a more modest salary and bonus, the company could have paid him the rest of the money as a dividend. The corporation receives no tax deduction for dividends, so the corporation would first have to pay tax on it. Then Joe would pay personal income tax. For that reason, the IRS monitors compensation by closely-held companies. With closely-held (especially family) companies, the IRS has a keen eye for who is getting paid too much.

The assumption is that some of the money being paid out and called "compensation" is probably a disguised dividend. But with public companies, the market is supposed to be at work. And the supposed $1 million cap on compensation that was put into the tax law was supposed to be effective. Only

performance-based pay could go beyond this. But sometimes, it might seem fair to ask if the rules are working as they are supposed to.

For alerts to future tax articles, email me at Wood@WoodLLP.com. This discussion is not legal advice.