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Tax Savvy Execs Work For $1, Get Paid Millions As Capital Gain

Forget minimum wage. CEO pay is the other end of the spectrum, but not for everyone. In fact, USA Today has listed the 9 lowest-paid CEOs, some earning only $1 a year. Consider Larry Page of Alphabet (Google), John Mackey, of Whole Foods Market, and Kosta Kartsotis of Fossil. Yet low pay for CEOs is not the norm. In fact, median CEO pay for S&P 1500 companies is $5.4 million, and some CEOs have broke the $30 million-a-year barrier.

The idea of *volunteering* to take a nominal $1 salary can be tax savvy. After all, stock growth and capital gain is taxed much more favorably. In 2012, Mark Zuckerberg earned $770,000 in salary and bonus, but then dropped to Facebook's *lowest*-paid employee. The tax-smart play is on the increase in the stock value. Rather than drawing large amounts of cash, taking a big equity stake and virtually no cash looks egalitarian. It also makes the CEO focused on growing the company's stock.

One dollar pay suggests that a CEO is really looking out for shareholders. That's one reason it's become popular. Google's Sergey Brin and Larry Page are examples. Compensation tied to stock value is attractive to both sides, a good deal for both company and exec. In the past, even some elected officials have taken the $1 challenge, including former Mayor Bloomberg and former Governor Schwartzenegger and former Governor Mitt Romney. And some famous past examples included Chrysler's Lee Iacocca and Steve Jobs.

But is there any tax game here? Yes and no. Long before the huge executive pay packages of the last few decades, the IRS labeled some pay unreasonable and levied extra taxes as a result. Usually, that's pay that is too big, so can't be deducted on the company's taxes. In fact, now most public companies face a limit on pay deductions of $1 million per employee unless the pay is performance based. But with closely held companies, the unreasonable compensation tax problem remains. How much pay is too much for a privately held company to deduct is fact specific.

Conversely, these days the IRS sometimes attacks pay for being too *low*. Once again, the IRS tries to impose extra taxes as a result. Why would the IRS care if you pay too *little*? Whether the IRS stands to collect more by arguing that pay is too low or too high turns primarily on the type of business entity paying the compensation.

A C corporation deducts pay as a business expense, so the IRS wants to argue pay is too high and can't be deducted. But in an S corporation, there are smaller taxes to the owners by paying amounts out as "dividends" not as pay. After all, income taxes apply in any case, and the rates on dividends can be better than pay. What's more, the payroll taxes on compensation are shared by the employer and the employee. That means each side is paying more tax.

Famous examples of this S corporation tax dodge involved John Edwards and Newt Gingrich. But there's little to suggest it is illegal. It is simply a question of degree. Many of the tax cases in which people are found to pay too little compensation involve extreme facts, as where someone claims to be working for nothing.

And that brings us back to Mr. Zuckerberg and his ilk. Does the same rationale apply to them? It is hard to see how, since these are public companies, not closely held. And that's especially true with people like Mr. Zuckerberg and the Google twins Brin and Page. These founders don't need lots of options and restricted stock.

Where an executive takes $1 cash compensation *plus* considerable non-cash compensation like options and stock, one could argue there's an abuse depending on exactly what's awarded and exactly how the plan is implemented. Even so, most equity in this context is subject to tax as wages. Employees–regardless of salary size–must carefully navigate the rules to get capital gain treatment.

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