Taxes Based on a CEO-to-Median-Wage Ratio are Unsound and Not Administrable

Policy Position

Position: *Predicating a state or local tax on a CEO-to-median-wage pay ratio has no basis in sound tax policy. Such measures create an artificial tax classification between publicly traded and private companies and create difficult compliance issues. Further, these taxes are constitutionally suspect because they measure and increase taxes based on business activities that typically take place outside of the jurisdiction imposing the tax.*

Explanation: Some local governments and states have introduced and/or enacted measures (*e.g.*, Portland, Oregon adopted an ordinance in December 2016) that would impose a higher tax rate or surtax on certain publicly traded companies based on their CEO-to-median-wage ratio. The basis for the tax in these measures is typically the company's ratio required by the U.S. Securities and Exchange Commission (SEC), pursuant to the Dodd-Frank Wall Street Reform and Consumer Protection Act of 2010.

Differential Treatment Represents Unsound Tax Policy. A CEO-to-median-wage ratio tax is generally only applicable to publicly traded companies subject to the SEC reporting requirements. A fair and neutral tax treats similarly situated taxpayers similarly. Publicly traded companies comprise less than 1% of U.S. companies, and there is no reasonable basis to treat public companies differently than private companies. Further, the SEC has provided companies with a large degree of flexibility to determine this ratio, creating additional disparities among impacted companies. Finally, the imposition of a CEO-to-median-wage ratio tax is highly unlikely to influence pay disparity—the supposed rationale for such measures. Like all taxes, the pay ratio tax would be borne by workers, consumers, and businesses, in some combination. Such a tax is an arbitrary assessment on a limited number of companies doing business in the imposing state or locality.

Inability to Audit and Potential Repeal of Dodd-Frank Would Create Compliance Difficulties. The use of the SEC CEO-to-median-wage ratio to determine a state or local tax is misguided and unworkable for several reasons. First, the SEC has stated that it does not intend to audit the ratio reported by subject companies. Thus, it is unclear how a state or local government expects to enforce such a provision in the absence of federal oversight. Second, the Dodd-Frank Act has been targeted for repeal by the current administration. If the Act is successfully repealed, pay ratio disclosure will likely be discontinued and the basis for applying and calculating the tax would no longer exist. Finally, using the SEC pay ratio as a basis for calculating a tax creates uncertainty and severe forecasting and financial reporting difficulties for companies whose pay ratio may fluctuate above and below the targeted ratio.

Executive Compensation Limited by Federal Tax Cuts and Jobs Act. Effective for tax years beginning after December 31, 2017, federal tax reform legislation significantly expanded the Internal Revenue Code's limitation on the deductibility of executive compensation in determining federal taxable income of publicly traded companies. Most state and local tax jurisdictions use federal taxable income as a starting point for determining state and local income subject to tax. Imposing a CEO-to-median wage ratio tax on top of these new limitations at the federal level would exacerbate the punitive nature of these proposals, and, further, is unnecessary and duplicative of the policy behind the federal limitation.

Constitutionally Suspect. CEO-to-median-wage ratio taxes raise significant state and U.S. Constitutional issues:

- State Uniformity Clause and U.S. Equal Protection Issues. Many states' "Uniformity Clause" provisions require that similarly situated taxpayers be taxed in the same manner and at the same rate. CEO-to-median-wage ratio taxes create differing tax treatment of similarly situated companies (*i.e.*, publicly traded versus private) with no rational basis. Further, two publicly traded companies may use different methods to calculate their respective ratios, both of which would be valid under the SEC rules even if, for example, they include the use of drastically different wage information. This all raises both Uniformity Clause concerns under state constitutions as well as Equal Protection Clause concerns under the U.S. Constitution.[1]
- U.S. Due Process and Commerce Clause Issues. The group of affiliated companies used to determine the SEC pay ratio encompasses all corporate entities worldwide and is based on a 50 percent ownership threshold. Under the US Constitution, states are prohibited by the Commerce Clause from taxing any entity that lacks "substantial nexus" with the taxing jurisdiction. Thus, the affiliated group of companies with nexus to the state or local jurisdiction imposing the tax will almost certainly be composed of different entities than those used to calculate the SEC pay ratio. In addition, a CEO-to-median-wage ratio tax impermissibly attempts to impose a tax that is based on activities with no connection to the taxing jurisdiction. For example, in most cases neither a company's CEO nor most of its employees (from which the wage ratio is derived) will be physically located in the taxing jurisdiction. These issues raise significant concerns under both the Due Process and Commerce Clauses of the U.S. Constitution.[2]

Accordingly, state and local governments should reject applying a higher tax rate, a surtax or determining any other tax treatment based on a CEO-to-median-wage ratio.

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[1] *Metropolitan Life Insurance Co.* (470 U.S. 869 (1985)).
[2] *See Complete Auto* (430 U.S. 274 (1977)) and *Jefferson Lines* (514 U.S. 175 (1995)).