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Duty Calls

# Latest Twist in Corporate Pay: Tax-Free Income for Executives

Companies Reimburse Bosses For Levies on Perks, Stock; Scant Details in Filings

A Recruiting Tool, Say Some

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Like most Americans, rank-and-file employees of **Home Depot Inc.** must reach into their own pockets to pay taxes.

But not Robert Nardelli, the home-improvement retailer's chief executive. Under his employment contract, Home Depot picks up a big chunk of his federal and state income taxes. Specifically, the company is obliged to reimburse its CEO for taxes due on a slew of perks, including a high-end luxury car, his family's travel on Home Depot jets and forgiveness of a \$10 million loan. Last year, these payments amounted to at least \$3.3 million, topping Mr. Nardelli's \$2 million base salary.

Amid soaring CEO compensation, a number of companies are paying extra sums to cover executives' personal tax bills. Many companies are paying taxes due on core elements of executive pay, such as stock grants, signing bonuses and severance packages. Others are reimbursing taxes on corporate perquisites, which are treated as income by the Internal Revenue Service. They run the gamut from personal travel aboard corporate jets to country-club memberships and shopping excursions.



"This smacks of Leona Helmsley-like treatment, that only little people pay taxes," says Patrick McGurn, an executive vice president of Institutional Shareholder Services Inc., an influential adviser to big investors that often critiques companies' corporate-governance practices. For these top executives, he says, companies "are removing taxes from the list of inevitable life experiences, leaving only death."

Details of the little-known payments, called "tax gross-ups," are often buried in impenetrable footnotes or obscure filings. In its 2005 proxy statement, Home Depot didn't disclose many of the perks it must give Mr. Nardelli, or that the company is required to reimburse him for taxes related

to those perks. The company provided specifics of these benefits and the gross-ups in his employment agreement, which was attached to a 2001 regulatory filing. ([Read Home Depot's filing<sup>1</sup>.](#))

A spokesman for Atlanta-based Home Depot wouldn't discuss the details of Mr. Nardelli's compensation. In a written statement, the spokesman says: "Consistent with the company's philosophy of attracting and retaining the highest performing leadership available, gross-up payments are sometimes utilized as a part of compensation to achieve a net after-tax effect." He also says the company "fully complies" with disclosure rules.

According to a study done by compensation-research firm Equilar Inc., 52% of companies disclosed they paid gross-ups to one or more top executives last year, up from 38% in 2000. The study, which was done this month for The Wall Street Journal, examined the U.S.'s 100 largest companies by revenue and counted those for which public filings could be found in both periods.

Compensation experts say it's hard to know for sure if more companies are paying gross-ups. The increase could also be explained by better disclosure of existing plans.

The Securities and Exchange Commission is conducting a broad crackdown on hidden compensation of all types, although it hasn't yet focused on gross-ups. The agency worries that investors may not realize just how much senior managers are paid beyond their base salaries.

Companies say they have to offer generous pay packages, including gross-ups, to attract top executive talent. For most corporate executives, these tax benefits are often a relatively small portion of total pay.

Some examples of tax gross-ups:

Coca-Cola Bottling Co. Chief Executive J. Frank Harrison III has received more than \$4 million since 2000 to cover taxes on a big restricted-stock grant. That's more than his total salary over the same period.

**Federated Department Stores Inc.**, which owns Macy's and Bloomingdale's, compensates executives for taxes due on big merchandise discounts they receive in company stores. The company said in a filing that the discounts and related tax gross-ups totaled about \$300,000 for its top executives in 2004, including more than \$100,000 for one vice chairman, Ronald Tysoe.

**Regions Financial Corp.**, a bank based in Birmingham, Ala., last year paid \$27.3 million in gross-ups to its CEO, Jackson Moore, who ran a bank that merged with Regions. His employment contract with the predecessor bank had a "change in control" clause that triggered the payment, even though Mr. Moore ended up running the combined entity. Such clauses are typically designed to protect executives who lose their jobs in a merger. ([Read Regions Financial's SEC filing<sup>2</sup>.](#))

North Fork Bancorp., in what appears to be one of the richest gross-up plans around, could pay more than \$125 million in tax reimbursements to top executives if the Long Island-based bank is ever acquired. ([See related article<sup>3</sup>.](#))

A Regions spokeswoman declines to comment. A Coca-Cola Bottling spokesman, Lauren Steele, says in a written statement that Mr. Harrison's restricted-stock plan "was unanimously passed by

the compensation committee, overwhelmingly approved by shareholders and all proper corporate governance protocols were followed."

Jim Sluzewski, a spokesman for Cincinnati-based Federated, says its tax-reimbursement plan had been around for "many years." He declines to discuss the rationale for paying it. He says the tax benefit is not available to rank-and-file employees.

### A Quick Spiral

In an effort to shield executives from any tax bite on their pay, gross-ups can quickly spiral into huge sums. When a company reimburses executives for their tax payments, that creates new taxable compensation. The company then has to cover taxes on that new amount, which creates yet more taxable pay, and so on. The spiral ends when the ever-decreasing amount of new income reaches zero, or close to it.

The bottom line: Grossing up an executive for taxes on \$1 million can easily cost an additional \$700,000 to \$900,000. In some circumstances, gross-up reimbursements can be more than double the covered pay.

Tax gross-ups have proliferated for one major reason, many compensation experts say: They allow companies to quietly pay more to top managers at a time when executive compensation is increasingly controversial. The current rules don't require companies to disclose tax reimbursements separately in pay tables given to shareholders.

Instead, gross-ups tend to get lumped into a category called "other annual compensation" in companies' proxy statements. The details are then relegated to densely worded footnotes. Even there, some companies don't disclose the exact amounts of gross-up payments.

Gross-ups are "disguised compensation," says Art Meyers, an attorney at Edwards Angell Palmer & Dodge LLP in Boston. Mr. Meyers, who advises companies on compensation matters, says, "even I am shocked," by some of the more unusual gross-up payments. He thinks better disclosure would kill the practice because it looks bad.

Activist investors have long disliked gross-ups, but until recently thought they were a relatively minor abuse. Now, corporate-governance advocates, such as the American Federation of State, County and Municipal Employees union, say they plan next year to put greater emphasis on the matter, spurred in part by some recent, high-profile cases.

Earlier this year, the SEC sued **Tyson Foods** Inc. and its former chairman, Donald Tyson. The regulator said the Springdale, Ark., poultry and meat supplier provided misleading or inadequate disclosure of perquisites granted to Mr. Tyson, including lawn maintenance for a series of homes, oriental rugs, a horse and use of company-owned homes in England and Mexico. Of \$3 million in perks cited by the SEC, more than \$1 million came in the form of payments to cover Mr. Tyson's personal tax liability on the other benefits.

#### More, Please

Many companies reimburse top officers for personal taxes levied on various executive perks. Examples from 2004:

Company	Paid	To	For taxes on
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Tyson Foods and Mr. Tyson, without admitting or denying the allegations, settled the case and paid a total of \$2.2 million in penalties.

Tax gross-ups also played a little-noticed role in the

scandal at **Tyco International** Ltd. Tyco's former CEO L. Dennis Kozlowski and its former finance chief were convicted earlier this year of looting more than \$150 million from the company. Of that, at least \$29 million came in the form of unauthorized tax reimbursements on pilfered bonuses. They have denied wrongdoing and are planning to appeal.

Gross-ups first started gaining widespread acceptance in the 1980s after Congress slapped a 20% special tax on multimillion dollar "golden parachute" payments for executives who lost their jobs in mergers. At the time, Congress was reacting to public outrage about corporate pay packages. It designed this new "excise" tax to kick in if an executive's payout equaled or exceeded three times his average compensation over the prior five years. The excise tax is levied on top of regular income tax, which affected executives usually pay themselves.

Instead of curbing pay, the law had the opposite effect. Some companies adopted gross-up plans to cover the new tax and eventually that became common practice. In part, consultants say, boards were trying to make the severance process fairer. Because of a quirk in the law, executives paid the same amount of severance could end up being hit with widely varying amounts of excise tax depending on what they earned in previous years.

Of more than 1,000 public companies tracked by compensation-consulting firm Towers Perrin, 77% offered excise-tax gross-ups in their change-in-control plans last year, compared with 55% in 1999 and 10% in 1987. Usually, companies agree to reimburse executives not only for the excise tax, but for any income and excise taxes levied on that reimbursement.

Despite their often-considerable cost, these arrangements are often described in only general terms in company filings. Even when such payouts are about to be triggered, shareholders who vote on the proposed acquisition typically aren't given details.

James Kilts, the former CEO of **Gillette** Co., stands to receive about \$13 million in gross-up payments after selling the big razor maker to **Procter & Gamble** Co. this year, P&G says. The payments cover excise taxes triggered by a golden parachute, and the subsequent excise and income taxes levied on the initial reimbursement. His package includes, among other things, an estimated \$12.6 million lump-sum cash payment described as a severance and a pension enhancement valued at about \$7.3 million. The specific amount due to Mr. Kilts in gross-up payments wasn't disclosed to shareholders when they voted to approve the transaction.

Mr. Kilts is staying on for a year as a P&G vice chairman. Linda Ulrey, a P&G spokeswoman, says the company inherited Mr. Kilts's employment agreement when it bought Gillette. She says P&G's executive-compensation plans don't include tax gross-ups.

### **Change in Control**

An unusually generous type of change-in-control agreement resulted in last year's \$27.3 million gross-up payment to Mr. Moore, the CEO of Regions Financial. Mr. Moore had previously been CEO of Union Planters Corp., a Memphis-based bank. In 1997, Union Planters's board signed a contract with Mr. Moore that guaranteed the bank would compensate him for all federal, state and local taxes imposed on any compensation triggered by a change in control -- not just the federal excise tax.

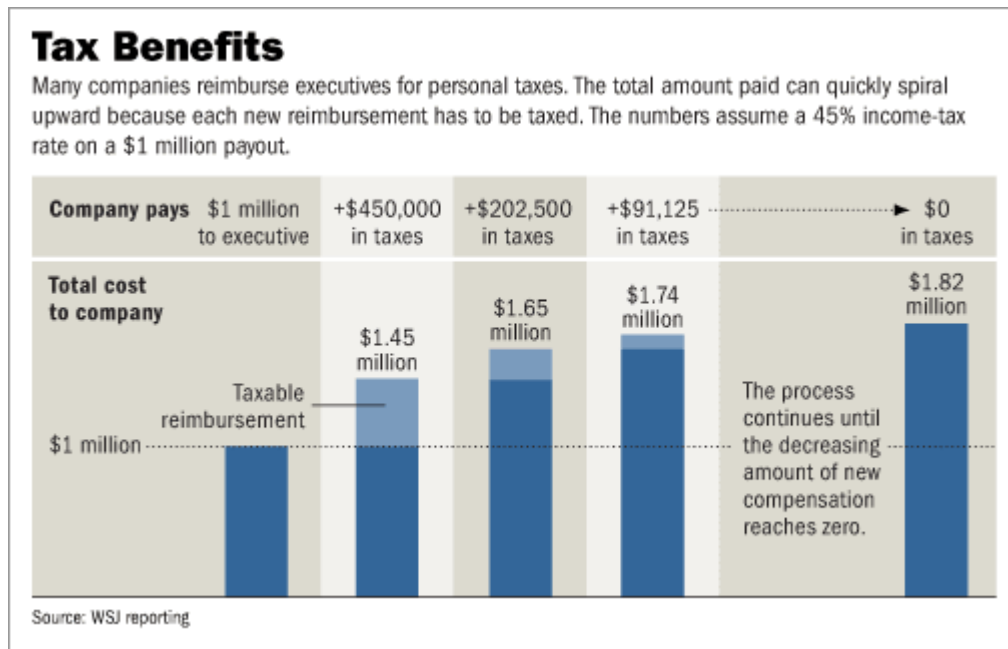
Marvin E. Bruce, a retired Union Planters director, says he was told at the time by a compensation

consultant that paying 100% of an executive's personal taxes after a change in control was "not uncommon." Mr. Bruce, who was then head of the board's compensation committee, says he can't recall the consultant's name.

Several compensation experts say such a policy is rare. "I've never personally heard of a change-in-control [clause] that took care of anything other than excise tax," says John England, who heads the global executive-compensation practice of Towers Perrin. "A change-in-control [clause] provides severance pay, with the full intention that's going to be taxed, just like salary or bonus."

When Union Planters announced a merger with Regions in early 2004, the banks agreed to make Mr. Moore the president and, later, CEO of the combined company. In return, he agreed to forgo his severance pay, but he still received other payments triggered by the deal, including accelerated vesting of existing stock grants and deferred compensation -- and gross-ups on those items.

When shareholders voted to approve the deal, they weren't told how much Mr. Moore would receive in gross-up payments. Mr. Moore's tax reimbursement last year amounted to 15 times his \$1.8 million combined salary and bonus.



Mr. Bruce, the retired Union Planters director, says he hadn't given any thought to the possibility that Mr. Moore could keep his job and still get a big gross-up payment from a change in control. Such clauses generally compensate those laid off in mergers and acquisitions. "It

might seem to be a little more self-enrichment," says Mr. Bruce, "but he was entitled to it by the company's policy."

A spokeswoman for Regions says in a written statement that the company's public filings "are our official response to all media inquiries on this topic." Earlier this year, Regions and Mr. Moore agreed to scale back a number of his benefits, including future potential gross-up payments. If Regions is acquired, the bank is obliged to cover only the federal excise tax on Mr. Moore's package. In a filing, the bank called the change "consistent with Regions' aspirations of best governance practices."

At many companies, giving employees restricted stock has become a popular compensation tool, often replacing stock options. Executives typically can only sell the stock after a waiting period, giving recipients an incentive to stay at the company. But when the stock becomes eligible for selling, even if it isn't sold, executives have to pay income tax on the market value. As an extra

benefit some companies then cover the taxes due on these stock grants for top officials.

At **Ryland Group Inc.**, a big homebuilder based in Calabasas, Calif., CEO Chad Dreier has received about \$12 million in gross-up payments since 2000, most of it to cover income taxes on restricted-stock grants. Other top executives at Ryland also get this benefit, amounting to an additional \$5.5 million over the past three years.

Marya Jones, a spokeswoman for the company, says the restricted-stock grants are intended to "align the interests of management with the stockholders" by giving executives a significant equity stake in the company. If the executives had to fork out for the taxes on these grants, she says, they might have to sell some of their restricted stock. She says the overall program has "been a benefit to our shareholders" because the company's stock has risen significantly.

As for Mr. Dreier, Ms. Jones says that "he pays taxes for all other aspects of his compensation, which is pretty hefty." His total pay last year was nearly \$20 million, including \$2.9 million in tax gross-up payments.

In addition to compensating executives for these big, one-time tax events, companies are also covering levies on everyday benefits. In explaining why, some consultants say companies want to avoid saddling executives with the need to pay cash taxes on what are typically noncash benefits.

St. Louis-based **Monsanto Co.** last year paid \$26,000 in tax reimbursements on \$50,000 in initiation fees so that CEO Hugh Grant could join the Bogey Club, a posh local country club founded in 1911. Lee Quarles, a Monsanto spokesman, says in a written statement that the club provides executives with a "convenient, local facility where they can interact with local civic and business leaders." He says the club does not accept corporate members, so membership was obtained in Mr. Grant's name "to benefit the company as a whole."

**Metris Cos.**, a Minnetonka, Minn., credit-card issuer, has disclosed grossing up its executives for a range of perks, including unspecified "holiday gifts." The board of **BEA Systems Inc.**, a software concern in San Jose, Calif., earlier this year authorized a payment of as much as \$600,000 to cover four years of taxes on a chauffeur service provided to its CEO, after realizing the benefit was likely taxable to him.

A spokesman at London-based **HSBC Holdings PLC**, which recently bought Metris, declines to comment, saying the company didn't own Metris at the time. A BEA spokeswoman declines to comment beyond the company's public filings.

### **Providing a Shield**

Even after executives stop working, a few companies continue to provide a shield from the tax man.

Last year, **Unisys Corp.** announced that its then-CEO, Lawrence Weinbach, would step down from that post early in 2005 and retire from his chairman's job in January 2006. The fine print of the arrangement also called for Unisys to sweeten Mr. Weinbach's \$1 million annual pension. Instead of paying out the pension over time, Unisys gave him close to a third of it up front in the form of a lifetime annuity purchased from an insurance company. That guaranteed at least a portion of Mr. Weinbach's pension, regardless of Unisys' financial situation. Unisys also agreed to cover all income taxes on the annuity payment -- an extra benefit valued at \$2 million.

A Unisys spokesman declines to comment, saying that Mr. Weinbach's compensation is a matter of public record in the company's filings.

**Alleghany Corp.**, a New York-based property and casualty insurer, has agreed to gross up its top executives for all income and employment taxes that might be imposed on their pensions. The company's filings say the plan aims to pay an after-tax annual pension of about \$530,000 for an executive with average compensation of \$1 million a year.

Robert Hart, Alleghany's general counsel, says the pension plan was designed that way because it replaced an earlier plan of long standing into which contributions were made on an after-tax basis. In making the switch, the gross-up was "something that was backed into." Mr. Hart says the company may reconsider the policy. "Cosmetically it isn't the best thing in this day and age," he says.

Sometimes, the largess extends well past retirement. Cal Turner Jr., the former CEO of Dollar General Corp., retired in 2003 after the company restated financial results for three years, a snafu for which he publicly took responsibility. He also repaid \$6.8 million in bonuses and other compensation. In October, he left his remaining post as an adviser to the board of the Goodlettsville, Tenn.-based retailer, which his family founded.

On Mr. Turner's departure, the company gave him benefits including an extra, \$1 million retirement payment, an Audi A8 car and half the season tickets purchased by the company for the Tennessee Titans professional football team. Dollar General also agreed to reimburse him for all federal income taxes due on these perks. Mr. Turner earlier this year was listed as the beneficial owner of 18.5 million Dollar General shares, now valued at about \$350 million. ([Read Dollar General's SEC filing](#)<sup>4</sup>.)

Tawn Earnest, a spokeswoman for Dollar General, says in a written statement that Mr. Turner retired without a supplemental executive retirement plan, "a rarity in today's corporate world." She says the retirement package was designed "to recognize his more than 35 years of service to Dollar General." She added that Dollar General "believes the retirement package provided to Mr. Turner was entirely reasonable."

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