

THE EFFECTS OF THE AFFORDABLE CARE ACT ON HEALTH INSURANCE  
EXECUTIVE COMPENSATION PACKAGES

by

Noah Terry Pepler

Submitted in partial fulfillment of the  
requirements for Departmental Honors in  
the Department of Accounting

Texas Christian University

Fort Worth, Texas

May 2, 2016

The Effects of the Affordable Care Act on Health Insurance  
Executive Compensation Packages

Project Approved:

Supervising Professor: Sandra Callaghan, Ph.D.

Department of Accounting

Barbara Wood, Ph.D.

Department of Finance

## ABSTRACT

I examine executive compensation level and structure changes for health insurance companies following the enactment of Internal Revenue Code section 162(m)(6) which reduces the deductibility of executive compensation for health insurers. I gathered executive compensation data from a sample of ten publicly traded, large, health insurance companies from 2009 through 2014. My data suggests that health insurers are willing to pay higher taxes instead of lowering executive compensation levels and risk losing high level executive talent and leadership. My study suggests that section 162(m)(6) is ineffective in lowering executive compensation levels for health insurers.

## TABLE OF CONTENTS

SECTION I: INTRODUCTION.....	5
SECTION II: LITERATURE REVIEW.....	8
Section 162(m)(6) in Depth Definition.....	8
Prior Executive Compensation Research.....	11
How Companies Have Responded to Previous Compensation Deduction Limitations...	13
Section 162(m)(6) and Executive Compensation.....	16
SECTION III: SAMPLE.....	17
Table I: Firm Characteristics.....	18
SECTION IV: DATA ANALYSIS.....	20
Table II: All Executive Compensation Data.....	21
Table III: All Executive Compensation Data – Percent Changes.....	22
Table IV: CEO Compensation Data.....	23
SECTION V: CONCLUSION AND LIMITATIONS.....	24
REFERENCES.....	27

## SECTION I: INTRODUCTION

Executive compensation levels have long been a controversial issue discussed amongst lawmakers, lower-level employees within U.S. businesses, and the American public (Anderson, Pizzigati, Wood, 2014). Much of the concern centers on both the seemingly excessive executive compensation levels and the large disparity between executive compensation and low-level employee compensation. Members of the financial press partially attribute the recent economic downturn to high levels of executive compensation and call for more legislation restricting executive pay levels (Eskow, 2014). Consistent with this sentiment, executive compensation for health insurance executives is addressed in the Patient Protection and Affordable Care Act (PPACA). The PPACA is landmark health reform legislation that is intended to make health insurance coverage “easier and less costly to obtain” (Levy, 2015). While PPACA legislation intends to make health insurance less expensive, health insurance executives’ compensation levels have not declined. High executive compensation levels are inconsistent with the goal of the PPACA legislation in promoting lower health care costs. A small, but potentially far-reaching, section of this transcendent health care act, imposed under section 162(m)(6) of the Internal Revenue Code (IRC) (Practical Law, 2013), introduces a cap on the tax deductibility of executive compensation for health insurance companies. This study will analyze the effect of section 162(m)(6) on executive compensation levels.

Section 162(m)(6) caps the deductibility of compensation at \$500,000 for employees of health insurers. While section 162(m)(6) introduces a strict deductibility cap for all health insurance employees, it is not the first legislation enacted to address seemingly excessive executive compensation. IRC section 162(m)(1), enacted in 1993, restricted the deductibility of executive compensation for executives in publicly traded companies to \$1 million of

compensation. However, this legislation contained a “performance pay loophole” that allowed deductibility of compensation in excess of \$1 million if it qualified as performance based compensation (Anderson, 2014, 1). For the most part, the performance pay loophole rendered the provision ineffective in reducing compensation packages for executives. In 2009, further legislation was passed which placed similar deductibility restrictions on executive compensation paid by financial institutions that received governmental aid in the wake of the U.S. financial crisis. These institutions were not permitted to deduct executive compensation in excess of \$500,000, regardless of whether it was performance based or not. Now, section 162(m)(6) restricts the deductibility of *all* forms of compensation for *all* health insurer’s employees.

Section 162(m)(6) has important policy implications. This provision places a higher tax burden on health insurers. If, consistent with the goals of the provisions, health insurance companies reduce compensation levels because of the increased cost in providing compensation in excess of \$500,000, we may observe skilled executives vacating positions in the health insurance industry in search of a more lucrative compensation package. A departure of skilled executives could result in a leadership void in the industry. Another potential implication is that if section 162(m)(6) is viewed as successful in reducing executive compensation levels in the health insurance industry, it could lead to the extension of this restrictive legislation to a broader set of industries.

While little research has analyzed the effects of section 162(m)(6), prior research (Johnson and Porter 1997) has analyzed the effects of section 162(m)(1) for executives of publicly traded companies. Johnson and Porter (1997) find that firms changed the structure of their compensation packages but did not decrease the compensation packages for executives as a result of the legislation. Cadman, Carter, and Lynch (2010) find that financial institutions with

CEOs exhibiting greater power are more likely to forego governmental funding to avoid public scrutiny associated with high executive compensation than less powerful CEOs. My study extends this line of research to a new setting, the health insurance industry. Specifically, I analyze how executive compensation has changed in level and in mix for public health insurance companies since the implementation of section 162(m)(6). The results will help policy makers understand health insurance companies' willingness to accept higher tax responsibilities to maintain high-quality executives. The tax revenue generated by this provision is likely to be relatively small given the size of the industry. However, it is possible that policy makers may choose to broaden the provision to include more companies in order to generate additional tax revenues. Top health insurers' reaction to section 162(m)(6) could spark a change for the legislative foundation and induce stricter caps for all industries, addressing years of public debate about high executive pay levels. Therefore, it is critical to understand how health insurers respond to inform future related legislative proposals and understand the intended and unintended consequences.

I hypothesize that executive compensation levels for health insurance executives will decrease as a result of the strict cap from section 162(m)(6). Additionally, I hypothesize that the percentage of cash compensation to total compensation will increase. Prior to section 162(m)(6), health insurance companies could not deduct cash compensation in excess of \$1 million of their executive compensation packages. Now that performance based compensation is not deductible, I expect companies to pay more cash compensation instead of performance based compensation.

In general, the results of my study do not support these hypotheses. I find that health insurer's executive compensation levels have grown, instead of declining, throughout my sample period. However, these observed increases are not significant at conventional levels. I largely

attribute this to a small sample size. Additionally, I do not observe an increase in the cash component of total compensation. To the contrary, I observe a decrease. Again, the decrease is not significant at conventional levels. Furthermore, this decrease in the compensation mix ratio is observed despite annual increases in cash salary which can be attributed to greater increase in performance based compensation than cash salary. These results are not consistent with the goals of section 162(m)(6).

Section II provides a review of legislation related to executive compensation as well as prior research related to compensation deductibility caps. Section III defines the sample and data collection method and provides descriptive statistics. Section IV presents the data analysis. Finally, Section V concludes.

## SECTION II: LITERATURE REVIEW

### **Section 162(m)(6) in Depth Definition**

It was widely anticipated that implementation of the PPACA could result in millions of new customers for health insurance companies. Both lawmakers and the public press asserted that this increase in customer base would increase profit for health insurance companies, much of which would be captured by health insurance executives in the form of increased compensation (Eskow, 2014). The policy motivation for section 162(m)(6) was to alleviate these concerns of profiteering by executives. Senator Tom Harkin, a supporter of the new law, said “consumers across America should know that when they pay their hard-earned dollars to cover the soaring cost of premiums, they are not just chipping in to pay for the CEO’s next new yacht.” (Anderson, 2014, 1). Some members of the press who believe CEO’s are already egregiously overpaid believe that the addition of this law is a “secret trick” that could narrow the gap between the “economy for the wealthy, and [the economy] for the rest of us” (Eskow, 2014, 1).



Section 162(m)(6) caps the deductibility of executive compensation at \$500,000 for all employees of health insurance companies. Prior to this provision, IRC section 162(m)(1) was more general and only limited the compensation deduction to \$1 million in compensation for the top five executives in publicly traded companies. However, if compensation over \$1 million was qualified as performance based compensation, or if the compensation was deferred into a year that the executive was not one of the top five highest paid executives within the company, it was not subject to the deductibility limitation. While similar in nature to section 162(m)(1), section 162(m)(6) specifically targets health insurers and is written to be more restrictive and apply more broadly to all employees rather than the top five executives. Section 162(m)(6) prevents the deduction of compensation, defined as applicable individual remuneration (AIR), over \$500,000 (6 USC §162m). AIR is the “aggregate amount allowable as income tax deduction for... remuneration for services performed by an applicable individual” (6 USC §162m). In other words, section 162(m)(6) applies to nearly all forms of compensation, including performance based compensation. Certain forms of compensation are not included in an individual employee’s AIR, including payments to a qualified trust, payments under a simplified employee pension, specific annuity plans, and certain employee benefits (6 USC §162m). The overall effect is that section 162(m)(6) significantly decreases the amount of compensation that is deductible by health insurance companies when compared to U.S. companies not subject to section 162(m)(6).

Further, section 162(m)(6) expands the definition of which employee compensation is subject to the new deductibility cap. The provision extends to any individual “who is an officer, director, or employee... who provides services for or on behalf of such covered health insurance provider” (6 USC §162m). Before the provision, deductibility was only limited for compensation

to the top five executives of publicly traded companies and the company could mitigate the effects by increasing deductible performance based compensation or by deferring compensation until retirement, meaning the executive would no longer be one of the five highest paid executives within a company. Now, under the new provisions, all employee compensation within health insurance companies is subject to section 162(m)(6), not just the highest five paid executives, so deferral is not a viable strategy for avoiding the deductibility cap.

While primarily intended to affect health insurers, section 162(m)(6) has potential undesirable tax consequences beyond the health industry. The \$500,000 deduction limitation applies to “covered health insurance providers” (Practical Law, 2013, 1). Initially after section 162(m)(6) became effective, any company that received premiums for providing health insurance coverage was considered a covered health insurance provider. Health insurance coverage is defined as “benefits consisting of medical care offered by a health insurance issuer” excluding specific benefits such as worker’s compensation insurance, liability insurance, and accident and disability income insurance (Groom Law Group, 2010, 1). Although there are exceptions, the definition of health insurance is far reaching, including coverage for dental, vision, long-term care, specific diseases, and more. This meant that any company receiving premiums for non-exempt health insurance coverage were subject to the PPACA limitation, prior to 2013.

However, congress recognized that this was more inclusive than intended, and the definition of what companies qualify as covered health insurance providers has changed. Following 2012, the definition of covered health insurance providers includes only providers who receive at least 25% of premiums from providing “minimum essential coverage,” the minimum coverage required by the PPACA. While the definition of covered health insurance provider is less

inclusive since the original legislation in 2010, the language is still broad enough to include companies whose main business operation is not related to providing health insurance.

Final regulations and amendments to section 162(m)(6) were issued by the IRS on September 23<sup>rd</sup>, 2014 further limiting which companies are subject to the deductibility cap. These final regulations set the *de minimis* exception as part of section 162(m)(6). The *de minimis* exception states that “a person that would otherwise be a covered health insurance provider... is not a covered health insurance provider... if the premiums received by that person... are less than two percent of the gross revenue... for that taxable year” (IRS Federal Register, 2014, 1). The *de minimis* exception also retroactively applies to the taxable years of 2010 to 2012. Essentially, the *de minimis* exception excluded nearly all non-health insurance companies from the deduction cap for as long as insurance premiums increase do not exceed 2% of gross revenues.

Section 162(m)(6) disallows the exclusion of performance based compensation in computing the deductibility cap. This could result in increased tax revenue. Recognizing this, members of Congress, including Senator Jack Reed, have proposed bills, such as the Stop Subsidizing Multimillion Dollar Corporate Bonuses Act, to extend this more restrictive deductibility cap to all public companies, rather than only health insurers. According to estimates by the Joint Committee on Taxation, closing the performance-pay loophole could save U.S. taxpayers \$50 billion over a 10-year window (Reed, 2013). As a result, many believe the compensation restrictions present in section 162(m)(6) will soon apply to all public companies (Anderson, 2014).

### **Prior Executive Compensation Research**

Murphy (2012) provides a review of executive compensation and considers how different external pressures, including legislation and tax policies, have affected executive compensation throughout the past century. Strong criticisms of the seemingly exorbitant levels of executive compensation are not a newfound controversy. In fact, as early as 1932, there were “controversies surrounding high salaries for executives in bailed-out railroads [that] led to pay disclosures and paycaps” (Murphy, 2012, 3). Decades of debates and policy changes have followed. Murphy argues that government intervention is a major driver in the changes of executive compensation levels while stating that any argument in regards to changes of executive compensation that ignores political factors is incorrect (Murphy, 2012). To magnify this point, Murphy (2012) highlights several time periods when the U.S. experienced economic distress, and these periods tend to coincide with legislative changes related to executive compensation.

A pointed attack on executive compensation followed the 1992 presidential election where excessive CEO compensation was heavily debated (Murphy, 2012). After President Clinton was elected, the Omnibus Budget Reconciliation Act of 1993 was passed and included IRC section 162(m), which limited the deductibility of non-performance based executive compensation to \$1 million. Section 162(m) caps income tax deduction for “the chief executive officer of the taxpayer... [and] the 4 highest compensated officers for the taxable year (other than the chief executive officer) (3 USC §162m).

Another more recent example of legislation targeted at executive compensation was enacted in 2009 as a part of the Emergency Economy Stabilization Act (EESA). At this time, “limiting executive pay was a long-term priority for Democrats and some Republican congressmen, who viewed the ‘Wall Street Bonus culture’ as a root cause of the financial crisis” (Murphy, 2012, 103). The EESA included the Troubled Asset Relief Program (TARP), a

program that allowed the U.S. government to bolster the financial sector by purchasing assets and equities from struggling banks. For banks to receive this financial assistance through TARP, they were required to comply with the executive compensation restrictions under the EESA. Restrictions set forth for TARP included an IRS cap on the deductibility of executive compensation in excess of \$500,000 as opposed to the \$1 million threshold for all public companies under IRC section 162(m)(1). This \$500,000 limit broadly applied to all types of compensation, including performance based compensation.

### **How Companies Have Responded to Previous Compensation Deduction Limitations**

Johnson and Porter (1997) examine how public companies reacted to section 162(m). They examine whether firms comply with section 162(m) by changing executive compensation levels and whether complying firms would do so by increasing performance based or by deferring compensation so it may be deducted. They studied 266 companies with unqualified compensation and found that 163 firms responded to section 162(m) by changing the structure of executive compensation. Of these 163 companies, 79.1% of the firms reduced executive compensation levels by qualifying compensation as performance based while 20.9% deferred compensation to a later deductible period. Most companies that deferred compensation deferred executive pay until retirement when the executive would no longer be among the highest paid at the firm. Firms that were larger, with higher compensation levels, and with more outside stockholders, were more likely to change the structure of their compensation. They further showed that companies with qualified compensation plans were more likely to have heavily involved investors, have a higher “prior pay-for-performance sensitivity,” and have younger CEOs than companies that deferred compensation (Johnson and Porter, 1997, 13). This study

showed that in 1997 a majority of their sample companies were proactive in complying following the implementation of section 162(m).

Johnson, Porter, and Shackell-Dowell (1997) extended this study by examining whether external stakeholder pressure impacted the level of executive compensation. Using a sample of 186 firms with 1992 CEO compensation over \$1 million, they analyzed whether stakeholder pressures were associated with firms' CEO compensation. They found that, despite rising stakeholder pressure associated with generous CEO compensation packages, compensation levels still increased, but short-term compensation was more reliant on firm performance (Johnson, Porter, and Shackell, 1997). They also found that the "\$1 million pay cap has [not] accomplished either of its two legislative goals. Increases in pay-for-performance sensitivities are not larger at firms that redesigned their incentive plans to assure deductibility under section 162(m) than at other firms, nor are compensation levels lower than at other firms" (Johnson, Porter, and Shackell, 1997, 37-38). Further, their study reveals strong evidence that firms are more likely to change the structure of executive compensation by decreasing compensation levels and increasing the sensitivity towards performance compensation following negative financial press coverage regarding current executive compensation policies (Johnson, Porter, Shackell, 1997). Overall, negative press coverage created more action to lower compensation levels when compared to legislation, such as section 162(m).

Rose and Wolfram (2000) also studied the impact of the \$1 million deduction limit on CEO pay. They hypothesize that firms with executive salaries near the \$1 million compensation cap would experience lower growth rates of salaries, while firms with executive salaries well below the cap would experience higher salary growth rates. In particular, they investigate whether companies actually lowered compensation packages for executives or if they qualified

compensation to preserve deductibility. By analyzing a sample of firms with executive compensation levels near \$1 million and a sample of firms with compensation levels well below \$1 million, they find that that “firms near the \$1 million cap [restrained] their salary increases, and perhaps [increased] the performance components of their pay packages” (Rose, Wolfram, 2000, 201). At the same time, they did not find an overall reduction in levels of compensation following the effective date of section 162(m). Rose and Wolfram (2000) suggest that the inability to view a change in level of executive compensation casts “doubt on the legislation’s efficacy in constraining CEO pay,” which was the original intention of the law. They further credit the performance pay qualification as the reason we do not observe lower executive compensation levels among U.S. companies (Rose, Wolfram, 2000, 201).

Balsam and Yin (2005) examine companies’ willingness to forfeit tax deductions in order to maintain compensation levels above the \$1 million compensation cap under section 162(m). They hypothesize that firms will trade off the benefits of preserving deductions with other associated costs, including “the costs of rewriting executive compensation contracts, costs of seeking shareholder approval of performance-based compensation plan... and paying additional compensation to compensate those executives for additional risks” (Balsam and Yin, 2005, 305). Using a sample of 119 firms with executive cash compensation greater than \$1 million, Balsam and Yin (2005) find that almost 40% of firms paid executive compensation that was not fully deductible. This suggests that section 162(m) was unsuccessful in reducing executive compensation levels. Rather firms opted to pay a higher tax bill than change existing contracts and potentially increase other costs. Balsam and Yin (2005) claim that “Congress needs to revisit this provision realizing that executives have the ability to navigate its provisions and look for other ways... to limit executive compensation.” They suggest that this provision was created by

Congress as a symbolic attempt to curb the outrage associated with high levels of executive pay rather than a provision that would result in economic changes to the way executives are compensated. While acknowledging that section 162(m) was not entirely successful, Balsam and Yin (2005) find that firms that are larger and with higher levels of CEO compensation were more likely to claim as much deduction as possible because the cost of qualifying compensation was less than the potential tax savings

Cadman, Carter, and Lynch (2010) focus on more recent legislation and study banks' willingness to participate in TARP despite the executive compensation restriction imposed by section 162(m)(5). They examine 401 of the largest 3,000 financial institutions and test whether the level and structure of CEO pay influences a firm's decision to accept TARP funding. They find that 298 of these firms applied for government-aided funding while 107 did not apply. Firms applying for TARP funding are larger, perform worse, and have higher CEO salaries but lower CEO bonuses when compared to firms that did not apply for TARP funding (Cadman, Carter, and Lynch, 2010). They further show that firms do weigh the costs of the compensation restrictions imposed by section 162(m)(6) with the costs of raising funds without government aid. The results "are consistent with restrictions on tax-deductibility and scrutiny of incentive-based pay leading to a lower likelihood of applying for funds while restrictions limiting the levels of pay and prohibiting non-stock incentive pay leading to a lower likelihood of accepting those funds" (Cadman, Carter, and Lynch 2010, 1). The study also tested whether CEOs with greater power, based upon compensation levels in comparison to other executives, are more likely to allow their compensation to affect the decision to apply for TARP. The results suggested that firms with CEO's who exhibited greater power are less likely to accept funds in



an attempt to avoid public scrutiny associated with high CEO pay (Cadman, Carter, and Lynch, 2010).

### **Section 162(m)(6) and Executive Compensation**

Little academic research directly tests the effects of section 162(m)(6) on compensation levels for health insurance executives. Anderson, Pizzigati, and Wood (2014) provide descriptive statistics regarding the short-term effects of section 162(m)(6) on the ten largest U.S. health insurance companies. They find that, in 2013, the ten largest insurers paid top executives a total of roughly \$300 million (Anderson, Pizzigati, and Wood, 2014). Only 27% of this compensation was deductible under the new section 162(m)(6) restrictions while 96% of the \$300 million would have been deductible prior to the income tax deduction restrictions. This change in percentage of deductible compensation is a stark change, and the study argues that \$72 million in tax savings was generated for the average U.S. taxpayer. The percentage of deductible compensation in 2013 would have been lower if it were not for grandfathered stock options. Any stock awards that were granted prior to 2010 are not subject to the new deductibility cap. Had these deductible stock options not been included in the \$300 million amount of compensation paid to health insurance executives in 2013, the tax savings for taxpayers would have been greater. Pizzigati and Wood (2014) argue that as these grandfathered stock awards are not included in executive compensation packages, the amount of deductible compensation will fall, and health insurers will face larger tax bills.

### SECTION III: SAMPLE

Consistent with a study by the Institute of Public Studies (2014), I examine the compensation packages for executives at ten large publicly held health insurance companies to test the effects of section 162(m)(6) from 2009 to 2014. I focus on these publicly traded

companies and only the top executives because all executive compensation data for public companies must be disclosed in accordance with SEC regulations. Detailed data for lower level employees is not publicly available

**Table I: Firm Characteristics**

Descriptive Data of the Sample

As of 12/31/2014

<u>Firms</u>	Firm Size (in millions)			Profitability			Exchange Membership	Change in CEO during sample period?
	Total Sales (mm)	Total Assets (mm)	Market Value (mm)	Return on Assets	Profit Margin	EPS		
Aetna	58,003	53,402	36,676	4.32%	3.52%	\$5.74	Nasdaq	Yes
Anthem Inc.	73,874	62,065	35,496	4.64%	3.48%	\$9.31	NYSE	Yes
Assurant	10,382	31,562	5,552	0.41%	4.54%	\$6.52	Nasdaq	No
Centene	16,560	5,838	7,038	5.50%	1.64%	\$2.33	NYSE	No
Cigna	34,914	55,896	34,588	3.79%	6.02%	\$7.97	NYSE	Yes
Health Net	14,009	5,396	4,954	2.79%	1.04%	\$1.83	NYSE	No
Humana	48,500	23,466	25,177	5.43%	2.36%	\$7.44	NYSE	Yes
Molina Healthcare	9,667	4,477	3,554	2.95%	0.64%	\$1.33	NYSE	No
UnitedHealth	130,474	86,382	109,045	6.30%	4.31%	\$5.78	NYSE	No
WellCare Health Plans, Inc.	12,960	4,495	3,463	2.41%	0.49%	\$1.45	NYSE	Yes

My study focuses on the period 2009 through 2014. This sample period includes two full years, 2013 and 2014, in which health insurers were subject to the provisions of section 162(m)(6). I obtained the compensation data for the top five highest paid executives from each health insurance company's annual proxy statement. The annual proxy statement reports compensation data for the current year and two years prior. I used each company's annual proxy statement from 2010 through 2015. The following components of executive compensation are separately reported in the proxy: salary, bonus, service based stock-award, etc. For the purpose of my study, I combined all compensation that was not listed as cash salary to estimate performance based compensation. I obtained all other non-executive compensation financial data used to populate Table I from the Yahoo! Finance and MarketWatch websites.

There were 104 executives disclosed in the proxy statements throughout my sample period. Of these 104, 16 are CEOs, interim CEOs, or former CEOs. Only five of the ten health insurers employed CEOs for my entire six-year sample period. The remaining 88 executives in

my sample were not CEOs, but were among the top highest paid executives within that fiscal year in which they were listed in the proxy. Compensation data for non-CEO executives is not required to be reported in a company's annual proxy statements if that executive's compensation does not rank in the top five for the company in that fiscal year. Thus, it was not uncommon for non-CEO executives to be reported in one year and not in another. To allow for comparability across years, I analyzed non-CEO compensation in aggregate by combining the compensation data available for all non-CEO's reported from 2011 through 2014. I did the same for all the CEO's over the period 2009 through 2014. Thus, I did not trace individual executives but instead averaged across all to compensate for the turnover at this position.

Table I provides descriptive information for my sample. As of the end of the fiscal year, 12/31/2014, I report size and profitability estimates, the exchange membership of each firm, and whether the firm had a change of CEO during the sample period. I estimated three measures of firm size: total sales, total assets, and market value. For my sample, sales range from \$130,474 million by UnitedHealth to \$9,667 million by Molina Healthcare. Total assets range from \$86,382 million from UnitedHealth to \$4,477 from Molina Healthcare. The market values range from \$109,045 million from UnitedHealth to \$3,554 from Molina Healthcare. The size measures in Table 1 reveals that the largest health insurance companies tend to be significantly larger than the smallest firms. The large differences in size can be attributed to consolidation within the health insurance industry (Dafny, 2015). Over the past several years, larger firms have commonly acquired smaller firms motivated by "attempts by regional insurers to gain broader service areas and attempts by national insurers to obtain a presence in virtually all geographic areas" (Dafny, 2015, 1).

In addition to size measures, I provide three measures of profitability for my sample in Table I: return on assets (ROA), profit margin, and earnings per share (EPS). ROA measures how profitable each firm is in relation to its total assets. UnitedHealth had the highest ROA of my sample at 6.30% while Assurant was the lowest at .41%. Profit margin is measured by dividing a company's net income by its total sales. Profit margins range from 6.02% from Cigna to .49% from WellCare Health Plans, Inc. EPS measures profitability by dividing net income by the average outstanding shares of a company. EPS range from \$9.31 from Anthem Inc. to \$1.33 by Molina Healthcare. It is important to consider the profitability because multiple components of compensation are tied to the profitability.

Also listed in Table I is the exchange membership for each firm and whether or not the firm employed the same CEO for the entire sample period. Aetna and Assurant are listed on the NASDAQ stock exchange while the other eight sample firms are listed on the NYSE. Five companies, Aetna, Anthem, Inc., Cigna, Humana, and WellCare Health Plans, Inc. employed the same CEO for the entire six-year sample while the other five firms experienced CEO turnover during the sample period.

#### SECTION IV: DATA ANALYSIS

Table II presents compensation data for my sample of 104 executives. For each year, 2012 through 2014, I determined cash salary, performance based compensation, and total compensation. I estimated a ratio to proxy for compensation mix, cash to total compensation, cash salary divided by the total compensation. I follow the same process to calculate a ratio to compare performance based compensation to total compensation. Additionally, I present the mean total compensation for the entire sample for 2012 through 2014. In total, these measures

provide an overall view of compensation structure for my sample and facilitates my analyses of individual components of compensation.

<b>Table II: All Executive Compensation Data</b>			
Executive compensation measures for all sample executives			
From 2012-2014			
n = 104 executives			
	2012	2013	2014
<b>Cash Salary/Total Compensation</b>	0.1362	0.1260	0.1265
<b>Performance Compensation/Total Compensation</b>	0.8638	0.8740	0.8735
<b>Mean Total Compensation</b>	4,899,217	5,351,005	5,609,638
Pre-section 162(m)(6)			
First year of section 162(m)(6)			
Post-section 162(m)(6)			

Cash salary ranges from 13.6% in 2012 to 12.6% in 2013 of total compensation. Performance based compensation ranged from 87.4% in 2013 to 86.4% in 2012 of total compensation. The average annual increase in compensation ranged from \$5.6 million in 2014 to \$4.9 million in 2012. Further, I observe that cash salary has decreased and performance based compensation has increased in relation to total compensation. The average total compensation from 2012 to 2014 suggest that in the health care industry, executive compensation has increased over the three-year sample despite the potential for increased taxes as a result of section 162(m)(6).

<b>Table III: All Executive Compensation Data - Percent Changes</b>				
Percent changes for all sample executives				
From 2011-2014				
<b>CEOs</b>		2011-2012	2012-2013	2013-2014
<b>Cash Salary</b>	Mean	12.20%	-2.69%	21.31%
	Median	-0.41%	3.89%	12.37%
<b>Total Performance Based Compensation</b>	Mean	-1.21%	26.59%	2.66%
	Median	-16.78%	39.93%	9.29%
<b>Total Compensation</b>	Mean	0.08%	23.45%	4.23%
	Median	-15.88%	36.05%	9.27%
<b>Non-CEOs</b>		2011-2012	2012-2013	2013-2014
<b>Cash Salary</b>	Mean	5.35%	1.19%	1.04%
	Median	3.36%	-1.50%	5.43%
<b>Total Performance Based Compensation</b>	Mean	-7.72%	2.77%	11.63%
	Median	6.81%	10.05%	12.45%
<b>Total Compensation</b>	Mean	-6.19%	2.88%	9.95%
	Median	6.02%	7.18%	9.65%
Pre-section 162(m)(6)				
First year of section 162(m)(6)				
Post-section 162(m)(6)				

Table III presents executive compensation measures for CEOs and non-CEOs in my sample. I calculated the year-to-year percent changes for cash salary, total performance based compensation, and total compensation for all the sample CEOs and non-CEO from 2011 through 2014 to provide insight into changes in compensation by component for the periods before and after the enactment of section 162(m)(6). Average CEO cash salary increased in 2012 and 2014 and decreased in 2013. In 2013, cash salary for CEOs decreased by 2.69% and increased by 21.31% in 2014. Average CEO performance based compensation decreased in 2012 by 1.21% but increased by 26.59% in 2013. Total average CEO compensation increased each year with the highest increasing of 23.45% in 2013. Non-CEO average cash salary increased annually, ranging from an increase of 5.59% in 2012 to an increase of 1.04% in 2014. Non-CEO average

performance based compensation decreased by 7.72% in 2012 but increased in 2013 and 2014, including an increase by 11.63% in 2014. Average total non-CEO compensation decreased by 6.19% in 2012 but increased in 2013 and 2014, including an increase of 9.95% in 2014. Despite the potential for increased compensation related tax costs after the enactment of section 162(m)(6), we do not observe a decrease in executive compensation in health insurance companies.

For the five CEOs in the same position each year over the period 2009 through 2014, I document the mean and median cash, performance based, and total compensation. Additionally, I present the annual percent change for each of the compensation components. To analyze the change in compensation structure, I estimate compensation mix by dividing the annual total cash salary by the annual total compensation. These descriptive measures are shown in Table IV.

<b>Table IV: CEO Compensation Data</b>		For the five CEOs who were in position since 2009 n = 5 CEOs					
<b>CEOs</b>		2009	2010	2011	2012	2013	2014
<b>Cash Salary</b>	Mean	1,060,000	1,080,923	1,102,000	1,122,000	1,150,000	1,152,827
	Median	1,000,000	1,100,000	1,100,000	1,200,000	1,200,000	1,200,000
<b>P value</b>			0.8458	0.8305	0.8258	0.7357	0.9687
<b>Percent Change - Cash Salary</b>	Mean		1.97%	1.95%	1.81%	2.50%	0.25%
	Median		10.00%	0.00%	9.09%	0.00%	0.00%
<b>Total Performance Based Compensation</b>	Mean	4,326,723	6,530,741	8,603,741	8,177,586	9,792,695	12,126,121
	Median	5,077,900	6,845,720	9,128,479	8,049,036	10,773,284	11,266,216
<b>P value</b>			0.1553	0.2049	0.8086	0.3622	0.2768
<b>Percent Change - Performance Based Compensation</b>	Mean		50.94%	31.74%	-4.95%	19.75%	23.83%
	Median		34.81%	33.35%	-11.83%	33.85%	4.58%
<b>Total Compensation</b>	Mean	5,386,723	7,611,664	9,705,741	9,299,586	10,942,695	13,278,948
	Median	6,077,900	7,869,488	10,328,479	9,024,036	11,903,124	12,480,353
<b>P value</b>			0.1705	0.2222	0.8248	0.3691	0.2846
<b>Percent Change - Total Compensation</b>	Mean		41.30%	27.51%	-4.18%	17.67%	21.35%
	Median		29.48%	31.25%	-12.63%	31.90%	4.85%
<b>Compensation Mix</b>							
<b>Cash/Total Compensation</b>	Mean	0.197	0.142	0.114	0.121	0.105	0.087
	Median	0.165	0.140	0.107	0.133	0.101	0.096
Pre-section 162(m)(6)							
First year of section 162(m)(6)							
Post-section 162(m)(6)							

Average CEO cash salary ranged from \$1.06 million in 2009 to \$1.15 million in 2014 and increased annually. The percent change ranges from 2.5% in 2013 to 0.25% in 2014. Total average CEO performance based compensation increased annually except in 2012, ranging from \$4.3 million in 2009 to \$12.1 million in 2014. The percent change for average CEO performance based compensation ranges from -4.95% in 2012 to 50.94% in 2010. Average total CEO compensation increased annually except in 2012, ranging from \$5.4 million in 2009 to \$13.3 million in 2014. The percent change for average total CEO compensation ranges from -4.18% in 2012 to an increase of 41.3% in 2010. The average CEO cash salary as a percentage of total compensation decreased each year except for 2012, ranging from .087 in 2014 to .197 in 2009. The cash salary as a percentage of total compensation decreased overall despite an annual increase in cash salary because performance based compensation increased at a higher volume when compared to cash compensation.

Tests of statistical significance of the changes in compensation are estimated on an annual basis from 2009 through 2014. The resulting p values are presented in Table IV below the tested values. I am unable to document statistical significance in the test of differences of the calculated averages of the three components of compensation. Although the magnitude of the differences appeared large between the calculated annual averages of compensation, I cannot assert that the differences are significant. I attribute this to the small sample size of only five CEOs.

#### SECTION V: LIMITATIONS AND CONCLUSIONS

This study suffers from important data limitations. Because regulations only require disclosure of compensation for the top five executives in the firm, I am unable to track compensation for many executives over the entire sample period resulting in a small sample size.



This turnover prevented me from comparing individual executive compensation on a year-to-year basis. Consistent with section 162(m)(6), it would have been informative to test compensation changes for all employees, rather than focusing on executives. However, compensation data is only publicly available for the top five executives. Therefore, my analyses is similarly limited to these executive level employees.

This study is also limited by the small population of publicly traded health insurance companies. Again, this makes it very difficult to find statistically significant difference in the means of the executive compensation levels.

Finally, my executive compensation data is not adjusted for inflation. As a result of not adjusting my data for inflation, some of the increase in my sample's compensation packages could potentially be attributed to inflation. However, it is important to note that the deductibility cap in section 162(m)(1) has not been adjusted for inflation since its enactment. Also, the deductibility cap in section 162(m)(6) has not been adjusted for inflation since its enactment in 2010.

In this study, I analyzed the executive compensation levels for health insurance executives for changes in level and structure of compensation packages following the enactment of section 162(m)(6). The results of my study are not consistent with my hypotheses. My results show that health insurers' executive compensation levels have grown throughout my sample period, contrary to my expectation. Also, I do not observe, as hypothesized, an increase in cash salaries after the implementation of section 162(m)(6). I observe just the opposite.

For the two years following the enactment of section 162(m)(6), we do not observe lower executive compensation levels despite the increased tax burden associated with high compensation levels under section 162(m)(6). My results are instead consistent with increased

executive compensation levels. Thus, health insurers appear willing to pay higher taxes to maintain high levels of compensation rather than risk losing high level talent and leadership. Health insurers failing to reduce executive compensation levels despite a higher tax burden could influence executive compensation legislation for all U.S. businesses. Legislators may rely on the response to this legislation to better understand whether companies are willing to pay higher taxes rather than see their executives leave for more lucrative opportunities. The results can spark legislators to extend section 162(m)(6) from the health insurance industry to all U.S. industries. This would produce more tax revenue for the Internal Revenue Service, or it could ultimately force companies to lower compensation packages for executives.

A next step for this study could include regressing executive compensation packages with overall firm performance. This regression would provide a better analysis of how much of the compensation increase seen in my study can be credited to firm performance as opposed to an intentional increase of compensation by the firm. Another step could be extending my analysis to similar future data. Extending my current analysis could reveal that health insurers lowered executive compensation levels after suffering financially from the increased taxes from high executive compensation levels. Contrarily, extending my analysis to future years' compensation data could reveal that health insurers are still willing to pay higher taxes for high level talent and leadership.

## REFERENCES

- Anderson, S. (2014, August 27). How Obamacare can end bloated CEO pay. Retrieved November 30, 2015, from <http://fortune.com/2014/08/27/how-obamacare-can-end-bloated-ceo-pay/>
- Anderson, S., Pizzigati, S., & Wood, M. (2014, August 26). Executive Excess 2014: The Obamacare Prescription for Bloated CEO Pay - IPS. Retrieved November 30, 2015, from <http://www.ips-dc.org/obamacare-prescription/>
- Balsam, S., & Yin, Q. J. (2005). Explaining firm willingness to forfeit tax deductions under Internal Revenue Code Section 162 (m): The million-dollar cap. *Journal of Accounting and Public Policy*, 24(4), 300-324.
- Cadman, B., Carter, M. E., & Lynch, L. J. (2012). Executive Compensation Restrictions: Do They Restrict Firms' Willingness to Participate in TARP? *Journal of Business Finance & Accounting*, 39(7-8), 997-1027.
- Dafny, L. S. (2015, November 20). Evaluating the Impact of Health Insurance Industry Consolidation: Learning from Experience. Retrieved March 15, 2016, from <http://www.commonwealthfund.org/publications/issue-briefs/2015/nov/evaluating-insurance-industry-consolidation>
- Devers, C. E., Cannella, A. A., Reilly, G. P., & Yoder, M. E. (2007). Executive compensation: A multidisciplinary review of recent developments. *Journal of Management*, 33(6), 1016-1072.
- Eskow, R. (2014, August 17). Obamacare's "Secret Trick" Could Cure CEO Pay Excesses. Retrieved November 30, 2015, from <https://ourfuture.org/20140827/obamacares-secret-trick-could-cure-ceo-pay-excesses>
- Groom Law Group. (2010, April 20). PPACA \$500,000 Compensation Deduction Limit on Health Insurers May Have Broader Reach. Retrieved March 15, 2016, from [http://www.groom.com/media/publication/690\\_memo to clients - health care reform legislation\\_final.pdf](http://www.groom.com/media/publication/690_memo%20to%20clients%20-%20health%20care%20reform%20legislation_final.pdf)
- IRS Federal Register (2014). The \$500,000 Deduction Limitation for Remuneration Provided by Certain Health Insurance Providers; Final Rule 79 Fed. Reg. 184 (September 23, 2014) (to be codified at 26 C.F.R. pt. 1)
- Johnson, Marilyn F., Porter, Susan L., and Shackell-Dowell, Margaret B. (1997, May). Stakeholder Pressure and the Structure of Executive Compensation. Retrieved March 15, 2016 from <http://ssrn.com/abstract=41780>
- Johnson, M., Nabar, S., & Porter, S. (1996). *How firms responded to the new tax law limiting the deductibility of certain executive compensation*. Working paper (University of Texas, Austin, TX).

- Levy, M. (2015, June 6). Patient Protection and Affordable Care Act (PPACA). Retrieved April 22, 2016, from <http://www.britannica.com/topic/Patient-Protection-and-Affordable-Care-Act>
- Murphy, K. J. (2012). Executive compensation: Where we are, and how we got there. *Handbook of the Economics of Finance*. Elsevier Science North Holland (Forthcoming).
- Practical Law (2013). Internal Revenue Code Section 162(m)(6): The Compensation Deduction Limit Imposed under the ACA. (2013, August 6). Retrieved November 30, 2015, from <http://us.practicallaw.com/3-536-7346?q=&qp=&qo=&qe=>
- Reed, J. (2013, August 2). Reed-Blumenthal Introduce the Stop Subsidizing Multimillion Dollar Corporate Bonuses Act. Retrieved November 30, 2015, from <http://www.reed.senate.gov/news/releases/reed-blumenthal-introduce-the-stop-subsidizing-multimillion-dollar-corporate-bonuses-act>
- Rose, N. L., & Wolfram, C. (2000). Has the "million-dollar cap" affected CEO pay?. *American Economic Review*, 197-202.