Deferred Compensation Reform: Taxing the Fruit of the Tree in Its Proper Season

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Executive pensions (or deferred compensation) grabbed headlines after Enron’s collapse and fresh concerns over ever-increasing executive pay. They also grabbed the attention of Congress, which reformed executive pensions legislatively in 2004 with § 409A of the Internal Revenue Code. Section 409A merely tightens and clarifies the doctrines that had already governed executive pensions, leaving the basic economics of executive pensions unchanged. Executives can still defer taxation on current compensation until actual payment is made in the future. Deferral still comes at the same price to the employer, namely the deferral of its deduction for the compensation expense. Thus, the timing of deduction and inclusion are matched. Because of this matching, deferral has no tax advantage at all except in three scenarios: (1) where the executive faces lower tax rates in the future, (2) where the employer faces higher tax rates in the future, and (3) where the employer can earn higher after-tax investment returns than the executive can earn. The first scenario (higher future tax rate for executives) is the most compelling, as executives will often face lower tax rates in the future because retirement will bring an end to their prime earning years. The second scenario (lower future tax rate for employers) is less compelling, as corporate income does not have the same life cycle as executives’ income. The third scenario (greater ability for the employer to earn after-tax returns) is less compelling as well, given the lower tax rates that executives (but not corporate employers) pay on capital gains and dividend income. Thus, the primary problem of executive pensions is the temporal shifting of executive compensation from high-tax years to low-tax years. This temporal shifting is clearly allowed by current law, in contrast to personal shifting of compensation income from high-rate taxpayers to low-rate taxpayers. The policy concerns are largely the same, however, and the tax laws should limit the temporal shifting as well. The ideal response would be a system of accrual taxation on executive pensions.

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The second best would be taxing the delayed payment at the highest marginal tax rates that apply to individuals.

I. INTRODUCTION

Suppose a corporation makes the following promise to an executive on January 1, 2005: “Corporation promises to pay executive $2 million on January 1, 2015.” When should the executive first pay any tax—2005 or 2015? The promise is clearly valuable in 2005, even though the executive must wait ten years to be paid. Nonetheless, present law allows the corporation and the executive to arrange the promise in a way that defers their tax consequences until 2015.

The path to deferral goes through two gates. The first gate is the constructive receipt doctrine, which limits the executive’s ability to control the timing of payment. A promise will not fit through if the executive has an unqualified right to demand immediate payment. The second gate is the economic benefit doctrine, which limits the security that can be given for the promise. A promise will not fit through if the corporation irrevocably secures the payment with a trust or similar arrangement. In other words, the executive must have a mere unfunded promise to pay, which would be compromised if the corporation goes bankrupt or becomes insolvent.

If the promise can pass through these two gates, the executive will not pay tax until 2015. If the promise cannot pass through these gates, the executive will pay tax in 2005. The corporation can deduct its expense under the promise no sooner than the time that the executive includes the payment in income. Lawyers and consultants work hard to structure promises so that they pass through the gates.

The prior paragraphs briefly sketch the taxation of executive pensions or nonqualified deferred compensation (“NQDC”) arrangements. Executive pensions are ubiquitous in corporate America, with participation in such arrangements usually including most or all low-level and high-level executives of public companies. And, executive pensions became front-page

1 If the discount rate is seven percent, then the promise to pay $2 million ten years hence has a present value of about $1 million.
news with the collapse of Enron Corporation. As Enron's decline and fall became apparent internally, its executives took early distributions from their Enron executive pensions—the deferred taxation of which was supposedly premised on exposing the executives to the credit risk of the employer. Thus, in the view of many, Enron executives sidestepped the financial disaster that befell their rank-and-file employees. Antagonism toward executive pensions increased with the disclosure of the $140 million deferred compensation that the New York Stock Exchange granted its chairman, Richard Grasso.

Congress responded with hearings and enacted § 409A of the Internal Revenue Code ("Code") in October 2004. Section 409A narrowed the constructive receipt gate and patched some holes in the economic benefit gate, but continued to allow for deferred taxation on executive pensions. Much of the debate leading up to Code § 409A focused on Enron (and like scandals) and asked whether the two gates to deferral were too wide. With a notable exception, little attention was paid to the economics of deferral.

Perhaps at the margin, fewer executives and corporations will bother passing through § 409A's gates. For those who make it through, the economics are unchanged. Taxation is still deferred until the date of actual payment. The employee pays no tax until then, and the employer takes no deduction until then. But why is it that companies and employers defer taxation at all?

Recall the promise made in 2005 to pay $2 million in 2015. The promise is surely worth something in 2005, perhaps $1 million or so. Compensation occurs in 2005, whereas taxation occurs only in 2015, provided that the

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9 See, e.g., Bronstein & Levin, supra note 7, at 230–33.


11 See supra note 1.
parties structure the promise properly. Hence, the executive is essentially
assigning current compensation to a future tax year.

By comparison, the executive could not avoid tax by having the
corporation pay compensation to a child or other object of his or her bounty.
The compensation is still taxed to the executive under the assignment-of-
income doctrine. Justice Holmes likened compensation to fruit that must be
taxed to the tree that bore it.12 Because the executive is the one who bore the
fruit, then the executive is the one who must pay the tax.

To extend Holmes' analogy, the executive is "like a tree planted by the
streams of water, that yields its fruit in its season."13 Tax law successfully
attaches the fruit to its tree. So, the executive cannot assign compensation to
someone else. But, tax law fails to attach the fruit to the season in which it
grew. Thus, the executive (with the corporation's consent) is free to assign
compensation to some future tax year. This Article explores this freedom and
asks whether it matters to the fisc.

This Article begins with an introduction to the taxation of executive
pensions in Part II. (After this point, executive pensions are referred to by the
term of art "nonqualified deferred compensation" or simply "NQDC.") Part
II describes the dimensions of the constructive receipt and economic benefit
gates as amplified by § 409A. It also describes the critical rule that a
corporation cannot deduct NQDC until it is actually paid.

Afterwards, this Article asks whether NQDC is actually costly to the fisc.
Part III first sets the groundwork for this question by showing that NQDC is
not costly where executives and corporations are subject to the same
unchanging tax rates. Next, Part III proceeds from this "wage neutrality
principle" by showing that NQDC saves taxes in potentially three situations:
(1) where the executive's tax rate will fall in the future, (2) where the
corporation's tax rate will rise in the future, and (3) where the corporation
has a lower effective tax rate on investment income.

Part IV evaluates these results under the current tax system. The
conclusion is that the primary tax savings come from executives' shifting
compensation to low-tax years in the future. Unlike executives, however,
corporations are unlikely to have a systematic incentive to assign the tax
consequences of compensation to future tax years. Corporations do have an
incentive to assign the compensation expense to future years if current
compensation is not deductible because of certain limits on executive
compensation. Finally, the shifting of investment income from the executive
to the corporation is unlikely to produce tax savings because of the huge tax
preference that individuals receive for capital gains.

13 Psalms 1:3.
Part V examines current doctrine in light of the conclusions from Part IV. By merely limiting control and security, current doctrine does not address the impact that NQDC has upon the fisc. Part V proposes a first best and a second best reform of the taxation of NQDC. The first best is to tax it on an accrual basis (i.e., when earned rather than when paid). Doing this would give NQDC no tax advantage or disadvantage compared with current compensation. The second best is to retain today's regime of deferred taxation, but to tax all ultimate payments at the highest marginal rates. This reform would eliminate the incentive to shift compensation from high-tax years of employment to low-tax years of retirement. Part VI has some concluding remarks.

II. TAXATION OF DEFERRED COMPENSATION

A. Tax Accounting for Deferred Compensation

The tax issues of NQDC are of accounting: When should an employee include deferred compensation in income? When should an employer deduct such compensation? For properly planned NQDC, the answer to both questions is “upon cash payment.”

Individual employees may—and almost always do—use the cash method of accounting to calculate their taxes. Under the cash method, amounts are included in gross income upon receipt by the taxpayer. Payments are deducted when actually made. The year in which the amounts are earned (or accrued) is irrelevant to the determination. The year of “receipt” is what matters. Actual receipt of compensation always triggers taxation under the cash method and is usually accomplished by cash, check, or similar transfer. Deferral of tax cannot extend beyond the time of actual receipt.

Recall the promise from above where the corporation promises to pay an executive $2 million in 2015. Actual receipt occurs in 2015, and properly planned NQDC will allow the executive to defer taxation until this date. The fact that the executive has clearly been enriched when the promise was made in 2005 is usually irrelevant.

14 What makes NQDC “properly planned” is discussed infra Part II.B.
15 See Stephen F. Gertzman, Federal Tax Accounting para. 3.01[2] (2d ed. 1993 & Supp. 2003); Boris I. Bittker & Lawrence Lokken, Federal Taxation of Income, Estates, and Gifts para. 105.3.1 (2d ed. 1992) (“[The cash method] is almost universally employed by wage earners and employees. It is almost equally popular among . . . taxpayers engaged in furnishing personal services, such as doctors and lawyers”).
17 See id.
Sometimes, however, taxation may occur before actual receipt. Under the doctrine of constructive receipt, an employee may be taxed earlier if the employee may choose between withdrawing or deferring distributions from the plan. Under the doctrine of economic benefit, an employee may be taxed earlier if payment of future benefits is sufficiently secured. The development and contours of these two doctrines are discussed below. 18

As for who pays NQDC, this Article focuses on large corporate employers. The reason for this focus is that large corporate employers almost certainly pay the large majority of NQDC, which is used to compensate professional managers (not owner-managers) 19 who demand more deferred compensation than can be given under the more advantageous system of qualified retirement plans. Indeed, some view NQDC in terms of agency costs or hidden compensation rather than tax advantages; these explanations are most apt to professionally managed corporations. 20

Large corporate employers may not use the cash method of accounting. Instead, the Code forces them to use the accrual method. 21 Under the accrual method, amounts are included in, or deducted from, income based on the “all-events test.” A right to payment produces income when “all the events have occurred that fix the right to receive the income and the amount of the income can be determined with reasonable accuracy.” 22 Similarly, a liability produces a deductible expense “in the taxable year in which all events have occurred that establish the fact of the liability, the amount of the liability can be determined with reasonable accuracy, and economic performance has occurred with respect to the liability.” 23

The accrual method of accounting does not, however, apply to NQDC. As noted before, the executive must use the cash method. Under Code § 404(a)(5), employers can deduct the cost of NQDC only after the executive has included benefits in taxable income. 24 So, employers are locked into the cash method of accounting used by the executive. 25

18 See infra Part II.B.

19 Sole proprietors, partners, or S corporation shareholders are taxed directly on the income of their businesses.


23 See id.

24 I.R.C. § 404(a)(5) (2000). If benefits are included because the employee is the beneficiary of a separate trust, then a separate account must be established for the
Recall again the promise, made by the corporation in 2005, to pay the executive $2 million in 2015. The expense appears to have satisfied the all-events test, which would ordinarily allow for deduction in 2005. Indeed, the executive would include income in 2005 if he or she operated under the accrual method. Because the executive is on the cash method, he or she waits until 2015 to include the amount in income. Section 404(a)(5) forces the corporation to wait until 2015 to deduct its expense.

By matching the accounting methods of the corporation and executive, § 404(a)(5) makes it at least plausible that NQDC is tax neutral. The possibility of tax neutrality is developed more fully below, but first consider a world without the matching system of § 404(a)(5). In this world, the corporation would deduct its NQDC when the expense accrues, but the executive would include it in income only upon payment. Returning to our example, the corporation would deduct the $1 million expense in 2005. Presumably, the corporation will invest the $1 million in a suitable vehicle for the benefit of the executive. Suppose that the return is ten percent per year. So, in the first year, the investment returns $100,000. The corporation pays tax on $100,000 as investment income, but it also deducts $100,000 as compensation expense to the executive. It is a wash, and the corporation is effectively tax exempt on the investment income. Upon ultimate payment by the corporation, the executive will pay tax on the $1 million that was originally deferred plus all of the interim investment gains.

This imaginary world of NQDC without § 404(a)(5) describes the real world taxation of qualified retirement plans and individual retirement accounts. The employer gets a current deduction, interim investment income is tax exempt, and the employee pays no tax until actual cash payment. This special tax treatment is equivalent to complete forgiveness of tax on employee before the employer can take a deduction. Treas. Reg. § 1.404(a)-12(b)(3) (2005).


26 Cf. Burnham Corp. v. Comm’r, 90 T.C. 953, 958 (1988) (holding that future payments are not discounted for present value under the all-events test), aff’d, 878 F.2d 86 (2d Cir. 1989).

27 See infra Part III.A (wage neutrality principle).

28 If the future payment is reasonably ascertainable, the future payment itself may be deductible in 2005 without any discount for the time value of money. Burnham Corp., 90 T.C. at 958.
investment.\textsuperscript{29} The public cost of this special treatment for qualified retirement plans is stupendous, estimated at more than $120 billion for 2005.\textsuperscript{30}

Current law is clear that the corporation cannot deduct any part of the expense of NQDC until actual payment. The taxpayer in \textit{Albertson's, Inc. v. Commissioner},\textsuperscript{31} however, attempted to secure a partial mismatch. To simplify the facts, assume again that the executive defers $1 million. There was no question in \textit{Albertson's} that the corporation had to wait until actual payout to deduct this amount. What the taxpayer did claim was that it could deduct interim interest credits on an accrual basis. On this theory, the taxpayer would be effectively tax exempt on any interest income it received with respect to the $1,000,000. This would have placed NQDC on essentially the same footing as a nondeductible IRA, as the initial contribution does not receive a tax preference, but the interim investment returns do. The taxpayer in \textit{Albertson's} at first won in the United States Court of Appeals for the Ninth Circuit. Upon rehearing en banc, the court reversed, noting how the taxpayer's position would have moved the treatment of NQDC closer to that of the subsidized qualified retirement plans.

Tax students are often taught from day one that deferral of taxation is inherently valuable to the taxpayer and costly to the fisc.\textsuperscript{32} Section 404(a)(5) ensures, however, that deferral is not inherently valuable in the context of NQDC. The burden of taxation to the executive is deferred, but so is the benefit of deduction to the corporation. The next Part of this Article explores when NQDC produces tax savings at all.

This Part next examines the doctrines associated with NQDC. These doctrines determine when the taxation of compensation can be deferred at all. After that, this Part examines qualified retirement plans, which receive an enormous tax subsidy (as already noted), presumably to promote savings.

\textsuperscript{29} See Myron S. Scholes et al., \textit{Taxes and Business Strategy} 68 (3d ed. 2005) ("[P]ension savings are equivalent to tax exemption.").

\textsuperscript{30} The number is drawn from the tax expenditure budget prepared by the Joint Committee on Taxation. It includes the tax expenditures for employer-provided pension plans, IRAs, and Keogh plans. See \textit{Staff of Joint Comm. On Taxation, Estimate of Federal Tax Expenditures for Fiscal Years 2005–2009}, JCS 1–05, at 39–40 (2005).

\textsuperscript{31} The three decisions are \textit{Albertson's, Inc. v. Commissioner}, 95 T.C. 415 (1990) (holding for Commissioner), rev'd in part, 38 F.3d 1046 (9th Cir. 1993), rev'd on reh'g 42 F.3d 537 (9th Cir. 1994).

B. Doctrines of Deferred Compensation

The basic tax accounting of NQDC was just presented. Properly structured, NQDC defers taxation on the executive, but also defers the deduction for the corporation. Any investment gains during the interim are taxed to the corporation.

This section examines what goes into the proper structure of NQDC. The goal is to show that there are two gateways to deferral—the economic benefit doctrine (which limits security) and the constructive receipt doctrine (which limits control). The following Part III shows that the tax savings of NQDC come solely from differences in tax rates between the parties and over time. These differences have nothing to do with the excess control or security that concerns current doctrine. Part V elaborates on this disconnectedness and ultimately argues for new doctrine that addresses the economics.

Starting on January 1, 2005, the income taxation of NQDC is largely statutory. The two key statutes are § 83 (which taxes the transfer of "property") and § 409A (which provides additional rules on the taxation of NQDC). Conceptually, § 83 implements the economic benefit doctrine, whereas § 409A implements the constructive receipt doctrine. Section 83 is the broader and conceptually more coherent statute and is dealt with first.

Section 83 taxes transfers of "property" to employees once the interest in the property is vested. Property is defined as "[r]eal and personal property other than either money or an unfunded and unsecured promise to pay money or property in the future." Thus, § 83 does not reach such promises, and they escape tax (unless they trigger constructive receipt). An "unfunded promise to pay" is at the heart of current doctrine and the classic description of NQDC. Because this mere promise to pay might be breached, it is thought that future payment is too speculative to trigger current taxation on the cash method of accounting.

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33 Code § 409A does, however, augment some aspects of the economic benefit doctrine, notably by limiting the use of so-called rabbi trusts. See infra notes 152-158 and accompanying text.
36 See also Rev. Rul. 60-31, 1960-1 C.B. 174 (not imposing tax on a "mere promise to pay, not represented by notes or secured in any way").
37 Some commentators feel that the exemption for unsecured and unfunded promises to pay is practically limited to NQDC situations. In their discussion of unsecured and unfunded third-party promises to pay, Professors Polsky and Hellwig recently argued that Code § 83’s exemption for unsecured and unfunded promises applies exclusively to two-party promises between service recipients (employers) and service providers.
The upshot of this formulation is that the executive must bear the risk that the corporation will go bankrupt or become insolvent. The requirement of credit risk is highlighted by the § 83 regulations. They state that "[t]he term [property] also includes a beneficial interest in assets (including money) which are transferred or set aside from the claims of creditors of the transferor, for example, in a trust or escrow account." Thus, a cash basis executive will be taxed if the corporation places funds into an irrevocable trust for the executive's benefit—even if the executive could not control the timing of payment.

There is a corollary—assets still subject to the claims of an employer's creditors escape tax under Code § 83. So-called "rabbi trusts" illustrate the limits of this notion. A rabbi trust is used to fund NQDC and pay executives their benefits when due. The key to avoiding current taxation is that trust assets are available to pay the claims of the employer's general, unsecured creditors in the event of the employer's insolvency or bankruptcy. Assuming other (less important) requirements are met, the executive will not be taxed under economic benefit principles by reason of benefiting under a rabbi trust. Instead, the rabbi trust will be disregarded as a tax entity, and its assets will be deemed to be owned directly by the corporation.

Thus, the rabbi trust does not completely remove the credit risk. The executive does have some security, in that the corporation cannot stonewall executives or force them to sue in court while funds sit in trust. These concerns are particularly high where a change in control is expected. Still, the remaining credit risk puts the executive in the same posture as an unsecured creditor of the corporation.

(employees), effectively closing the door on applying the § 83 exemption in any context but NQDC. See Gregg D. Polsky and Brant J. Hellwig, Taxing the Promise to Pay, 89 MINN. L. REV. 1092, 1127–29 (2005).


39 See also Sproull v. Comm'r, 16 T.C. 244, 247 (1951) (imposing tax on economic benefit principles before enactment of § 83), aff'd per curiam, 194 F.2d 541 (6th Cir. 1952).

40 See also I.R.C. § 402(b)(1) (2000) ("Contributions to an employees' trust ... shall be included in the gross income of the employee in accordance with section 83 . . . .").

41 The rabbi trust derives its name from the IRS ruling first approving such an arrangement in 1980. See MICHAEL S. SIRKIN & LAWRENCE K. CAGNEY, EXECUTIVE COMPENSATION § 8.04[2][a] n.7 (citing I.R.S. Priv. Ltr. Rul. 8113107 (Dec. 31, 1980)).


43 See, e.g., SIRKIN & CAGNEY, supra note 41, at § 8.04[2].
A mere unfunded promise to pay also might be taxable if it is readily assignable. 44 This notion is illustrated by Cowden v. Commissioner,45 in which the court said:

We are convinced that if a promise to pay of a solvent obligor is unconditional and assignable, not subject to set-offs, and is of a kind that is frequently transferred to lenders or investors at a discount not substantially greater than the generally prevailing premium for the use of money, such promise is the equivalent of cash and taxable in like manner as cash would have been taxable had it been received by the taxpayer rather than the obligation.46

Thus, readily assignable obligations would be subject to tax. Such obligations would not technically be property under § 83, as they are unfunded promises to pay.47 Nonetheless, they are taxed essentially as property because they give the recipient the extra security of being able to assign the obligation to a third party.48

The economic benefit doctrine mandates a lack of security in payment from the employer. Acting alone, the executive may take steps to secure payment. The IRS has approved purchases by executives of insurance policies and surety bonds payable upon default of NQDC obligations.49 These arrangements negate the credit risk inherent in rabbi trusts and unfunded NQDC while still deferring taxation. The IRS implied that the policy or bond needed to be purchased without the help of the employer. A practitioner questions the usefulness of these techniques, reporting that the market for them is thin and expensive.50

45 Cowden v. Comm'r, 289 F.2d 20, 25 (5th Cir. 1961).
46 Id.
48 It is curious that Code § 409A does not address assignability, as Revenue Procedure 92-65 prohibited assignability of NQDC. Presumably, the cash equivalency doctrine would fill this void. Cf. IRS Notice 2005-1 I.R.B. 274 (stating that cash equivalency doctrine still applies after I.R.C. § 409A (2000)).
The other key doctrine is constructive receipt, which is implemented primarily by Code § 409A (at least with respect to NQDC). The seminal statement of constructive receipt is from the regulations which state:

Income although not actually reduced to a taxpayer’s possession is constructively received by him in the taxable year during which it is credited to his account, set apart for him, or otherwise made available so that he may draw upon it at any time, or so that he could have drawn upon it during the taxable year if notice of intention to withdraw had been given. However, income is not constructively received if the taxpayer’s control of its receipt is subject to substantial limitations or restrictions.51

More colloquially, the courts and the IRS have said that “under the doctrine of constructive receipt, a taxpayer may not deliberately turn his back upon income and thereby select the year for which he will report it.”52 However it is expressed, constructive receipt limits the control that an executive may have over NQDC. Too much control triggers current taxation.

“How much is too much” was litigated by the IRS (with little success) for decades.53 The key issues were the degree of freedom over initial elections to defer and over later elections to withdraw. For example, suppose an executive will earn a salary of $500,000 in 2006 and wants to defer $100,000; when must such an election be made? Suppose the executive previously deferred $500,000, can the executive reach this while still employed? How much flexibility can the executive have in determining the timing of payments?

These questions are largely settled by the enactment of Code § 409A in October 2004.54 After December 31, 2004, an NQDC plan must satisfy


53 For example, cases allowed terminating employees to choose between a lump-sum and installment distribution. See Martin, 96 T.C. at 829. They also allowed employees to choose between current and deferred payment after the compensation had been earned. See Veit v. Comm’r, 8 T.C. 809, 818 (1947), acq. 1947-2 C.B. 4 (I.R.S. 1947) (Veit I); Veit v. Comm’r, 8 T.C.M 919 (1949) (Veit II).
54 What ultimately prompted Congress to enact Code § 409A was not a desire to remedy IRS failures. Instead, it was a response to the corporate scandals at Enron and elsewhere. A prime example of the perceived abuse was the so-called haircut distributions than many NQDC plans allowed.
§ 409A if tax deferral is desired. Section 409A contains the following restrictions on NQDC:

Elections to Defer: Elections to defer compensation be made before the calendar year in which services are rendered, subject to a 30-day grace period for new plans and new employees.\(^5\)

Timing of Distributions: Distributions cannot be made until the earliest of (i) separation from service, (ii) disability, (iii) death, (iv) change in control, (v) unforeseeable emergency, or (vi) according to the time or schedule specified in the plan when the deferral is made.

Additional Restrictions on Top Executives: Distributions to the top fifty executives of a publicly traded company are subject to even tighter restrictions.\(^5\) They may not receive a distribution until six months after separation from service (although a beneficiary could receive a distribution immediately after an executive’s death).

Accelerations Not Possible: The NQDC plan must not allow or make any distributions before the earliest time specified above. Thus, the haircut distribution\(^5\) is outlawed. More generally, suppose that an NQDC plan specifies that an executive will receive benefits in ten annual installments starting one year after separation from service. Section 409A prohibits the plan from paying benefits faster than per this schedule.\(^5\) So, the executive who previously elected installments could not later elect to receive a lump-sum payment.

Delays Possible, Subject to Limits: Unlike acceleration, delay is allowed at the executive’s election (subject to limits). Any election to delay benefit payments must be made at least twelve months before the first payment is to be made. Also, the delay must be for at least five years. Again, suppose that an NQDC plan specifies that an executive will receive benefits in ten annual installments starting one year after separation from service. Up until separation from service, an executive could elect to delay receiving benefit payments.


\(^5\) Technically, all key employees of a publicly traded company are subject to this restriction. “Key employee” is defined in I.R.C. § 416(i)(1)(A) (2000). As a practical matter, the only people who will qualify as key employees will be the top fifty officers described in I.R.C. § 416(i)(1)(A)(i) (2000).

\(^5\) A haircut distribution is an early distribution subject to a penalty. See Lee A. Sheppard, News Analysis: The Thin End of the Wedge of Deferred Compensation, 96 Tax Notes 1549, 1551 (Sept. 16, 2002).

\(^5\) Limited exceptions are available for accelerated payments. They include domestic relations orders, forced divestitures, cash outs of benefits worth $10,000 or less, and the payment of employment taxes. See IRS Notice 2005-1 I.R.B. 274, Q&A-15.
payments. The delay must be of at least five years. So, for example, the executive could elect to receive ten annual installments starting six years after separation from service.

*Penalties for Noncompliance:* Failure to satisfy Code § 409A will subject the executive to current taxation, plus interest and a 20% penalty, on any benefits that have been fully earned.\(^59\)

One might initially think that § 409A will curtail the use of NQDC. Section 409A does curtail the amount of control that an executive can have over elections to defer compensation and to take distributions. Also, it harshens the consequences for triggering constructive receipt by imposing interest and a twenty percent penalty. Thus, § 409A lines the gateway of constructive receipt with the barbed wire of interest and penalties.

However, § 409A will (with further IRS guidance) clarify a previously murky area of law. In some ways, NQDC is less risky now that discernable rules are in place. Moreover, § 409A does not change the basic tax issues of NQDC plans that successfully pass through the gateways constructive receipt and economic benefit. Executives and employers can still defer taxation. If tax deferral reduces tax revenues, it will continue to do so.

C. *Comparison with Qualified Retirement Plans*

Qualified retirement plans are not the subject of this Article. Nonetheless, a brief description of their taxation is useful for two reasons. First, given the superiority of qualified retirement plans, employers usually resort to NQDC only when qualified retirement plans are unavailable or too expensive. Second, the limits on qualified retirement plans represent the limits on the public subsidy for savings. Thus, NQDC should be treated neutrally, not preferentially, by the tax system.

For low-paid employees, qualified retirement plans are the sole source of employment-based savings. Empirical evidence suggests that low-paid employees do not take full advantage of their opportunity to save in qualified retirement plans.\(^60\) So, employers have no incentive to offer such employees any savings vehicle other than qualified retirement plans. Moreover, ERISA effectively prohibits employers from offering NQDC to low-paid employees. In general, pension and deferred compensation plans must be funded under

\(^{59}\) The benefits are fully earned when they are not subject to a substantial risk of forfeiture. *See* I.R.C. § 409A(a)(1)(A)(i)(II) (2000). A substantial risk of forfeiture exists when the executive has to perform further services to earn the benefits. *See* IRS Notice 2005-1 I.R.B. 274, Q&A-10(a).

ERISA, but such funding is inconsistent with the economic benefit doctrine. ERISA's funding requirements do not apply, however, if a plan is maintained for a "select group of management or highly compensated employees." So, NQDC is effectively and formally limited to executives and other highly paid employees.

NQDC would not exist if qualified retirement plans had no limits, because qualified retirement plans are almost always superior. Qualified retirement plans have three tax advantages: (1) the employer deducts contributions at the time they are made to the plan, (2) these contributions grow tax free while held by the plan, and (3) the employee pays no tax until benefit payments are actually made by the plan, even if the employee could demand an earlier payment. Theoretically, this arrangement is tantamount to the forgiveness of all taxes on the income earned while amounts are held by the qualified retirement plan. As noted above, the cost of this preferential tax treatment is enormous, more than $120 billion in 2005.

Because of this treatment, qualified retirement plans receive much more favorable tax treatment than that received by NQDC. Even though the executive defers his or her tax burden through NQDC, the corporation must defer its deduction. Any funding for NQDC is held directly by, and taxed directly to, the employer. The only time NQDC has a tax advantage over qualified retirement plans is when the employer’s current marginal tax rate is much lower than it will be when benefits are ultimately paid.

Qualified retirement plans are superior for the additional reason that they are not subject to the economic benefit doctrine. In fact, security is mandated, not prohibited. Benefits must be secured by an irrevocable trust for the sole
purpose of paying benefits. The funded trust protects employees from the risk that the employer would go bankrupt or become insolvent. Defined benefit plans must be partially insured by the Pension Benefit Guaranty Corporation, a quasi-governmental agency.

Qualified retirement plans are superior for the final reason that they are not subject to the constructive receipt doctrine. The unexercised power to demand a distribution at will does not trigger taxation. The primary restrictions on employee control protect the employee’s spouse, limit distributions while the employee is still employed, discourage distributions before the employee reaches age 59.5, and mandate the commencement of distributions shortly after the employee reaches age 70.5. The theory behind these restrictions is that qualified retirement plans should be used for the retirement needs of the employee and his or her spouse. The restrictions are not imposed in order to implement any doctrinal or accounting notion of constructive receipt.

Thus, qualified retirement plans appear to be unambiguously better than NQDC. Qualified retirement plans receive an enormous tax subsidy, are secured by irrevocable funding, and can be subject to the control of the employee. The advantages are constrained, however, when employers give benefits to highly paid employees. The Code and regulations purport to ensure that low-paid employees receive some benefits by prohibiting discrimination in favor of highly paid employees. Discrimination is measured by complex formulae set forth in the regulations. It is sufficient for current purposes to note that an employer who grants qualified retirement plan benefits to executives must also grant benefits to lower-paid employees.

Dollar caps also apply to benefits, and these dollar caps are often significant to NQDC. If an executive hits one of these caps in a qualified

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69 See ERISA § 4001–4402.
75 For this purpose, a highly compensated employee is one who earned more than $90,000 in the previous year or who was a five percent owner of the employer for the current or previous year. The $90,000 figure is for 2004 and is adjusted annually for inflation. See I.R.C. § 414(q) (2000); IRS Notice 2003-73, 2003-45 I.R.B. 1017 (Nov. 10, 2003). What constitutes “discrimination” is beyond the scope of this Article.
76 See Treas. Reg. §§ 1.401(a)(4)-0 (2005); 1.410(b)-0 (2005).
retirement plan, employers often give more benefits through NQDC. The following dollar caps are for the year 2005:

Compensation Cap: If plan benefits are based on compensation, then compensation over $210,000 must be disregarded.\(^{77}\)

401(k) Cap: An employee under age fifty cannot contribute more than $14,000 to a 401(k) plan for year 2005.\(^{78}\) An employee age fifty or older may contribute an extra $4,000 for year 2005.\(^{79}\)

Defined Contribution Cap: A defined contribution plan may not grant benefits greater than $42,000 in year 2005.\(^{80}\) This $42,000 cap also includes any amounts contributed by the employee. So, if an employee contributes $14,000 to a 401(k) plan, the employer could give no more than $28,000 in extra benefits via a defined contribution plan.

Defined Benefit Cap: A defined benefit plan may not give a benefit greater than $170,000 per year starting at age sixty-five.\(^{81}\) The benefit may also not exceed 100% of the participant’s average compensation for the three years when compensation was highest.\(^{82}\)

The nondiscrimination rules and the benefit caps illustrate the limits of public subsidies for savings. Executives and highly paid employees can receive a subsidy for their employment-based savings through a qualified retirement plan. However, this subsidy is limited (because of the caps) and conditional (because of the nondiscrimination rules). Once employers and highly-paid employees hit the caps or become unwilling to abide by the nondiscrimination conditions, they should not receive any further subsidy for employment-based savings as a matter of policy.

III. ECONOMICS OF DEFERRED COMPENSATION

A. Wage Neutrality Principle

The prior Part developed the doctrine of NQDC and some of the rudimentary economics. NQDC must pass through the two gates of economic benefit and constructive receipt. Once through, NQDC generates no tax for the executive—and no deduction for the corporation—until actual payout. Finally, the taxation of NQDC is almost always inferior to that of qualified


\(^{78}\) I.R.C. § 402(g) (2000).


retirement plans. Nonetheless, we must ask whether NQDC produces any tax savings where qualified retirement plans are unavailable.

If the corporation and the executive face the same tax rate, then the payment of compensation produces no net revenue to the government. The corporation’s deduction causes a depletion of the fisc, and the executive’s income causes an addition. The size of the depletion and addition are the same because the tax rates are assumed the same. Thus, the potential for tax neutrality exists because of the two-party matching system of § 404(a)(5). Since the cash payment of compensation produces no net revenue, it does not matter whether cash payment occurs today or in the future.

Of course, investment taxation comes into play with NQDC. Suppose compensation is earned in period one but not paid until period ten. During the interim, the corporation will pay tax on any investment gains it might receive. In contrast, the executive would pay this tax if the compensation had not been deferred. This does not change the analysis so long as the executive and the corporation are at the same tax rate.

This wage neutrality principle shows that tax deferral is not inherently valuable where the corporation must defer its deduction. This point no longer applies, however, when differing tax rates are introduced. The corporation and executive may be subject to different tax rates both currently and in the future. These different rates will affect the value of any tax deduction and the burden of any taxable income. Also, deferred compensation may be invested between the time it is earned and the time it is paid. Differing tax rates here may also affect the tax savings from deferral. Elaboration on how these shifting and differing rates affect NQDC is the goal of the remainder of this Part.

B. Future Value of Current Compensation

Deferred compensation occurs when an employee foregoes current compensation and purchases a “security” of the employer firm with the foregone compensation. The security is the rights under the NQDC plan.

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84 See Geier, supra note 25.
86 The model developed here is based on SCHOLES ET AL., supra note 29, at 212–16.
The goal of this section is to quantify the future value of current (i.e., undeferred) compensation.

Current cash compensation is the baseline against which NQDC is measured. Thus, the question is whether the employee would be better off receiving current cash or NQDC. Whether the employee would be better off under some third program (like stock options or other form of equity compensation) is not explored here.

Rather than deferring compensation into the future, the employee could take current compensation and invest it. Starting with current compensation, we assume the following variables:

- \( D \) = amount of current compensation
- \( N \) = deferral horizon measured in years (e.g., ten years)
- \( t_{10} \) = individual tax rate today (time zero)

For now, we can ignore corporate tax rates and changes in the executive’s tax rate. These will, however, be critical in examining the future value of deferred compensation. We must, however, have a function that expresses the after-tax growth of the executive’s investments:

\[ F_t(N) = \text{after-tax future value factor for individual investments measured as a function of the years held (} N \text{)} \]

For example, if we knew that \( F_t(10) = 1.63 \), then a current investment of $1 would grow to $1.63, after tax, in ten years. Such a return would represent an annual after-tax return of about 5%.

If an executive takes current compensation of \( D \) and pays tax on that amount, he or she will be left with \( D \times (1 - t_{10}) \). Investing this for \( N \) years, produces:

Equation 1
\[ D \times (1 - t_{10}) \times F_t(N) \]

Equation 1 is the baseline against which NQDC will be measured. It shows how much money the executive has, after tax, in period \( N \).

For example, if the executive can receive 5% after-tax annually, then we know:

\[ 1 - (1.63)^{0.10} = 0.05. \]
\[ F_c(N) = (1.05)^N \]

Suppose that \( D \) is $100,000 and that the executive pays tax \((t_0=35\%)\) currently. \( D \) has $650,000 to investment. If the investment horizon is \( N=10 \) years, then future value is:

\[
100,000 \times (1-0.35) \times (1.05)^{10} = \$105,878.15
\]

C. Future Value of Deferred Compensation

Setting the baseline is not quite enough. An employee is always better off receiving more compensation, and the employer is better off paying less. To neutralize this tension, we assume that the cost and (to the extent possible) risk to the employer are the same for current or deferred compensation. Thus, the employer is assumed to be indifferent between paying current cash or granting the NQDC “security.” Any benefits to NQDC will go to the employee under these assumptions.

The following variables are now defined:

- \( t_{c0} = \) corporate tax rate today (time zero)
- \( t_{cw} = \) corporate tax rate in future (time “\( N \)"
- \( t_{in} = \) individual tax rate in future (time “\( N \)"

The ability of the corporation to earn income after-tax is represented by the following function:

\[ F_c(N) = \text{after-tax future-value factor for corporate investments measured as a function of the years held (} N) \]

To fulfill the assumption of indifference, we assume that the corporation is unwilling to spend more on deferred compensation than on current compensation (measured on an after-tax basis). The after-tax cost of paying current compensation is \( D \times (1-t_{c0}) \). This is gross compensation \((D)\) minus the value of the tax deduction. Next, we assume that the corporation is willing to set aside this after-tax amount and let it grow through investment until time \( N \). At time \( N \), it will have grown to:

Equation 2

\[
D \times (1-t_{c0}) \times F_c(N)
\]

Note that the corporation will receive a deduction when it actually pays this amount at time \( N \). Thus, the corporation should be willing to “gross up” the payment so that its after-tax cost at time \( N \) is simply the amount it has set aside per Equation 2. To find the pre-tax amount of payment, Equation 2 is divided by \((1-t_{cn})\):

Equation 3

\[
\frac{D \times (1-t_{c0}) \times F_c(N)}{(1-t_{cn})}
\]
The executive must pay tax on this gross payment based on the rate at time $N$. So, the net amount received by the executive is
equation 4
\[ \frac{D \times (1 - t_{CN}) \times F_c(N) \times (1 - t_{IN})}{(1 - t_{CN})} \]

Above, we analyzed current compensation where $D=100,000$, $N=10$, $t_0=35\%$, and $F_f(N) = (1.05)^N$. Suppose now that the corporation pays 35\% tax as well (both today and at $N$) and has the same earning ability as the executive. So, $t_{CN} = t_{CN} = t_0$ and $F_f(N) = F_c(N)$. However, suppose that at $N$ the executive will be at a tax rate of $t_{IN}=25\%$. The future value of the deferred compensation is thus:
\[ \frac{100,000 \times (1 - .35) \times (1.05)^{10} \times (1 - .25)}{(1 - .35)} = 122,167.10 \]

Because the executive is paying a lower future tax rate (25\%) than today (35\%), deferral produces a significantly better return ($122,167.10$ versus $105,878.15$).

D. Measuring Advantage of Deferred Compensation

1. Three Ratios

The previous example showed that deferred compensation was superior when individual rates are falling. Now, the Article turns to a more general comparison.

The future value (at time $N$) of deferred compensation is given above in Equation 4. The future value of current compensation (at time $N$) is given above in Equation 1. Let $Q$ be the quotient of the two equations. $Q$ is the surprisingly elegant:
equation 5
\[ \frac{F_c(N)}{F_f(N)} \times \frac{1 - t_{IN}}{1 - t_{f0}} \times \frac{1 - t_{CN}}{1 - t_{CN}} = Q \]

Where $Q>1$, we know that deferred compensation is superior. Where $Q<1$, we know that current compensation is superior. Where $Q=1$, the two are equivalent.

Equation 5 is based on three ratios. The first compares the ability to produce after-tax investment earnings, $F_c(N)$ and $F_f(N)$. The second...
compares current and future individual tax rates, $t_{I0}$ and $t_{IN}$. The third compares current and future corporate tax rates, $t_{C0}$ and $t_{CN}$. Thus, NQDC tends to be attractive under the following three circumstances: 93

1. when corporate employers can earn greater after-tax investment income than their employees (presumably by lower tax rates);
2. when individual tax rates are falling; and
3. when corporate tax rates are rising.

The tax rates in the equations above are marginal tax rates. In the case of a corporation, they state the marginal tax benefit to deducting compensation. In the case of an executive, the equations state the marginal tax cost of including compensation.

2. Wage Neutrality Revisited

The wage neutrality principle is illustrated where all the ratios are the same. Here, $Q=1$, and there is no advantage or disadvantage to deferral. This highlights the important point that deferral of income is not inherently valuable where the deduction must be deferred as well.

Recall how, under the wage neutrality principle, the payment of wages might simply allocate the tax burden associated with economic profit. Suppose $F_{C}(N)=F_{I}(N)$, $t_{C0}=t$ and $t_{CN}=t_{IN}$. So, there is a single tax rate for the corporation and the executive (although the single rate might change over time). In this case, employer deductions and employee income always offset each other. This is so even if the rate changes so long as corporate and individual rates are the same after the change. Declining rates help the executive but hurt the corporation because the deduction is less valuable. The declining rate has, in fact, reallocated the tax burden from the employee to the employer. But it has not increased or decreased total revenues.

\[
\frac{1-t_{C0}}{1-t_{I0}} \times \frac{1-t_{IN}}{1-t_{CN}} \times \frac{F_{C}(N)}{F_{I}(N)} = Q
\]

The after-tax investment comparison is the same. This equation shows how structural changes in the tax system might affect the value of NQDC if both rates are increasing or decreasing. (If rates are moving in different directions, then the ratios in Equation 5 are sufficient.) NQDC has a tax advantage if corporate rates are lower today, but the rates are the same at time $N$. So, if the rate structure is converging, NQDC has an advantage if corporate rates are currently lower. It also has an advantage if rates are the same today, but individual rates are lower at time $N$. So, if rates are diverging, NQDC has an advantage if individual rates are lower in the future. Since the dynamics of this alternate equation would seem to depend more on tax law changes than on the cycles of individual or corporate earnings, it reveals less about potential planning.

93 These three elements have been identified in Scholes et al., supra note 29, at 214; see also Halperin, supra note 83, at 540 (discussing comparative advantage in after-tax returns).
Next, note how the stability of tax rates affects $Q$. Suppose $t_{co}=t_{cn}$
$F_c(N)=F_e(N)$ and $t_{io}=t_{in}$. So, there are two tax rates, one for the corporation
and one for the executive, and the two rates do not change over time. The
executive cannot move into a lower tax bracket in the future. The corporation
cannot move into a higher tax bracket. Here, again, $Q=1$, and deferral is not
valuable.

3. After-Tax Return Ratio

The first element of $Q$ highlights the possibility that corporate employers
can earn greater after-tax investment income than their executives.
Differences in the comparative abilities to earn after-tax returns might allow
the employee to shift investment income to the employer. This is a variant of
the classic problem of personal holding companies, which used the corporate
rate structure to shield investment income from high personal rates.\footnote{See \textsc{Boris I. Bittker \& James S. Eustice, \textit{Federal Income Taxation of Corporations \& Shareholders}} para. 7.20 (7th ed. 2004).} Or, corporations might have a greater ability to take advantage of tax preferences
that apply to investments. For example, corporations can deduct 70\% or more
of the value of corporate dividends received.\footnote{See \textsc{I.R.C. § 246b(3)(A) (2000).}} However, the dividends
received deduction is meager compared to the capital gains preference, which
is available only to individuals. This and other advantages are discussed
below.

Might the corporation have some economies of scale or bargaining
power over investment management services? These advantages would
translate into a greater ability to produce after-tax returns. Yet, it is hard to
imagine how the corporation could not allow the executive to take advantage
of such economies or power. For example, any investment advisors that the
corporation might hire could advise on the investment of NQDC or on the
investment of current compensation. Thus, the focus is on the comparative
taxation of investments earned by corporations and individuals.

4. Individual Rate Ratio

$Q$’s next element highlights the possibility that individual tax rates might
be falling. The corporation and the executive might have the same ability to
generate after-tax investment returns. If so, the sole determinants of $Q$ will be
the marginal corporate and individual rates. If corporate rates and earning
abilities are constant, then $Q$ is determined solely by individual rates.
The rate decline encourages an executive to shift income into a year with a lower tax bracket. The executive can average income over multiple periods. Declining individual rates may occur if an executive defers current income from prime earning years into retirement. Because taxable income may be lower in retirement, the executive may be in a lower bracket.

Exploiting declining individual rates may be the most serious tax issue of NQDC. One simple way of combating it would be to tax all distributions of NQDC at the highest marginal rate. If such a rule were adopted, \( t_{in} \) is always less than or equal to \( t_{in} \) (unless the rates are changed legislatively).

5. Corporate Rate Ratio

The final element of \( Q \) highlights the possibility that corporate tax rates might be increasing. Increasing corporate rates makes deferred compensation attractive. If individual rates and earning abilities are constant, then \( Q \) is—

\[
\frac{1-t_{in}}{1-t_{io}} = Q
\]

The reason is similar to that for decreasing individual rates. The corporate deduction is worth more if taken in a future year when marginal tax rates are higher. There may be less of a natural life cycle to corporate earnings than to individual earnings. In addition, corporations can carry back and carry forward any net losses to years in which they have taxable income. Thus, the marginal corporate tax rate in a loss year will not be zero. Nonetheless, the marginal corporate tax rate will be lower in a loss year than it would be in a profitable year. 96

Code \$ 162(m) limits the deduction of non-performance-based compensation paid to a public company’s top five executives. 97 The limit is \$1,000,000. If a corporation is subject to this limit, its marginal tax rate—with respect to the excess compensation—is essentially zero. By deferring compensation until the executive retires, the corporation can then fully

96 See infra notes 116–126 and accompanying text.
97 I.R.C. \$ 162(m) (2000). NQDC is not the only outlet for avoiding \$ 162(m). “Performance-based compensation” over \$1 million is always deducted. Many practitioners have long viewed this exception as a gaping hole in \$ 162(m). The IRS may, however, be increasing its scrutiny of \$ 162(m) in light of recent corporate scandals. See generally Daniel Nelson, Executive Compensation Deduction Limits Revisited, 106 TAX NOTES 304, 304 (2005).
deduct the amount paid. Thus, by statute, a corporation might face an increasing marginal tax rate.

E. Summary

This Part has shown that there are three ways in which NQDC can generate global tax savings and thus be costly to the fisc. These ways are: income averaging by executives, income averaging by corporations, and income shifting from executives to corporations.

Individual income averaging occurs because executives defer current salary into future periods. This produces global tax savings when the executive’s future marginal tax rate is lower than the current rate. Because tax rates are progressive and because compensation is typically deferred into nonproductive years, individual income averaging appears to be a significant problem of NQDC.

Corporate income averaging likewise occurs because corporations defer current deductions into the future. This produces global tax savings when the corporation’s future marginal tax rate is higher than the current rate. Tax rates for corporations are not as progressive as they are for individuals. Moreover, corporations do not have a natural life cycle of earnings as do individuals. The most important element of corporate income averaging appears to be avoiding the limits on deducting executive compensation over $1 million.

Income shifting from executives to corporations occurs because corporations are taxed on interim income from investments. If the corporation is subject to a lower effective rate on this income, global tax savings result.

The goal of the next Part is to examine these three elements in light of the Code. The conclusion is that individual income averaging and avoiding limits on deducting executive compensation are the most likely reasons for using NQDC.

IV. TAX AVOIDANCE THROUGH DEFERRED COMPENSATION

A. Likelihood of Falling Individual Rates

The first element to be examined is the ability of executives to shift income from high-tax years to low-tax years using NQDC. This homemade income averaging is different from the advantages of deferral that come with 401(k) plans which effectively grant tax exemption on investment income. Here the issue is solely comparing the rates in effect currently versus those in effect in the future.
The federal income tax is progressive, containing six nominal brackets ranging from 10% to 35%. The top rate applies to taxable income over $326,450 in 2005. These nominal brackets do not, however, accurately reflect true marginal income tax rates in the Code. The nominal rates are distorted by phase outs of exclusions and distortions at certain levels of income. Nonetheless, they do provide a reasonable idea of how tax burdens increase when taxable income increases.

An executive might be in a high rate bracket (for example, 35%) in 2005 but expects to be in a lower bracket (for example, 25%) in later years. He or she then has an incentive to defer the receipt of income to the later, low-bracket year. In their classic article against progressivity, Professors Blum and Kalven criticized the progressive rate structure itself on the grounds that it encourages this type of tax planning.

This increasing rate structure applies to taxable income, which is calculated every taxable year. For most executives and other individuals, the taxable year is the calendar year. Time—or at least the calendar year—is the common arbitrator for the income tax rate. Before 1986, however, the Code expressly allowed some income averaging by taxpayers. The sweeping tax changes of 1986 repealed these income averaging provisions.

98 The rates are 10%, 15%, 25%, 28%, 33%, and 35%. See I.R.C. § 1(a)-(c), (i) (2000); Rev. Proc. 2004-71 § 3.01, 2004-50 I.R.B. 971.

99 For example, itemized deductions begin to be phased out after a taxpayer reaches $145,950 of adjusted gross income (AGI) in 2005. See Rev. Proc. 2004-71 § 3.11, 2004-50 I.R.B. 971. For every dollar of AGI above this threshold, itemized deductions are reduced by 3%. See I.R.C. § 68(a) (2000). This phaseout is tantamount to a 3% increase in the marginal income tax rate. See STAFF OF JOINT COMMITTEE ON TAXATION, OVERVIEW OF PRESENT LAW AND ECONOMIC ANALYSIS RELATING TO MARGINAL TAX RATES AND THE PRESIDENT'S INDIVIDUAL INCOME TAX RATE PROPOSALS 37 (Comm. Print, 2001), available at http://house.gov/jct/x-6-01.pdf. So, while the phaseout applies, the 33% rate would be equivalent to a 34.99% rate. The phaseout ends after 80% of all itemized deductions have been eliminated. I.R.C. § 68(a)(2) (2000). Marginal rates can actually decline just after a phaseout has ended. Many other phaseouts exist in the Code beyond the one for itemized deductions. For example, the Joint Committee on Taxation identified twenty-three provisions affecting individual taxpayers that are subject to phaseout. See STAFF OF JOINT COMMITTEE ON TAXATION, OVERVIEW OF PRESENT LAW AND ISSUES RELATING TO INDIVIDUAL INCOME TAXES, tbl. 18, JCX 18-99 (Comm. Print, 1999); JOINT COMMITTEE ON TAXATION, PRESENT LAW AND ANALYSIS RELATING TO INDIVIDUAL EFFECTIVE MARGINAL TAX RATES, JCS-3-98 (Comm. Print, 1998).

100 See Walter J. Blum & Harry Kalven, Jr., The Uneasy Case for Progressive Taxation, 19 U. CHI. L. REV. 417 (1952) ("It is remarkable how much of the day to day work of the lawyer in the income tax field derives from the simple fact that the tax is progressive.").


102 See id. para. 3.5.5.
because the rate structure became so compressed. These averaging provisions have not returned, even though the top rates increased and the bottom rates fell after 1986.

NQDC, however, allows taxpayers to engage in homemade income averaging. An executive at a high rate today may defer income to a future period when (it is hoped) the rate will be lower. If the executive is always subject to the highest rate, however, deferral may bring no relief. In this respect, NQDC works in much the same way as income shifting among family members. If a mother is in the top rate bracket and her child is in the lowest, she has an incentive to shift income to the child. If the mother and child are in the same bracket, no such incentive exists. By comparison, NQDC shifts income from one period to another. Both involve attempts to minimize the impact of the progressive rate structure.

The assignment of income doctrine limits the ability of taxpayers to shift income to other taxpayers. The wellspring for this doctrine is Lucas v. Earl in which a husband and wife agreed

that any property either of us now has or may hereafter acquire . . . during the existence of our marriage . . . and all the proceeds, issues, and profits of any and all such property . . . is declared to be received, held, taken, and owned by us as joint tenants, and not otherwise, with the right of survivorship.

Justice Holmes said that the agreement would not shift any income tax burden from the husband to his wife. He said that

[t]here is no doubt that the statute could tax salaries to those who earned them and provide that the tax could not be escaped by anticipatory arrangements and contracts however skillfully devised to prevent the salary when paid from vesting even for a second in the man who earned it. That

105 See, e.g., Halperin, supra note 83, at 549; see also JAMES J. FREELAND ET AL., FUNDAMENTALS OF FEDERAL INCOME TAXATION 658 (13th ed. 2004) (presenting Rev. Rul. 60-31 under the heading "Do-It-Yourself Averaging").
106 An interpersonal shift also occurs between the employer and employee with respect to interim investment income.
108 Id. at 113-14. The couple made this agreement before the income tax arose. Thus, they were not intending to lower their tax bill, but were seeking the benefits of accidental planning.
seems to us the import of the statute before us and we think that no
distinction can be taken according to the motives leading to the arrangement
by which the fruits are attributed to a different tree from that on which they
grew.109

The fruit-and-tree analogy of Lucas v. Earl has deeply shaped the tax
jurisprudence of assignment of earned income.110 Income from personal
services is “fruit.” The person who performed the services is the “tree.”
Despite its richness, the fruit-tree metaphor is not always loved by tax
scholars, who rightly recognize the danger of extending it carelessly.111
Outside its purview of intrafamily assignments of earned income, the
metaphor loses its vigor and can produce strange results.112 Nonetheless, a
seasonal extension of the metaphor is worthy of consideration.

Perhaps the taxpayer is not just a fruit bearing tree, but is “like a tree
planted by the streams of water, that yields its fruit in its season.” Lucas v.
Earl focuses on assigning fruit to tree. NQDC, however, allows this year’s
fruit to count toward a future harvest. Why has the law not responded to this
temporal shift the way it responded to personal shifts in Lucas v. Earl?
Professor Marvin Chirelstein briefly but insightfully ponders this
inconsistency in his short treatise. He says,

[It may still be of some interest—perhaps only archaeological—to ask why
the Commissioner should have succeeded so well . . . in preventing the
assignment of earned income to other taxable persons, while largely failing
to prevent the assignment of such income to other taxable periods . . . . The
answer, most probably, is that the question of taxable person was not
thought to be constrained by accounting rules to the same degree as the
question of taxable period. [With assignments to other persons], the courts
and the Service were at liberty to invent rules of income attribution under
the general authority of § 61. By contrast, the taxpayer [with NQDC] could
draw support from the cash method itself, which apparently contains no
intrinsic distinction between short-term, involuntary deferrals and deferrals

109 Id.
110 See BITTKER & LOKKEN, supra note 15, para. 75.2.1.
111 See, e.g., Traci A. Sammeth, Note, Beyond the Fruit Tree: A Proposal for the
Revision of the Assignment of Income Doctrine—Caruth Corp. v. United States, 865 F.2d
644 (5th Cir. 1989), 65 WASH. L. REV. 229, 240 (1990); Lauren E. Sheridan, Note, Trees
in the Orchard or Fruit from the Trees?: The Case for Excluding Attorneys’ Contingent
112 Gregg D. Polsky, A Correct Analysis of the Tax Treatment of Contingent
Attorney’s Fee Arrangements: Enough with the Fruits and the Trees, 37 GA. L. REV. 57,
113 Psalms 1:3.
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which are extended and also prearranged. To tax both currently, however, would virtually be to abrogate the cash method of accounting. More generally, it may simply be that the courts have intuitively favored the idea of self-help income-averaging—which does, after all, appeal to one’s sense of equity—while viewing income-splitting as a dangerous avoidance device and one with a wide potential for mischief.\footnote{See Marvin A. Chirelstein, Federal Income Taxation 272–73 (9th ed. 2002); cf. I.R.S. Priv. Ltr. Rul. 82-43-001 (July 30, 1982) (refusing to apply assignment-of-income doctrine to deferred compensation).}

This is surely correct as a matter of doctrine, but the economics of personal and temporal income shifting are indistinguishable. Assignments of income allow high-rate taxpayers to shift income to low-rate taxpayers. NQDC allows taxpayers to shift income from high-rate years to low-rate years. Moreover, such shifts are likely to produce tax savings in practice. Executives (other than the very wealthiest) are very likely to face higher tax rates when they earn money than when they receive it via NQDC. The only limits are the modest control and security limitations of Code § 409A and economic benefit and constructive receipt doctrines.

B. Likelihood of Rising Corporate Tax Rates

As we have seen, executives have a systematic incentive to shift income to future periods. This incentive favors the use of NQDC. Do corporations have an incentive to shift deductions into future periods? If so, this would favor the use of NQDC as well. As we will see, there is no clear incentive to do this, except when payments are made to a top executive.

The marginal rate structure for corporations is less complicated than for individuals. The rate is 35% for taxable income of $18,333,333 or more. Most profitable public companies will be subject to this rate. The rate fluctuates between 34% and 39% for taxable income between $75,000 and $18,333,333. Rates of 15% and 25% apply at or below income of $75,000.\footnote{I.R.S., 2004 Instructions for Forms 1120 and 1120-A, at 21. The brackets are as follows:}

<table>
<thead>
<tr>
<th>Rate</th>
<th>From</th>
<th>To</th>
</tr>
</thead>
<tbody>
<tr>
<td>15%</td>
<td>$0.00</td>
<td>$50,000.00</td>
</tr>
<tr>
<td>25%</td>
<td>$50,000.00</td>
<td>$75,000.00</td>
</tr>
<tr>
<td>34%</td>
<td>$75,000.00</td>
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<td>39%</td>
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<td>34%</td>
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<td>35%</td>
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<tr>
<td>38%</td>
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<td>$18,333,333.00</td>
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A tentative candidate for deferral might be unprofitable corporations. This is somewhat counterfactual, because NQDC is used by almost all large corporations (profitable and unprofitable). Nonetheless, NQDC might be particularly costly when used by unprofitable ones.

If a corporation’s deductions exceed its gross income, it has incurred a “net operating loss.” For example, if deductions are $20 million and gross income is $5 million, the net operating loss is $15 million. The net operating loss essentially represents negative taxable income. The corporation may carry the net operating loss back to the prior two taxable years or forward to the subsequent twenty taxable years. However, the IRS does not pay interest on refunds or tax reductions due to net operating losses.

The provisions for net operating losses actually reduce the imperative for NQDC. This is because the net operating loss is an alternate income-averaging method. Purely refundable and purely nonrefundable corporate taxes—both of which are hypothetical—can illustrate the stakes involved. Suppose that the tax rate is 35%. Under a purely refundable tax, a current net loss of $1 million would result in a refund of $350,000. Thus, the marginal rate is 35%, whether or not the corporation is profitable. Under a purely nonrefundable tax, a current net loss of $1 million would result in no refund at all. Thus, the marginal rate for an unprofitable corporation is 0%, and the marginal rate for a profitable corporation is 35%.

In the real world, a net operating loss (i.e., negative taxable income) may be carried back two years and carried forward twenty years under current law. In one scenario, net operating losses make the system purely refundable. Suppose that the corporation can carry its current loss back to a prior, profitable year. Its current marginal tax rate would equal its marginal rate in the prior year when the loss is used. This rate may well be 34% or

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The uncouth 39% and 38% brackets are “bubble brackets” that phase out the advantages of lower marginal rates. See generally I.R.C. § 11(b)(1) (2000); BITTKER & EUSTICE, supra note 94, para. 5.01[1].

See supra note 4 and accompanying text.

See I.R.C. § 172(d) (2000). Net operating losses are more important to corporations than to individuals for two reasons. First, a corporation is more likely to have deductions that exceed income. Second, the deductions that go into calculating a net operating loss for an individual are more limited than for a corporation. See I.R.C. § 172(d)(4) (2000); BITTKER & EUSTICE, supra note 94, para. 5.03[4].

See BITTKER & LOKKEN, supra note 15, para. 25.10.1.


But cf. Halperin, supra note 83, at 540, 552 (contending that net operating losses reduce marginal corporate rates and make NQDC more attractive).


See SCHOLES ET AL., supra note 29, at 187 (“Scenario 1”).
35%. In effect, such a corporation is operating under a purely refundable system and a marginal rate of 34% or 35%.

Outside this scenario, net operating losses make the system partially refundable. Suppose that the unprofitable corporation must carry forward its loss. Thus, its current effective rate of tax is its marginal rate in the future year when the loss will ultimately be used, but discounted for time value of money. For example, assume the loss is used in five years. Let the discount rate be 5% and the future year rate be 35%. The effective marginal rate in the current year is about 27%. The result is the same if the corporation is currently profitable, but its current profits are being consumed by net operating losses that it carried forward from the past.

Under narrow assumptions, net operating losses may even reduce the effective marginal rate of a currently profitable corporation that has no net operating losses. The reason is that future losses might be carried back to the current year and fully offset current income. This would only occur when the future losses occur within two years and the future losses equal or exceed current income. Even under these narrow circumstances, the effect on the current marginal rate of effective taxation may be small.

In short, net operating losses push the corporate tax toward a refundable system, thereby increasing the effective marginal tax rate on unprofitable corporations. Essentially, the provisions for net operating losses tend to smooth the tax rates faced by companies, raising them in unprofitable years and perhaps even lowering them in profitable years. As a result, there is a weakened incentive for an unprofitable corporation to shift its deductions to a future (and hopefully profitable) year.

There is, however, a strong incentive to defer the compensation of the top five executives of publicly held companies. In general, a publicly held company cannot deduct compensation over $1 million paid to one of its top five officers. A major exception to this rule exempts certain performance-
based compensation. The $1 million limit applies to compensation paid to the executive if he or she is one of the top five executives during the taxable year of payment. So, no limit applies to compensation paid in years after the executive is no longer in the top five group. As a result, public companies often require executives to defer any base salary over $1 million.

An incentive might also exist to defer compensation if the corporation must wait to deduct the compensation anyway. If that is the case, then the corporation is not losing the immediate deduction by deferring. The most likely situation in which this would happen is when the corporation must capitalize compensation expense. Doctrinally, the capitalization of compensation expense is unclear, but should certainly occur under the right circumstances (e.g., the executive is working solely on the acquisition of another company). As a practical matter, compensation is probably not capitalized very often.

Unlike executives, corporations do not face a systematic likelihood that deferral will lower their tax bills. Even if the corporation is currently unprofitable, the use of net operating losses dampens any incentive to shift deductions to the future. One area in which there is a strong incentive is in the payment of compensation to the top five executives of a public company. Payments over $1 million are nondeductible. Thus, corporations would like to defer these payments (essentially averaging them) into periods when the recipient is no longer an executive and no longer subject to the limits.

C. Comparative Taxation of Investment Income

If corporations face lower rates on investment income, then executives could enjoy these lower rates as well through NQDC. Taxation of earnings at the corporate and shareholder level does not, however, disadvantage corporations in the provision of NQDC. Any income earned by the corporation to fund deferred compensation will not be distributed (and taxed) to shareholders. Stated a different way, the executive's claim is as a creditor, not as a shareholder.

For example, suppose we lived in a world with the following rates—

- Executives (compensation income) 35%
- Shareholders (corporate distributions) 35%

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128 See I.R.C. § 162(m)(4)(C) (2000). Stock options are often designed to fall within this exception.
130 See SIRKIN & CAGNEY, supra note 41, para. 2.02(4)(a).
Corporations (corporate income) 30%

Deferred compensation is still feasible, even though corporate income is subject to double taxation. Here, investment income is taxed to the corporation at 30%, but to the executive at 35%. This differential provides an incentive to NQDC. Suppose that the corporation sets aside funds, invests them, and pays 30% tax on the annual income. In the future, it pays out the funds to the executive. The shareholders are not implicated directly in this transaction. In essence, the corporation acts as a holding company for the executive with respect to NQDC. The shareholders and their tax rates are irrelevant. The only relevant measures are the tax rates of the corporation and the executive.

As for what is relevant, the rate structures for high-income executives and for profitable corporations look the same. Both are subject to statutory rates of 34% or 35%. Additional preferences or loopholes might, however, give one side a comparative advantage. Indeed, Professor Daniel Halperin argues for a special tax on employers that offer NQDC. 132 Halperin’s premise is that the income shift to employers would allow for the sheltering of investment income. 133 Halperin notes that the deductions for dividends received by corporations 134 and the use of net operating losses. 135

Corporations do enjoy reduced statutory rates on dividends. The dividends received deduction is a licit “shelter” that may give the employer/corporation some investment advantage. A corporation receives a deduction for at least 70% of the dividends received from another domestic corporation. 136 All of the dividends are deductible if received from a close affiliate of the payee (e.g., a subsidiary) or from a small business investment company. 137 As executives usually cannot invest in close affiliates of the employer, the relevant deduction is 70%.

Where the marginal corporate tax is 35%, the marginal rate on dividend income will be 10.5%. This appears to be a significant advantage when one

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133 Part of Halperin’s concern was that plans maintained by nongovernmental, tax-exempt organizations were not regulated. Id. at 540. These plans are now, however, covered by the strictures of Code § 457. But cf. Daniel Halperin, Letter to the Editor, Section 457 Should Be Replaced by a Special Tax on Investment Income, 100 TAX NOTES 730, 730 (2003) (arguing that special investment tax should apply to all deferred compensation plans).
134 The deduction was then 85% but is now 70%. See I.R.C. § 243(a)(1) (2000).
135 Halperin, supra note 83, at 552.
recalls that individuals pay a rate of 15% on dividends.\textsuperscript{138} However, the dividend yield on public companies is far less than the return from capital appreciation.\textsuperscript{139} Individuals—but not corporations—enjoy a 15% tax on long-term capital appreciation, whereas corporations are taxed at their ordinary rate (e.g., 34% or 35%).\textsuperscript{140} Overall, then, corporations appear to be comparatively disadvantaged in the area of equity investing.

Net operating losses were discussed in the previous section, where it was argued that unprofitable corporations had less incentive to shift deductions to the future. The reason is that net operating losses tend to raise marginal rates in unprofitable years by making losses partially refundable. For the same reason, executives have less incentive to shift investment income to unprofitable corporate employers. Again, allowing net operating losses dampens the incentive for income shifting.

Quantifying effective marginal tax rates in light of net operating losses and other factors is a challenge. The legal literature contains efforts at describing the average tax rates paid by corporations.\textsuperscript{141} The relevant measure for NQDC is, however, the marginal tax rate—how costly is it for a corporation to receive an extra dollar of income? Financial economists have tried to estimate the rates.\textsuperscript{142} For large public companies, data compiled by economist John Graham suggest that the effective marginal tax rate is around 30\% to 35\%.\textsuperscript{143} This result, when compared with the 15\% capital gains rate for individuals, suggests that, at least for large corporations, executives should be able to earn higher after-tax returns than their corporate employers.

A secondary advantage of investments held by an individual is the basis step up rules of Code § 1014. Under the step up rules, the tax basis of an

\textsuperscript{138} See I.R.C. § 1(h)(1)(c) (2000). However, the 15\% rate and the preference for dividends are set to expire at the end of 2008. Then, capital gains will be subject to a 20\% rate, and dividends will become subject to ordinary income rates. See Jobs and Growth Tax Relief Reconciliation Act of 2003, Pub. L. No. 108-27, 117 Stat. 758 (2003); BITTKER & LOKKEN, supra note 15, para. 46.2.3 n.12.


\textsuperscript{142} See SCHOLES ET AL., supra note 29, at 210 (citing sources).

asset equals its fair market value as of the owner's death. This is essentially government-provided life insurance to investors. The amount of the insurance is the tax bill on any unrealized appreciation in investment assets owned by the executive. The tax bill is not forgiven if the "investment" is in NQDC, which is treated as compensation (not as an investment). Thus, NQDC does not receive a step up in basis, and is fully taxable as income in respect of a decedent.

All of this is presented as a prima facie case that corporations have no tax advantage in investing. Proving this point definitively might be nearly impossible. A corporation might conceivably have an advantage in equity investing because of the realization requirement and differing cash flow needs. For example, we have assumed all along that the corporation will set aside assets to pay NQDC and sell those assets when its obligation becomes due. The corporation may, however, be able to pay the NQDC obligation using other sources, and might even keep the assets set aside for the next generation of executives. The conceptual point is that the corporation might not need to sell the set aside asset upon payout to the executive. If some other use can be found for the asset, then the corporation could conceivably hold the asset—and defer its own tax bill—indefinitely.

Moreover, tax shelters could conceivably (but may not inevitably) affect the marginal tax rate. A classic corporate tax shelter reduces taxes due without a significant reduction in economic income. Thus, where taxes are expressed as a percentage of economic income, tax shelters reduce the average tax rate. Unless tax shelters push the corporation into a lower tax bracket, tax shelters may not reduce marginal rates at all. Perhaps the appetite for shelters is related to the amount of taxable income the corporation would otherwise have. Corporate tax shelters are thus an issue if the extra income from NQDC "allows" a corporation to engage in more shelter activities, which would lower the marginal tax rate.

The strongest shelter-based argument against NQDC is that corporations can too easily shelter investment income. For example, corporate-owned life

\[144\] See I.R.C. § 1014(a)(1) (2000). If the estate was subject to estate tax, the relevant time may be six months after date if elected by the executor. See I.R.C. § 1014(a)(2) (2000).


\[146\] Cf. Black's Law Dictionary 1503 (8th ed. 2004) (defining a tax shelter as a “financial operation or investment strategy (such as a partnership or real-estate investment trust) that is created primarily for the purpose of reducing or deferring income-tax payments”).
insurance (COLI) is a common method for funding NQDC, 147 but also prominent as a tax shelter in its own right. 148 COLI is life insurance, owned by the corporation, on the lives of employees. Because policy proceeds and inside investment gains on the policy are tax free, COLI essentially allows the corporation to shelter investment income from taxation. 149 COLI policies are often taken out on all (or many) employees, prompting some to call COLI "dead janitors" or "dead peasants" insurance. 150 The large number of insured allows for much more frequent payments of the tax-free policy proceeds.

There is some debate over whether the tax savings of COLI are captured mainly by the employer or by the insurer. 151 Presumably, there is some efficiency in COLI to explain its widespread use. If so, NQDC may well represent a way for executives to share in the tax advantages of COLI. COLI works because it covers a wide group of employees. The executive could not purchase this type of policy directly, because the executive would not have an insurable interest. Nonetheless, it is reasonable to say that the problem is with COLI itself, which is exploited in ways other than through NQDC.

In short, however, most of the structural aspects of the Code suggest that individuals have an advantage over corporations in earning investment returns. Individuals receive an enormous preference for capital gains, and also receive a step up in basis upon death. Moreover, empirical data suggest that large corporations pay marginal tax of around 35%. The primary advantage of corporations might be their ability to engage in tax shelter transactions. To be relevant to NQDC, tax shelters would have to reduce marginal, not average tax rate. COLI is the most likely candidate for such a shelter. But, if COLI is a tax policy problem, it should be analyzed and remedied separately.

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147 See Clark Consulting, supra note 4, at 20 (reporting that 61% of respondents used COLI to fund NQDC when they do fund the plans).
148 See Mark P. Gergen, The Logic of Deterrence: Corporate Tax Shelters, 55 TAX L. REV. 255, 255–57 (2002). The classic COLI shelter involved purchasing the policy with borrowed funds. The borrowing produced interest deductions, while the policy produced tax free proceeds. This is essentially arbitrage, producing a gain because of the cost of borrowing is cheaper than the amounts received. The Code now contains some limits on this arrangement. See I.R.C. § 264 (2000).
151 See Martin, supra note 149, at 666.
D. Summary

Three plausible tax reasons exist for using NQDC. Executives might shift their income from high-tax years to low-tax years. In other words, they might average their income. Corporations might shift their deductions from low-tax years to high-tax years. Again, they might average their income. Finally, executives can shift investment income from themselves to their employers.

Only two reasons are compelling. First, NQDC gives lower- and middle-level executives an opportunity for income averaging. These are the executives who might expect to be in a lower tax bracket upon retirement. Second, NQDC allows the corporation to avoid the limits of Code § 162(m) in compensating its top five executives. This is a limited type of income averaging by the corporation.

Beyond avoiding Code § 162(m), corporations probably do not use NQDC to average their own income. If general corporate income averaging were prominent, then NQDC would be used primarily by less profitable corporations. Almost all public corporations, however, use NQDC. Moreover, unprofitable corporations can defer deductions (but without interest) using net operating losses. Income shifting from executives to corporations is not a compelling explanation either. Such shifting would save taxes only when corporations enjoy lower marginal effective rates. The enormous tax preference for capital gains, which is available only to individuals, belies this explanation. Empirical research on marginal corporate tax rates does not support it either.

V. REFORM OF DEFERRED COMPENSATION

A. Inadequacy of Current Doctrine and Prior Reforms

In governing NQDC, the tax laws look to constructive receipt and economic benefit. Constructive receipt limits the degree of control that an executive may have while deferring taxation. Economic benefit limits the degree of security an executive may have while deferring taxation. Thus, NQDC cannot be tailored to every risk preference, as there must be limits on the executive’s control and security. As a result, these doctrines make NQDC less attractive at the margin, and may control any cost to the fisc that comes from NQDC. Neither doctrine, however, addresses the interplay of corporate and executive tax rates that determines the costs of NQDC.

Recent reforms show that regulatory focus is still on security and control. Code § 409A was enacted in October 2004 in order to tighten the control and
security limitations of prior law. \(^{152}\) Two common NQDC techniques were banned. One was the so-called haircut distribution, which allowed an executive to withdraw benefits at will subject to a small forfeiture. The other was offshore rabbi trusts, which burdened the ability of general creditors to reach the assets of rabbi trusts.

Many employers, including Enron, designed NQDC plans that allowed an executive to withdraw benefits at any time, so long as the executive forfeited a portion, for example 10\%, of his or her benefits (thus the haircut). \(^{153}\) In fact, the Enron executives who took distributions on the eve of bankruptcy did so under the authority of a haircut provision. \(^{154}\) Of course, these Enron executives had taxable income on withdrawal. They had actual receipt of income. It is the rights left unexercised that implicate constructive receipt. So, the question is why they did not have constructive receipt of income in an earlier year—when they could have, but did not, take a distribution. The theory was that the 10\% forfeiture was a restriction on the executive that would prevent immediate taxation under constructive receipt. \(^{155}\) Although it was not clear whether this strategy would have survived IRS challenge under prior law, Code § 409A clearly disallows it.

Code § 409A also clarified the amount of risk to which an executive could be exposed. To reduce credit risk, some corporations established rabbi trusts in offshore (non-U.S.) jurisdictions. \(^{156}\) The theory behind these moves was that an effective rabbi trust need only make its assets available to general, unsecured creditors if the employer becomes insolvent or bankrupt. They do not need to be easily or readily available. The creditors would still need to get a judgment against the rabbi trust, and doing so would be


\(^{153}\) See Sirkin & Cagney, supra note 41, § 7.04[2]; Clark Consulting, supra note 4, at 22 (reporting that 56\% of their respondents allowed haircut distributions).


\(^{155}\) Cf. Treas. Reg. § 1.451-2(a) (2005) ("However, income is not constructively received if the taxpayer's control of its receipt is subject to substantial limitations or restrictions."). Often, such withdrawal rights were subject to the administrative discretion of the employer or its appointed committee. In theory, the discretion prevented any withdrawal right from being considered unqualified and thus subject to constructive receipt. Cf. Metcalfe v. Comm'r, 43 T.C.M. 1393 (1982) (holding that discretionary withdrawal rights do not trigger constructive receipt even if routinely granted). It was thought that this discretion added another layer of protection against a charge by the IRS of constructive receipt.

cumbersome if the trust were in a foreign jurisdiction. The hope, of course, was that the creditors would not bother, and the executives would keep their benefits even if the corporation became insolvent or went bankrupt. Starting on January 1, 2005, offshore rabbi-trusts do trigger current taxation (unless the services were actually performed offshore).

A more comprehensive (but unsuccessful) reform was proposed in 1978. In that year, the IRS proposed accrual taxation on elective deferrals of compensation. The proposed regulations said that

If . . . payment of an amount of a taxpayer’s basic or regular compensation fixed by contract, statute, or otherwise (or supplements to such compensation, such as bonuses, or increases in such compensation) is, at the taxpayer’s individual option, deferred to a taxable year later than that in which such amount would have been payable but for his exercise of such option, the amount shall be treated as received by the taxpayer in such earlier taxable year. For purposes of this paragraph, it is immaterial that the taxpayer’s rights in the amount payment of which is so deferred become forfeitable by reason of his exercise of the option to defer payment.

The proposed regulations looked to whether deferral was at the employee’s option. If so, the employee would be taxed immediately. A factual question would have existed as to whether deferral was at the employee’s option. The proposed regulations would have implemented an internal IRS proposal, made a year earlier, that would have taxed employees who exercised “dominion and control” over deferred compensation. The proposal looked to the historic assignment of income cases for analogy.

The proposed regulations were issued on February 3, 1978 and sparked immediate opposition from employers and their lobbyists. Congress quickly and emphatically killed the proposal. Section 132 of the Revenue Act of 1978 states that NQDC will be taxed according to “the principles set forth in regulations, rulings, and judicial decisions relating to deferred compensation.

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160 A parallel question exists with qualified retirement plans. A 401(k) plan is a qualified retirement plan with a cash or deferred arrangement (CODA). A CODA allows employees to elect between current compensation or contributions to their qualified retirement plans. See Treas. Reg. § 1.401(k)-1(a)(3)(i)–1(a)(4) (2005).
which were in effect on February 1, 1978."\textsuperscript{162} This went beyond simply undoing the proposed regulations. The 1978 Act also ossified the law of constructive receipt by prohibiting the IRS from reversing any of its prior rulings.\textsuperscript{163} The passage of Code § 409A has effectively freed the IRS and Treasury to regulate NQDC. Because Code § 409A clearly contemplates elective deferrals by executives, however, the 1978 proposed regulations will not be coming back without further legislation.

Obviously, the theory behind the 1978 proposed regulations was the same as the assignment of income. Nonetheless, it was actually not broad enough in applying this theory. By limiting itself to elective deferrals, the proposed regulations would have encouraged taxpayers to disguise NQDC so as to make it look nonelective. Electiveness would have likely joined control and security as the things to avoid in planning NQDC. Thus, the 1978 proposed regulations would have had the same effect as Code § 409A—restricting the types of arrangements that qualify for tax deferral. What is needed is a regime that taxes NQDC no more favorably than current compensation. This goal of tax neutrality is the next topic.

B. Goal of Tax Neutrality

NQDC can be contrasted with the U.S. system for qualified retirement plans. Such plans receive an express—and expensive—subsidy.\textsuperscript{164} Executives and other employees cannot, however, save unlimited amounts through qualified retirement plans. These plans must cover rank-and-file employees on a nondiscriminatory basis and are subject to benefit limitations and caps, which executives often hit. Thus, one could view these benefit caps and limitations as the limits on federal tax policy encouraging savings.

Any tax advantage for NQDC may actually discourage the establishment and maintenance of qualified retirement plans. A policy goal of qualified retirement plans is to ensure some coerced savings by lower-paid workers.\textsuperscript{165} The assumption is that highly compensated employees more greatly value subsidy than do lower-paid workers. This is because they can afford more savings and because they are in higher tax brackets. Highly compensated

\begin{footnotesize}

\textsuperscript{163} See, e.g., STAFF OF JOINT COMM. ON TAXATION, WRITTEN TESTIMONY OF THE STAFF OF THE JOINT COMMITTEE ON TAXATION ON EXECUTIVE COMPENSATION AND COMPANY-OWNED LIFE INSURANCE ARRANGEMENTS OF ENRON CORPORATION AND RELATED ENTITIES 16, 23 (JCX-36-03 Apr. 7, 2003).

\textsuperscript{164} See Part II. C.

\end{footnotesize}
employees cannot tap into the subsidy without giving some benefits to lower-paid workers. Giving a tax advantage to NQDC would undercut the policy goals behind qualified retirement plans.\footnote{Cf. Albertson’s, Inc. v. Comm’r, 42 F.3d 537, 545–546 (9th Cir. 1994) (observing that tax advantages for NQDC would undercut Congressional policy behind qualified plans).} Correcting any tax advantages to NQDC should be sufficient to ensure that the subsidy for qualified plans works properly.

So, NQDC should receive no tax advantage when compared with current compensation. But should it be disadvantaged? Doing so would appear to interfere with the commercial relationship between executive and corporation. For about a century, employers have given pensions to their employees,\footnote{JOHN H. LANGBEIN & BRUCE A. WOLK, PENSION AND EMPLOYEE BENEFIT LAW 3–17 (3d ed. 2000).} even though they have not always received tax advantages. Professor Steven Balsam gives the following reasons for the use of NQDC (and pensions generally):

1. NQDC can be structured to vest after a certain time, or can have backloaded formulae that give the highest benefits in later years.
2. NQDC encourages executives to stay with the employer.
3. Since NQDC are unfunded promises to pay, they temper the incentives to aggressive risk taking that stock options might otherwise give executives. For similar reasons, NQDC encourages executives to care about the employer’s long-term stability.
4. NQDC can be structured as a “bond on performance” which can be forfeited for misconduct.\footnote{See STEVEN BALSAM, AN INTRODUCTION TO EXECUTIVE COMPENSATION 181–84 (2002).}

Often, corporations will give executives a premium for deferring compensation, perhaps in order to align the interests of executives and corporations in the ways just listed. The premium comes through above-market rates of return to NQDC investments. Indeed, corporations often give a “private subsidy” to NQDC that mimics the government’s subsidy of qualified retirement plans.

The existence of above-market returns plays into rent-seeking theories of NQDC. Professors Lucian Bebchuk and Jesse Fried argue that public companies use NQDC to “camouflage” excessive executive compensation.\footnote{See LUCIAN BEBCHUK & JESSE FRIED, PAY WITHOUT PERFORMANCE 9–107 (2004).} According to their rent-seeking model, executives at public companies have wide latitude to set their own compensation. Shareholders are too weak to challenge executive pay. Boards of directors do not face any significant...
financial or legal consequences by failing to challenge excessive pay. Because of cronyism or lack of acumen, directors comply with executives’ requests for excessive pay. Finally, overpaid executives can use the structures of corporate law to prevent a hostile takeover, which might otherwise restrain excessive compensation.

These outside forces will remain inert unless executive compensation is perceived to be outrageous. An outrageous level of executive compensation will harm the reputations of the executives and complicit directors. It might also draw the ire of institutional investors. And, it might attract more interest from potential buyers in the hostile takeover market.

In order to avoid public outrage, executives will try to camouflage their total compensation. Under the rent-seeking model, camouflage is often the primary reason for the use of NQDC, along with equity-based compensation (like stock options), post-retirement perks, and post-retirement consulting arrangements. These compensation devices arguably obscure (or camouflage) the total level of executive compensation. 170 Bebchuk and Fried see a pattern that supports their theory of camouflaged compensation: Although firms often provide pensions and deferred compensation to lower-level employees, they do so only to the extent that these arrangements receive a tax subsidy. This pattern suggests that, absent such a subsidy, pensions and deferred compensation are generally not efficient. 171

This point is problematic for several reasons. ERISA effectively limits NQDC participation to “a select group of management or highly compensated employees.” 172 Employees outside of this group cannot participate. Even if they could, they probably would not be interested, as most lower-level employees do not fully avail themselves of their opportunity to participate in qualified retirement plans. 173 Because qualified retirement plans are superior to NQDC 174 and because lower-level employees are not fully contributing to their qualified retirement plans, there is no reason to extend NQDC coverage to lower-level employees (even if doing so were legal).

Bebchuk and Fried appear to be asserting that NQDC is offered only to executive rent-seekers. They do not, however, define this group. Perhaps it is

170 Bebchuk and Fried bifurcate NQDC between supplement executive retirement plans (SERPs) and deferred compensation. See id. at 95; see also infra notes 180–82 (discussing deferred compensation and SERPs).
171 BEBCHUK & FRIED, supra note 169, at 95.
172 See supra note 62 and accompanying text.
174 See SCHOLES ET AL., supra note 29, at 212.
the top five or ten executives of a corporation. For example, the SEC requires
detailed compensation disclosures for a security issuer’s top five executives
(the CEO and four other most highly compensated employees).\footnote{175} As to these
executives, corporations have a strong interest in deferring their pay. For the
top five officers of a public company, compensation over $1 million is not
deductible.\footnote{176} Abundant techniques allow corporations to avoid this
restriction. One of these is to defer taxable income to years in which the
executive would otherwise make under $1 million in compensation or would
not be one of the top five executives.\footnote{177}

Often, the goal with NQDC is not to limit participation to the top five or
ten executives.\footnote{178} Rather, it is to expand participation, occasionally in ways
that might violate the ERISA precept that NQDC be open only to a select
group of management or highly compensated employees. Because NQDC is
exempt from the vesting, funding, and fiduciary rules of ERISA, disgruntled
participants will sometimes challenge NQDC on the grounds that
participation is too wide.\footnote{179} If participation was not sufficiently limited to the
top hat group, then the exemptions will no longer apply.

The breadth of NQDC coverage can be illustrated by two standard plan
designs. For example, NQDC often gives extra benefits to an employee
whose \textit{qualified} plan benefits are subject to the limits of Code § 401(a)(17)
or § 415.\footnote{180} The § 401(a)(17) limit applies to any employee who makes more
than $210,000 in 2005.\footnote{181} Consider a qualified defined benefit plan that gives

\begin{footnotes}
\footnotetext[175]{See 17 C.F.R. § 229.402 (2005). This information is found in the issuer’s annual
proxy or annual report. \textit{See} U.S. Securities and Exchange Comm’n, Executive
Compensation: A Guide for Investors, \url{http://www.sec.gov/investor/pubs/execomp0803.htm} (last visited Apr. 11,
2006); U.S. Securities and Exchange Commission, Executive Compensation,
\url{http://www.sec.gov/answers/execomp.htm} (last visited Apr. 11, 2006).}

\footnotetext[176]{See I.R.C. § 162(m) (2000).}

\footnotetext[177]{See BITTKER & LOKKEN, \textit{supra} note 15, at para. 64.6 (“\text{[T]he deduction
limitation does not apply to amounts earned under a nonqualified deferred compensation
agreement while an employee was a covered employee if the employee is not covered
when the compensation is paid (e.g., after retirement).”)) Performance-based pay and
stock options are also exempt. \textit{See} id.}

\footnotetext[178]{See Bronstein & Levin, \textit{supra} note 7, at 216. For example, Enron Corporation
offered NQDC participation to about 300 of its employees. \textit{See} STAFF OF JOINT COMM.
ON TAXATION, \textit{supra} note 154, at 604.}

\footnotetext[179]{See, \textit{e.g.}, Demery v. Extebank Deferred Compensation Plan (B), 216 F.3d 283
(2d Cir. 2000).}

\footnotetext[180]{Such plans are usually called Supplement Executive Retirement Plans (or
SERPs). They are very common. \textit{See} Clark Consulting, \textit{supra} note 4, at 26 (reporting that
83% of respondents have SERPs).}

\end{footnotes}
an employee a pension at age sixty-five equal to one-percent times final average pay times years of service. An employee who makes $400,000 per year and has thirty years of service would have earned a pension equal to $120,000 per year if Code § 401(a)(17) did not apply. However, § 401(a)(17) prohibits the qualified plan from counting compensation over $210,000. So, the pension for the hypothetical employee is limited to $63,000 per year. A standard NQDC design would give the employee an extra benefit of $57,000 per year at age sixty-five (i.e., $120,000 minus $63,000). Such plans are often open to any employee who is participating in a qualified defined benefit plan and is making more than $210,000 per year.

NQDC can operate in a similar, but more elective, fashion when employees maximize their elective deferrals to a 401(k) plan. For year 2005, the limit on 401(k) contributions is $14,000. An employer might allow an employee who hits this limit to defer extra amounts to an NQDC plan, which might mirror the 401(k) plan. Such plans are often open to all employees who maximize their 401(k) contributions.

So, NQDC cannot solely be a special perk reserved for the top five or ten executives of a company. Rather, it is often given to all employees who make more than $210,000 per year. The lack of participation by lower-paid employees is easily explainable by the top hat restrictions of ERISA. The active participation by the top five executives is easily explainable by the deduction rules of Code § 162(m).

In summary, NQDC can be best explained by tax efficiency or business necessity. If it were solely a rent-seeking device, participation in such plans would not be so wide. Removing the tax incentives for NQDC should be the focus of reform, as discussed in the next two sections.

C. First Best: Putting Deferred Compensation on the Accrual Method

One fact is indispensable to the current taxation of NQDC—an unfunded promise to pay cash in the future is not considered "property." Thus, it is beyond the reach of Code § 83 and the economic benefit doctrine. From this point, taxpayers can navigate the weaker doctrine of constructive receipt by ensuring the executive does not have too much control. Code § 409A maps this region with new clarity.

Professor Daniel Halperin has criticized possible accrual taxation of NQDC on two grounds. First, benefits might never be paid even though the

183 See Treas. Reg. § 1.83-3(e) (2005) ("For purposes of section 83 and the regulations thereunder, the term 'property' includes real and personal property other than either money or an unfunded and unsecured promise to pay money or property in the future."); Rev. Rul. 60-31, 1960-1 C.B. 174.
executive was taxed. This could occur if the plan had forfeitures based on mortality or if the employer goes bankrupt. Second, accrual taxation would lead to income bunching in the year when earned.

NQDC is essentially a security of the corporate employer. Despite the executives' views on the matter, losses on NQDC should be treated like any other investment loss. This is a significant but surmountable problem. Suppose that an employer makes an unsecured promise to pay a fifty-five year-old employee a benefit of $100,000 per year for life starting at age sixty-five. Assume that the present value of this promise is determined to be $500,000. At the 35% rate, this leads to tax of $175,000. It is possible, then, for the employee to pay tax without receiving any benefits if he dies before reaching age sixty-five. The same is true if his employer goes bankrupt and fails to pay any benefits. Recognition of a deductible loss would be in order in either case. Where the employer goes bankrupt, the employee could probably take a loss deduction under Code § 165. The employee's estate might have difficulty claiming a deduction if the employee died prematurely because the risk of forfeiture upon death was part of the bargain.

Of course, allowing a deduction upon loss does not keep the executive whole. Suppose that the executive includes $500,000 in income in 2005 but deducts $500,000 in 2010 because of the employer's bankruptcy. One might initially object that the executive has given the government an interest-free loan for five years but has received nothing of value in the end. The


185 This deduction would not be subject to the two-percent floor or phase out. See I.R.C. § § 67(b)(3), 68(c)(3) (2000).

186 See Rev. Rul. 72-193, 1972-1 C.B. 58. Two issues would bear on deductibility if payments end on death. First, if the deferred compensation plan were taxed as an annuity contract under § 72, a deduction would be allowed under § 72(b)(3). Second, if cessation were considered a "loss", it might be deductible under § 165(a).
executive (or his heirs) would certainly feel that way. Yet, the treatment would be the same if the executive purchased any other investment asset that later became worthless.

The other criticism of the accrual approach is the bunching of income. In other words, executives are being taxed on more income in the years when they earn it. This critique essentially condones the income averaging elements of NQDC. A large part of this Article, however, has argued that income averaging is the most significant problem with NQDC and should be banished from the tax laws.

Taxing the unfunded promise to pay as property would solve most of the tax problems described above. NQDC generates tax savings to the parties because it exploits falling individual rates, rising corporate rates, and different rates between corporations and individuals. These problems can be traced to the fact that the law allows for deferred taxation on current compensation.

It need not be so. Unlike stock options, NQDC does not have any particularly controversial issues of public accounting. Even though the employer defers its tax deduction and actual payment, it must take a current charge to earnings as NQDC benefits are earned. Interest credited to the executives is a charge as well, offset by any interest earned by the employer in funding the arrangement.

The Code even contains a system for taxing NQDC on an accrual basis. While the income tax defers taxation, the Federal Insurance Contributions Act (FICA) does not. FICA levies taxes to fund the Social Security and Medicare programs. The Social Security tax is 6.2% of wages payable by the employer and by the employee. (That is, each pays a 6.2% tax.) Wages above the wage base ($90,000 in 2005) are exempt from the Social Security tax. The Medicare tax is 1.45% of wages payable by the

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187 Cf. Halperin, supra note 83, at 541 ("[E]mployees might find it difficult to understand why they should be taxed on money that they may never receive.").
188 See Halperin, supra note 83, at 542.
189 See id. at 186–87.
employer\(^{196}\) and by the employee.\(^{197}\) (Again, each pays a 1.45% tax.) The Medicare tax applies to all wages without limit.\(^{198}\)

NQDC is subject to FICA taxation when the benefits are no longer subject to a substantial risk of forfeiture.\(^{199}\) This is essentially an accrual system, with the existence of a substantial risk of forfeiture following Code § 83.\(^{200}\) Only the initial grant of NQDC is subject to FICA taxation. Earnings attributable to a previously taxed grant are exempt.

Because of immediate taxation and the wage base, deferred compensation enjoys a de facto exemption from the 6.2% Social Security tax. For example, suppose that an executive earns $500,000 in 2005, and defers $100,000 of it to 2015. Only $90,000 is subject to the Social Security tax in 2005. When the deferred compensation is paid in 2015, it will not be subject to Social Security tax then either (whether or not the executive has any other income).

Thus, the only relevant employment tax is the 1.45% Medicare tax. Suppose that an executive defers $100,000 in 2005, payable in 2015 with 7% annual interest. The $100,000 will be subject to Medicare tax in 2005. The 7% earnings, however, will not be taxed in 2005, 2015, or any other year.\(^{201}\)

The FICA regulations are a starting point for income taxation, but there would need to be some mechanism for taxing earnings. As noted above, the FICA regulations tax the base amount of NQDC when it is initially earned. Any earnings on the base amount are not themselves subject to FICA tax. The most obvious type of earnings is an investment return. If an account with $100,000 is established and pays a reasonable amount of interest (say, five percent), then the account generates $5,000 of income in the first year. Another type (less obvious and less frequent) is mortality gains. Suppose the NQDC promise is to pay an annuity of $100,000 per year at age sixty-five but to pay nothing if the executive dies before that time. The initial promise must be discounted to reflect mortality risk and the time value of money.\(^{202}\) Each year that passes will increase the value of the promise because both discounts will decrease.


\(^{198}\) See Treas. Reg. § 1.3121(v)(2)-1(d)(1) (2005) ("However, because there is no wage base limitation for the HI portion of FICA for years after 1993, the entire amount deferred (in addition to all other wages) is subject to the HI tax for the year and, thus, will not be considered taken into account for purposes of this section unless the HI tax relating to the amount deferred is actually paid.").


Here are three plausible means to tax earnings on NQDC under a system of accrual taxation:

*Mark-to-market taxation.* All gains or losses, whether realized or not, on NQDC would be reflected in income every year. This mark-to-market system is often thought of as an ideal system of taxation, but it is rare in the Code.\(^{203}\) One might legitimately claim that such a system would disadvantage NQDC, because other investments by the executive are not subject to mark-to-market taxation.

*Deferred taxation.* If NQDC is paid in a lump sum, then the reformed Code could simply tax the executive on the total amount received minus the amount previously subject to tax. This would give the executive “basis” or “investment in the contract” of the initial grant. Problems arise if NQDC is paid in installments. One method would be to tax the executive only after the basis or investment in the contract has been fully recovered. Suppose that the initial grant was $100,000, but that the executive will ultimately receive ten payments of $15,000 each. The first six payments would be received tax free. Of the seventh payment, $10,000 would not be taxed. The rest of the seventh payment ($5,000), along with the eighth, ninth, and tenth would be fully taxed.

*Ratable recovery.* The method just described applied to annuity contracts before 1934.\(^{204}\) Since then, annuitants recover basis ratably. In the example just given, the executive would recover $10,000 of his or her investment in the contract upon each $15,000 payment.\(^{205}\)

Such would be the treatment if the corporation had transferred a commercial annuity to the executive rather than making the NQDC promise. The executive would pay tax on the value of the annuity when it becomes substantially vested.\(^{206}\) However, the employee would pay no further tax on the annuity until payments commence. Future payments under the contract are, in part, financed by income that the insurer receives on the initial purchase price.\(^{207}\) Future payments may also be financed, in part, by the forfeitures of other annuity holders who suffer early deaths. Once payments start, the annuitant/executive is taxed on these gains. The annuitant/executive must also be allowed to recover his or her “investment in the contract” (i.e.,


\(^{204}\) *See BITTKER & LOKKEN*, supra note 15, at para. 12.3.1.

\(^{205}\) *See I.R.C. § 72 (2000); See BITTKER & LOKKEN, supra note 15, at para. 12.3.2.

\(^{206}\) *See I.R.C. § 403(c) (2000) (applying § 83 principles to the taxation of nonqualified annuities); supra notes 34–44 and accompanying text (discussing § 83 principles).

\(^{207}\) *But cf.* I.R.C. § 72(u) (2000) (imposing tax on the income associated with annuity contracts owned by policy holders who are not natural persons).
Allocating payments between gains and investment in the contract is the province of Code § 72.

A remaining obstacle to accrual taxation is assigning a current value to the NQDC promise. Actuarial principles solve some of this when the problem is valuing mortality risks and the like. The biggest problem, however, is the credit risk of the employer. Deferral with a small, shaky company is different from deferral with a Fortune 100 giant. Voluntary deferrals might signal the value. Treating voluntary deferrals differently reintroduces the problems of the 1978 proposed regulations discussed above.

The FICA regulations essentially value unsecured promises to pay at their face value. The error might be acceptable in the FICA context because the rate of taxation is so low. And, maybe it is acceptable in income taxation as well, particularly since taxation on earnings would likely be deferred. The problem might disappear, however, under a system of current taxation. Executives and employers may well look to irrevocably funded arrangements. There is no reason to discourage such arrangements, and they should not be subject to the burdensome double taxation under current law as described below. 208

A final problem would be the treatment of NQDC under Code § 162(m), which limits compensation deductions to $1 million for the top five executives of a public company. Current law allows NQDC to escape these limits because payments are made in the future, after the executive is no longer employed (and no longer part of the top five group). How would Code § 162(m) apply under an accrual system? The issue is what one thinks of Code § 162(m), not what one thinks of NQDC. A supporter of Code § 162(m) would likely embrace accrual taxation as it would make avoidance even harder. An opponent would likely want, at a minimum, to retain the status quo and allow NQDC to escape the limits of Code § 162(m). NQDC reform could accommodate either position.

In summary, NQDC can and should be taxed on a current basis. The most significant difficulties would be taxing earnings on the initial award of NQDC and actually valuing the award. These difficulties should be surmountable. If they prove too difficult politically, an effective second best solution might be in order.

D. Second Best: Taxing Executive at Highest Marginal Rate for Individuals

A simple, second best solution would curtail many of the advantages of NQDC. This is taxing NQDC at the highest marginal rates that apply to

208 See infra notes 217–23 and accompanying text.
individuals. Recall that NQDC has three possible tax advantages: shifting
individual income to low-tax years, shifting corporation deductions to high
tax years, and shifting investment taxation from individuals to corporations.
The structure of the Code suggests that the first of these advantages is
probably the most serious.\footnote{209}

Such an approach has precedence where income shifting is problematic.
Under the so-called kiddie tax,\footnote{210} a child under age fourteen must pay tax on
unearned income at his or her parents' rate. The kiddie tax was enacted to
curtail income shifting from high-bracket parents to low-bracket children.\footnote{211}
Another example is the drastically compressed tax brackets that apply to non­
grantor trusts. Married couples filing jointly reach the maximum rate of 35%
only after they reach $326,450 of income. Trusts, however, are subject to the
maximum rate after they reach only $9,750 of income.\footnote{212} Similarly, the Code
imposes a special tax on personal holding companies, which are “corporations
controlled by a small number of individuals and deriving prescribed percentages of their income from specified, mostly passive sources.”\footnote{213}
The purpose of these special rules is to curtail income shifting
from high-bracket individuals to low-bracket entities.

A tentative concern might be the blanket application of the highest
marginal rate regardless of the personal situation of the executive receiving
benefits. This concern was obviously overcome in the trust context. In the
NQDC context, ERISA effectively limits participation to highly compensated
employees. Under 2005 rates, the 33% bracket applies to a married-filing­
jointly couple with more than $182,800.\footnote{214} Anyone with less taxable income
than that is questionable as an NQDC participant.\footnote{215}

Some might complain that such a special tax generates more complexity.
NQDC is already complicated, and a special tax would put less pressure on
administering the complexities of Code § 409A, the constructive receipt
doctrine, and the economic benefit doctrine. A principled complaint should

\footnote{209} Analyzing NQDC empirically is difficult. Before 2005, employers reported
distributions to employees on boxes 1 and 11 of IRS Form W-2. However, there was no
designation for accruals. The accruals should have been reported as Medicare wages on
box 5, but would have been excluded from the definition of taxable wages on box 1.
Other items, such as 401(k) contributions, would be in box 5 but not box 1.
\footnote{210} I.R.C. § 1(g) (2000).
\footnote{211} See STAFF OF THE J. COMM. ON TAXATION, 99TH CONG., GENERAL EXPLANATION
\footnote{212} I.R.C. § 1(e) (2000); Rev. Proc. 2004-71, supra note 98, at § 3.01.

\footnote{213} BITTKE\& LOKKEN, supra note 15, at ¶ 99.2.1.
\footnote{214} See Rev. Proc. 2004-71, supra note 98, § 3.01.
\footnote{215} Certification by the Social Security Administration should be a prerequisite to
avoid manipulation.
lead one to conclude, however, that accrual taxation is the best system—particularly because it already exists for employment taxation. One unwilling to embrace the first best because of perceived harshness should not have standing to reject the second best because of any complexity.

Another concern might be that such a special tax could be more burdensome than accrual taxation. Suppose a plausible case in which the falling rates faced by an individual are offset by the higher tax on investments paid by the corporation. Under current law, NQDC might be tax neutral. Imposing the special tax would disadvantage NQDC when compared with current compensation. A possible solution to this problem would be to allow the parties to elect either accrual taxation (i.e., the first best) or deferred taxation at the highest rate (i.e., the second best). Something like this election exists in the taxation of property transfers under Code § 83(b).

Even under current law, the parties will occasionally forgo tax deferral and more fully secure the benefits. This can be done with a "secular trust." (The name and purpose of the rabbi trust are inverted.) Assets of the secular trust cannot be reached by the employer’s creditors. The employee, however, will be subject to immediate taxation when amounts are credited to him or her under the NQDC plan (even though actual payment will be deferred). The employer will receive an immediate deduction for these amounts.

The taxation of contributions to a secular trust is sensible. The executive has recognized taxable income under the economic benefit doctrine. Because of this recognition, the corporation should be entitled to take an immediate tax deduction. There are two more elements beyond the taxation of contributions: taxation of earnings to the trust and taxation of distributions to the corporation. Technical problems in the Code, exacerbated by the IRS ruling positions, complicate these elements.

Executives are taxed on earnings and appreciation (both realized and unrealized) held in the trust on a mark-to-market basis. So, unrealized

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217 Although the secular trust might be exempt from the employer’s creditors, it might be subject to the employee’s creditors depending on the format used. An employer-settled secular trust would likely be subject to the spendthrift provisions of ERISA. See ERISA § 206(d)(1), 29 U.S.C. § 1056 (2005) ("Each pension plan shall provide that benefits provided under the plan may not be assigned or alienated."). An employee-settled secular trust might not be subject to ERISA at all. SIRKIN & CAGNEY, supra note 41, § 8.04[2][c][ii]. Rather, state trust law might preclude effective protection against the employee’s creditors.

218 I.R.C. § 402(b)(4)(A) (2000). Section 402(b)(4)(A) applies only to trusts that fail to satisfy the nondiscrimination rules of § 410(b) or § 401(a)(26). Because they benefit
capital appreciation would be taxed to the employee at ordinary tax rates. This extraordinary treatment would not occur if the executive owned the assets directly or if the trust were taxed under the rules that usually apply to private trusts. 219

Mark-to-market treatment should be more than enough income tax. But, the Code does not stop there. 220 Because the trust is a separate taxable entity, it will pay tax on realized income as well. 221 This second level of taxation can be avoided if the trust pays its income to the executive annually because the trust can deduct its "distributable net income." 222

All of these problems could be solved rather elegantly by recourse to the trust-taxation rules under subchapter J. 223 As under current law, a corporation that contributes to a nongrantor trust would get an immediate deduction for the contribution, and the executive would have income. The corporation should have no more connection to the taxation of the trust. After the contribution, undistributed trust income should be taxed to the trust, and distributed trust income should be taxed to the executive. Subchapter J would work well in taxing funded executive compensation because it was designed to prevent income shifting in the first place.

In summary, most of the gains from accrual taxation could be obtained by allowing tax deferral but taxing the executive at the highest marginal rates. Such an approach would largely keep intact the current regime of taxation, but would reduce the costs of income shifting. The approach could even be elective, with a choice between it and full accrual taxation. The approach has precedence with the kiddie tax and subchapter J. Indeed,
subchapter J itself should be the regime for taxing fully funded NQDC benefits.

VI. CONCLUSION

NQDC needs reform, as it allows for deferred taxation on current compensation. Executives (with the help of their employers) can shift taxation from high-tax earning years to low-tax retirement years. High-tax executives may also have the opportunity to shift investment income to their low-tax employers. Thus, the choice between payment today and payment in the future is distorted by the implicit (and potentially costly) tax benefits.

Unfortunately, the reforms of Code § 409A were the product of new corporate scandals and old tax doctrines. The result might make deferring the receipt of compensation somewhat less palatable for executives because they face stricter limits on their security and control. Those executives and corporations who still choose to defer receipt of compensation will face the same economics and taxation as before.

Full reform would recognize that NQDC is simply property, a security in the corporation. The executive performs services for this security rather than for current compensation. Thus, full reform would require that the executive be taxed when NQDC is earned, rather than when cash payments are made. A second best reform would allow for tax deferral but would tax the ultimate payments at the highest marginal rate. Such a regime would eliminate the problem of shifting compensation from high-tax earning years to low-tax retirement years. Moreover, such a regime is similar to others that prevent income shifting (such as the kiddie tax and the compressed rate schedules that apply to trusts).