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Executive Compensation and Tax Neutrality: Taxing the Investment Component of Deferred Compensation

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EXECUTIVE COMPENSATION AND TAX NEUTRALITY: TAXING THE INVESTMENT COMPONENT OF DEFERRED COMPENSATION

Eric D. Chason*

INTRODUCTION

Corporate executives and investment fund managers are not only paid more than the rest of us, but they are paid differently as well. Yes, they get semi-monthly paychecks and 401(k) matches. But the titans of American capitalism receive the bulk of their oft-criticized compensation through stock options and plans of deferred compensation.1 The size of executive pay packages has attracted steady and sustained attention from Congress and scholars for years, focused ever more sharply by the financial crisis of 2008-2009.2 Tax scholarship in particular has often focused on whether Congress could and should control the size of executive pay through the Internal Revenue Code.3 Until recently, traditional tax policy concerns, like the

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The timing of income from executive compensation reemerged as a prime consideration after the passage of § 409A of the Code in 2004. Section 409A addressed deferred compensation plans, which allow executives to earn compensation in one year but pay tax in the future when they actually receive payment. Before § 409A, deferred compensation was barely—if at all—regulated by weak common law and regulatory doctrines that allowed employers and employees to defer the tax consequences of compensation nearly at will. With the passage of § 409A in 2004, however, employers’ and employees’ ability to achieve deferral was restricted. In the years to follow, there has been a flourishing of scholarship that examines the timing and character of income from executive compensation. The focus of this Article is on the timing of income from deferred compensation (also called nonqualified deferred compensation or executive pensions). It does not address other elements of executive compensation such as stock options, or the “carried interests” held by investment-fund managers.

A simple example can be used to explain the structure of deferred compensation. The classic account from the legal academy is Daniel I. Halperin, Interest in Disguise: Taxing the “Time Value of Money,” 95 YALE L.J. 506 (1986), which analyzed several time-value of money transactions, including deferred compensation. Professor Halperin was also the first to call for a “special tax” on deferred compensation, a call reiterated and refined in this Article. The classic account from economics is Myron Scholes & Merton Miller, Executive Compensation, Taxes, and Incentives, in FINANCIAL ECONOMICS: ESSAYS IN HONOR OF PAUL COOTNER 179-201 (1982). American Jobs Creation Act of 2004, Pub. L. No. 108-357, § 885, 118 Stat. 1418, 1634 (2004).


My reluctance to address stock options comes from their vesting dynamics. The holder of a compensatory stock option is never truly vested in the option, because she must either forfeit or exercise the option upon termination of employment. See SIMON BENNINGA, FINANCIAL MODELING 467 (3d ed. 2008). This Article attempts to bifurcate deferred compensation into compensation and investment components, but bifurcating options is difficult (perhaps impossible) because of the vesting dynamics.

Taxing deferred compensation is a pure timing issue, whereas carried interests involve characterization as capital gains and interactions with the partnership tax provisions of the Code. For background, see Victor Fleischer, Two and Twenty: Taxing Partnership Profits in Private Equity Funds, 83 N.Y.U. L. REV. 1 (2008).
compensation and give a rough outline of tax theory to date. Suppose that an executive and her employer are negotiating her salary for the following year. The employer gives the executive a choice between $100,000 of extra cash compensation paid one year later, or $200,000 of extra cash compensation paid ten years later. It should be no surprise that choosing the $100,000 immediate payment results in immediate taxation to the executive. Choosing the $200,000, however, allows the executive to defer the tax bill for ten years when actual payment occurs. The price of the executive’s tax deferral, however, is that the employer must defer its deduction as well.9

Ideally, there would be no tax advantage or disadvantage from deferred compensation, which would thrive or die based on its economic usefulness. So the primary issue for tax theorists is whether deferred compensation has any tax advantages at all. Because tax deferral forces the employer to defer its deduction, it is difficult to tell whether deferral is actually advantageous. One clear advantage is that some employees can essentially engage in income averaging, deferring current compensation into their retirement years when their marginal tax rates might be lower.10 Another supposed advantage is that deferred compensation allows low-tax employers to hold investment assets as proxies for their high-tax employees.11

This Article attempts to build on prior work in the field to provide a more conceptual basis for understanding the tax advantages of deferred compensation. Toward this goal, this Article argues that deferred compensation is best viewed as a combination of compensation and investment components.12 An investment component must exist because employees would not ordinarily defer current compensation without the promise of interest or other investment potential. After breaking down deferred compensation into separate compensation and investment components, one can measure the adequacy of current law, because current law already provides straightforward rules for taxing simple compensation and investment transactions.

The established rules for taxing these simple transactions provide the basis for the normative proposal of this Article. Differences in the taxation of equivalent transactions create tax-planning opportunities, which are almost always bad for society.13 In brief, the existence of tax advantages attracts investments, potentially crowding out superior investments with higher pre-tax value. Indeed, tax planning itself

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9 See I.R.C. § 404(a)(5) (West 2010).
10 See infra Part II.D.
11 See infra Part II.A.
12 See also Yale & Polsky, supra note 6, at 575 (referring to the "two components of deferred compensation arrangements, the investment yield and the compensatory element").
involves the deployment of economic resources that could arguably be put to more productive use. Moreover, because only highly compensated employees can participate, deferred compensation benefits only well-off taxpayers, threatening the distributive policy of the tax system.

Thus, the primary measure of current law is how well it achieves parity with the taxation of the equivalent compensation and investment transactions. While current law adequately taxes the compensation component of deferred compensation, it fails to tax the investment component at all. In essence, deferred compensation allows employers and executives to opt out of the established system for taxing investment transactions. Using interest on debt as an example, deferred compensation effectively allows the employer to give tax-exempt interest to the employee, so long as the employer is willing to forgo its interest deduction.

Armed with this insight, this Article sets out to cure the failure of current law and find a way to ensure neutrality between deferred compensation and the equivalent compensation and investment transactions. As deferred compensation can serve important nontax goals (like managing agency costs), reform should be administrable and cure the failures of current law without imposing any additional burdens on deferred compensation. These constraints lead to a proposal for imposing a "special tax" on the payment of deferred compensation. Unlike prior proposals, the special tax proposed in this Article would be levied only when deferred compensation is actually paid. Again, using interest as an example, the special tax eliminates the ability of the employer to grant tax-exempt interest to the employee. At the same time, the employer would see its interest deduction restored.

In a prior article, this Author argued that employees should pay tax on deferred compensation at the highest marginal rate for individuals. The prior proposal, along with the one made in this Article, would effectively neutralize the tax advantages of deferred compensation. Passing these proposals would actually allow Congress to simplify the world of deferred compensation. The recent trend of legislative action has been to make deferral harder to achieve without altering the benefits of deferral; once achieved, however, deferral offers the same tax advantages that it always has. Eliminating those tax advantages would allow Congress to repeal the burdensome and ineffective system of regulating deferred compensation found in § 409A of the Code.

This Article is organized as follows. Part I provides a brief overview of deferred compensation and a framework for analyzing it. Deferred compensation is best viewed as a combination of debt and

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14 See infra note 128 and accompanying text.
investment components, each giving rise to claims by the IRS. Part II summarizes prior proposals for taxing deferred compensation. Part III provides a conceptual framework for current-law taxation of deferred compensation. While current law adequately taxes the compensation component of deferred compensation, it does not tax the investment component at all. Part IV proposes a "special tax" that would cure this failure where the investment component of deferred compensation is a simple debt transaction. Part V expands and refines this proposal, making it applicable to a wide array of deferred compensation arrangements. The Conclusion contains some concluding remarks, as well as appendices containing some technical details.

I. BACKGROUND ON DEFERRED COMPENSATION AND KINDRED ITEMS

A. Nonqualified Deferred Compensation: Taxation upon Actual Payment

The essence of nonqualified deferred compensation is that an employer makes an unfunded promise to pay funds in the future in exchange for services received currently. If properly arranged, this unfunded promise does not result in current taxation to the employee, even if the promise is unqualified and made by a financially solvent employer.\(^{15}\) Only upon actual payment will the employee face any tax consequences, even if the right to payment was secured by services performed in a prior year. The lynchpin allowing the employee to avoid taxation until actual payment is the cash-method of accounting, under which a taxpayer generally pays tax only upon actual receipt of an item of income.\(^{16}\)

The cash-method of accounting is subject to several conditions. It is possible (though rare) that an employee is subject to the accrual, not cash, method of accounting.\(^{17}\) More significant limitations are the


\(^{16}\) See Treas. Reg. § 1.446-1(c)(1)(ii) (as amended in 2006).

\(^{17}\) Cf. Boris I. Bittker & Lawrence Lokken, Federal Taxation of Income, Estates, and Gifts § 105.4 ("Nearly all individuals and most unincorporated service businesses use cash accounting."). Under the accrual method a taxpayer has gross income when the taxpayer's rights to the income have been secured and can be valued with reasonable accuracy. See Treas. Reg. § 1.446-1(c)(1)(ii)(A) (as amended in 2006). Tax theorists usually regard the cash-method of accounting as inferior to the accrual method, but this view is not unanimous. See Joseph M. Dodge, Exploring the Income Tax Treatment of Borrowing and Liabilities, or Why the Accrual Method Should Be Eliminated, 26 Va. Tax. Rev. 245 (2006). This Article concedes that accrual-method taxation of individuals is unlikely to occur, and instead attempts to design a "special tax" that achieves rough parity with the accrual method.
doctrines of economic benefit and constructive receipt. The economic-benefit doctrine will accelerate tax before actual payment if the employer irrevocably sets aside cash or property for the benefit of the employee. An unfunded promise itself is not considered to be property and does not trigger the economic benefit doctrine. Similarly, the constructive-receipt doctrine will accelerate tax before actual payment if the employee could have immediate and unrestricted access to the funds.

Historically, satisfying the two doctrines was the main goal in structuring deferred compensation arrangements. In 2004, however, Congress enacted § 409A of the Internal Revenue Code, which now extensively regulates deferred compensation. Rather than banning deferred compensation altogether, § 409A adds to the prior restrictions found in the constructive-receipt and economic-benefit doctrines. In broad terms, § 409A limits the ability of employees to elect both the initial deferral of compensation and the ultimate payment of amounts previously deferred. The operational rules of § 409A are quite complex and dominate the legal concerns of employers structuring deferred compensation plans. Fortunately, § 409A is largely irrelevant to the analysis of this Article. Section 409A regulates the types of plans that successfully defer compensation, but does nothing to alter the tax consequences of successful deferral. Moreover, the examples used in this Article are relatively simple deferred compensation arrangements that are not likely to raise difficult issues under § 409A or the prior judicial doctrines.

Successful deferral of compensation results in the employee paying no tax when compensation is earned. Rather, tax is due only when the compensation is actually paid. This rule of deferral applies to the

18 The economic-benefit doctrine is now largely (if not completely) codified in I.R.C. § 83 and the related regulations. Cf. Treas. Reg. § 1.83-3(e) (as amended in 2005) (imposing tax upon the beneficiary of 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). See Treas. Reg. § 1.83-3(e) (as amended in 2005).
20 Cf. T. David Cowart & Greta E. Cowart, Statutory Standards for Deferral under I.R.C. Section 409A, at § 14.01(1), in BENDER'S FEDERAL INCOME TAXATION OF RETIREMENT PLANS (Alvin Lurie ed., 2008) ("Prior to the enactment of the American Jobs Creation Act of 2004 ... the taxation of deferred compensation was principally governed by Section 451 ... and the judicial doctrines of constructive receipt and economic benefit.").
22 See I.R.C. § 409A (West 2010).
23 See I.R.S. Notice 2005-1, 2005-1 C.B. 274 ("[Section] 409A does not alter or affect the application of any other provision of the Code or common law tax doctrine. Accordingly, deferred compensation not required to be included in income under § 409A may nevertheless be required to be included in income under § 451, the constructive receipt doctrine, the cash equivalency doctrine, § 83, the economic benefit doctrine, the assignment of income doctrine or any other applicable provision of the Code or common law tax doctrine.").
24 See Cowart & Cowart, supra note 21, ¶ 14.01[1].
Example 1: It is 2008, and Ray Corp. is negotiating compensation with a senior executive, Emily. Ray Corp. will pay Emily a salary of at least $1,000,000 in 2009. Also, Ray Corp. will either pay an additional $100,000 in 2009, or promise to pay Emily $200,000 in 2019 (in lieu of the $100,000 of additional compensation). Agreeing to the deferral, Emily is taxed on $1,000,000 in 2009 and $200,000 in 2019. Ray Corp. takes corresponding deductions in the same years.

Note that Emily does not pay tax on the full $1,100,000 in 2009, even though there is strong evidence that this is the value of her 2009 pay package. Although such arrangements are now extensively regulated by § 409A, the basic tax consequences remain the same as they have for decades. Emily has, in substance, earned an extra $100,000 in 2009, but she pays no tax on this amount until 2019 when she receives the original $100,000, plus an additional $100,000 representing the time value of money. Ray Corp. bears a cost from agreeing to this deferral, as it must wait until 2019 to deduct the compensation.  

B. The Scholes-Wolfson Model: The Three Perspectives of Executive Compensation

The interesting question about deferred compensation is whether deferral is valuable to taxpayers. From the perspective of the employee alone, deferral is quite valuable, as evidenced by the popularity of Individual Retirement Accounts, 401(k) plans, and the like. From the perspective of the employer, however, deferral is potentially onerous. The employer will usually need to defer any deduction on the compensation until the time that the employee includes the compensation in income. Thus, whether tax deferral is advantageous is not immediately clear, as it must be examined from the perspective of both the employer and employee.

What is needed, then, is a method to examine taxes from the joint perspective of the parties, asking whether the tax savings to the employee outweigh the tax detriments to the employer. The joint (or "global" as the authors put it) perspective is the hallmark of the "Scholes-Wolfson model," named for the two original coauthors of Taxes and Business Strategy: A Planning Approach. As the authors

26 I.R.C. § 404(a)(5).
27 Id.
say:

[W]e adopt a global planning approach [to taxes and business strategy]. . . . [T]here are three aspects of planning globally:

1. Multilateral approach: All contracting parties must be taken into account in tax planning. This is a global or multilateral, rather than unilateral, approach.

2. Importance of hidden taxes: All taxes must be taken into account. We are interested in a global measure of taxes, not simply explicit taxes.

3. Importance of nontax costs: All costs of business must be considered, not just tax cost.29

This Article will not consider hidden taxes or nontax costs.30 Instead, it will examine the federal-income-tax treatment of deferred compensation from a joint perspective, including the tax treatment of both employer and employee.

The Scholes-Wolfson model views taxes as an item to be planned around by private parties. All else being equal, the private parties will attempt to minimize the claim of the tax authority. The authors say:

All of the interesting problems in tax planning arise because, from the standpoint of individual taxing entities, the taxing authority is an uninvited party to all contracts. The taxing authority brings to each of its “forced” ventures with taxpayers a set of contractual terms (tax rules). Unlike other contracting parties, the taxing authority generally does not negotiate these terms separately for each venture. . . . Instead, it announces a standard set of terms taxpayers must accept. In addition, although the taxing authority claims a partnership interest in taxpayer profits, it exercises no voting rights. Nor does it directly monitor taxpayer performance to determine whether taxpayers are violating the contractual terms. Of course, the taxing authority does conduct audits.31

If one focuses solely on the federal income tax, deferred compensation involves three parties: employer, employee, and the Internal Revenue Service (IRS). (Of course, the IRS is itself agent for the claims of American society at large.) The employer and employee have every incentive to act in concert so as to minimize the IRS’s share of transactions. Unlike private parties, policymakers should not set out to maximize what the IRS receives. Rather, they should seek to protect the IRS’s proper share of transactions. The question then becomes: What share of transactions properly belongs to the IRS?

29 Id. at 3.
30 I am agnostic as to whether hidden taxes or nontax costs are important to deferred compensation. Important work does, however, link those costs to important policy concerns. See, e.g., Calvin H. Johnson, A Thermometer for the Tax System: The Overall Health of the Tax System as Measured by Implicit Tax, 56 SMU L. REV. 13 (2003); David M. Schizer, Frictions as a Constraint on Tax Planning, 101 COLUM. L. REV. 1312 (2001).
31 SCHOLES ET AL., supra note 28.
The Scholes-Wolfson model simplifies policymaking by focusing our attention on the IRS's claims to transactions rather than individual parties. One can safely disregard any fairness concerns about the allocation of tax burdens of the executive or the employer because the parties are financially sophisticated and able to adjust their transaction in response to the formal incidence of any tax. Given a certain transaction, all that is important is that the IRS will receive its share. For basic transactions (like cash compensation or interest payments), the proper share of the IRS is determined by larger, societal goals surrounding the tax system. Basic transactions under the Scholes-Wolfson model are inherently impervious to tax planning. A contract for cash wages, payable as services are rendered, has clear tax consequences that are not easily avoidable.

Deferred compensation, in contrast, is a combination of wage and investment elements. The essence of deferred compensation is that the employer performs services today in exchange for cash in the future, and the employee will require that amounts currently deferred be augmented by some reasonable investment return. Recall that in Example 1 above, Emily had a choice between compensation of $100,000 today or $200,000 in ten years. Thus, the deferred compensation contract gives Emily $100,000 of compensation, plus $100,000 of investment return. In this example, the investment return is a certain sum, closely analogous to a promissory note. Indeed, Emily's return could be perfectly replicated by a combination of current wages and an interest-bearing promissory note. Ray Corp. could pay current cash wages, and Emily could then lend the wages to Ray Corp. for an interest-bearing promissory note. Thus, there are two transactions (deferred compensation and a wage/note combination) that produce identical cash flows absent taxes.

Despite their economic equivalence, the two transactions are subject to different tax treatment. Obviously, if the transaction is structured as wages and a promissory note, the IRS will have a tax claim to both elements. As discussed in Part III below, however, the taxes imposed on deferred compensation are usually less than the taxes imposed on the equivalent wage/note combination. Deferred compensation may be equivalent to a wage/note combination, but current law limits the IRS's claim to the wage element only. This Article, therefore, proposes a "special tax" on deferred compensation that recognizes the IRS's claim to the investment element of deferred payments.

32 See, e.g., BITTKER & LOKKEN: FEDERAL TAXATION OF INCOME, ESTATES AND GIFTS ch. 3 (discussing basics of federal tax policy). For a summary of the IRS's share of basic transactions, see infra Part I.C.

33 An exception would exist if future tax rates were so much lower that the employee would be willing to forgo the time-value of money.
compensation as well, thus minimizing the tax differences between the two equivalent transactions.

Policymakers should attempt to minimize (if not eliminate) the tax differences between the equivalent transactions for reasons of equity and efficiency. Negating tax planning achieves horizontal equity by ensuring equivalent tax treatment of taxpayers who engage in equivalent economic activities. The tax savings from deferred compensation may not be available to self-employed or retired workers. Because only highly compensated employees can participate, deferred compensation threatens vertical equity as well. As for efficiency concerns, the existence of tax advantages attracts investments, potentially crowding out superior investments with higher pre-tax value. Similarly, tax planning itself involves the deployment of economic resources that could arguably be put to more productive use.

The Code, of course, explicitly encourages tax planning in many cases. The “deferred compensation” of this Article refers to plans that do not qualify for the very significant tax benefits of § 401(a) and similar provisions. Plans that do qualify (such as 401(k) plans, ESOPs, and defined benefit pensions) are advantaged over deferred compensation in at least two ways. First, the employer can irrevocably set aside funds for the employee, free from the claims of the employer’s creditors, without triggering current taxation to the employee and without subjecting the funds to any income tax. Second, the employer can deduct the expense of qualified retirement plans before the employee pays tax on the benefits. Even with the limits of § 409A, however, deferred compensation is more flexible than qualified retirement plans, which have limits on the amounts of benefits and restrictions on the amounts that can be offered to highly compensated employees.

In contrast to the advantages Congress grants to 401(k) plans and the like, any tax advantages for nonqualified deferred compensation are unintentional. Deferred compensation is extended primarily to highly compensated employees, and there is no reason that either they or their employers should receive a tax break from the deferral. At the same time, deferred compensation may well have non-tax benefits, such as the control of agency costs. Just as there is no reason to encourage these arrangements, there is no reason for Congress to impose punitive taxes on them either. The premise of this Article is that policymakers

34 See infra note 128 and accompanying text.
35 I.R.C. § 401(a) (West 2010).
36 As used in this Article, deferred compensation is synonymous with nonqualified deferred compensation.
37 See Chason, supra note 6, at 361-62.
38 See I.R.C. § 415 (West 2010).
39 See id. §§ 401(a)(4), 410(b).
should strive to tax deferred compensation in the same manner that they
tax an equivalent transaction composed of simple cash wages and an
investment contract.

C. Taxation of "Basic" Compensation and Investment Transactions

1. Introduction

As a preliminary matter, it is necessary to break up deferred
compensation transactions into separate compensation and debt
components. Once the transactions are so divided, it becomes possible
to apply the ordinary tax rules applicable to compensation and interest
to those separate transactions, and then to compare those results with
the results that current law provides for deferred compensation.
Readers should be aware that the focus on debt is a simplifying
assumption. The investment component of deferred compensation can
also be based on a myriad of investment returns, such as employer
stock. Such non-debt deferred compensation arrangements are like
forward contracts, which are derivatives that roughly replicate the
returns on owning an asset.\textsuperscript{40} Ultimately, this Article will argue that
every deferred compensation plan can be thought of as a combination of
current compensation, debt, and forward-contract elements.\textsuperscript{41}

Part I.C provides a very brief overview of the taxation of
compensation, debt, and forward-contract transactions. In addition,
Part I.C describes the net economic claim that the IRS has from these
transactions. This Article focuses on the net claim of the IRS because
compensation and debt transactions involve two taxpayers, who—in the
context of deferred compensation—are both financially sophisticated
and well-off. Therefore, there should be no equitable concerns about
assigning tax liability to one or the other. Moreover, the parties can
quite easily shift the nominal tax burden between them contractually.
The controlling tax rules are thus irrelevant, so long as the net claim of
the IRS is the same. In short, what matters is what the IRS receives, not
the identity of the taxpayers.

To illustrate the methodology, this Article views wages, debt, and
forward contracts as private-party transactions giving rise to claims by
the IRS. An executive might give up to 35% of her wages to the federal
government, along with 35% of her interest income. This claim of the
government is not, however, a net winner in every situation. For every

\textsuperscript{40} Cf. Zvi Bodie et al., Investments 19 (6th ed. 2005) (describing "forward-type
contracts" as "'price fixing' agreements that saddle the buyer with the same price risks as actually
owning the asset").

\textsuperscript{41} See infra Part V.B.
employee there is an employer, for every lender a borrower. These counterparties often (but not always) deduct the wages and interest on which the employees and lenders pay tax. Thus, if an employer and employee are both paying tax at 35%, the payment of wages leads to no income tax to the government.

A brief word is in order on how to determine the net claim. The net value of the IRS's claim to compensation and debt transactions turns on the "marginal tax rate" faced by parties to the transaction. As used in this Article, the term marginal tax rate is an economic, not statutory, concept, referring to the present value of income taxes (current or future) to be paid on one dollar of additional taxable income.\(^\text{42}\) The marginal tax rate is not the average (or so-called effective) tax rate. Effective tax rates are relevant in determining whether certain taxpayers are paying too much or too little in taxes, but they are not relevant to determining the incremental taxes paid or saved from discrete transactions.

Because deferred compensation is almost always granted to highly-compensated employees,\(^\text{43}\) this Article assumes that the marginal tax rate of employees is the top statutory rate (currently 35%).\(^\text{44}\) Admittedly, this is crude and over-inclusive, but only somewhat. Federal pension law bars employers from offering deferred compensation to rank-and-file employees.\(^\text{45}\) Regrettably, the Department of Labor has never specified a compensation level that triggers eligibility for deferred compensation,\(^\text{46}\) but $245,000 is probably a de facto safe harbor.\(^\text{47}\) Everyone at that level of income is in the 33% bracket, at least.\(^\text{48}\) So the assumption does lead to some error, though to a tolerable degree.

Turning to the employer, this Article will assume that the employer is a publicly traded corporation. Like individuals, corporations pay a

\(^{42}\) See infra note 128 and accompanying text.

\(^{43}\) See infra note 128 and accompanying text.

\(^{44}\) See I.R.C. § 1(a)-(e), (i)(2). Of course, high-income taxpayers may see their marginal tax rates fall in retirement as they earn less income. In this Article, I will generally assume that marginal tax rates remain static over time.

\(^{45}\) See infra note 128 and accompanying text.

\(^{46}\) See Michael S. Sorkin & Lawrence K. Cagney, Executive Compensation § 7.03[2] ("The question of what constitutes a 'select group of management or highly compensated employees' has not been the subject of any definitive construction by the Department of Labor, which is the government agency with authority to administer Title I of ERISA, nor in court decisions.").

\(^{47}\) Deferred compensation plans often grant benefits that cannot be granted by qualified retirement plans once the employee earns more than the pay limit imposed by I.R.C. § 401(a)(17). See id. § 7.04[1]. For 2009, the pay limit is $245,000. See IRS Announces Pension Plan Limitations for 2009, I.R.S. News Release IR-2008-118 (Oct. 16, 2008).

maximum statutory rate of 35%, but there is good evidence that many publicly traded corporations face marginal tax rates lower than 35%. Unlike executives, corporations are not amenable to a universal assumption about their tax rates. Recall that the marginal tax rate, as an economic matter, is the present value of income taxes (current or future) to be paid on one dollar of additional taxable income. A firm with a current loss might have no additional current taxes paid from an extra dollar of income, yet an additional dollar of income will reduce the net operating losses (NOLs) that it accumulates. These NOLs can be carried forward to future years to reduce future tax liabilities. Once the firm becomes profitable, the NOLs can be "cashed in" against statutory taxes. So an additional dollar of income for a firm operating at a loss does result in additional future taxes that the firm must pay. If the statutory rate is 35%, the firm will face an additional tax of 35¢ at some point in the future. Of course, this 35¢ must be discounted to present value, and there is considerable difficulty of forecasting exactly when this future tax will be paid.

Financial economists have estimated the marginal tax rates that actual corporations face, ranging from 0% to 35% (the main statutory rate for corporations). If the corporation pays tax at the employee's rate (assumed to be 35%), then the IRS has no net claim to the investment component of deferred compensation. Deferred compensation becomes interesting only if the rate is lower than the employee's rate (assumed to be 35%). For purposes of illustration, this Article will frequently use a 20% marginal tax rate for its examples, though the ultimate proposal of this Article will turn on the employer's marginal tax rate at the time of payment.

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49 I.R.C. § 11(b)(1)(D).
50 The possible reasons for the disparity include net operating losses, leverage, and tax shelters. See SCHOLES ET AL., supra note 42, at 204-10; Johnson, supra note 30 (arguing that relatively high returns on municipal bonds implies low economic tax rates).
51 See supra text accompanying note 42.
52 Net operating losses can be carried back two years and forward twenty years. See I.R.C. § 172(b)(1). If the firm can carry the NOLs back to a prior year, they can be cashed in immediately. For such a firm, the marginal tax rate is the statutory rate. See SCHOLES ET AL., supra note 28, at 205.
53 See I.R.C. §172(b)(1).
54 See SCHOLES ET AL., supra note 28, at 205-06.
56 See infra text accompanying note 132.
2. IRS's Compensation Claim

Section 61 of the Internal Revenue Code expressly taxes "[c]ompensation for services" as gross income,\(^57\) thus subjecting the recipient of cash compensation to taxation.\(^58\) The broad principle of inclusion to the employee has a counterpart: Compensation expenses are generally deductible by employers. Under § 162(a), an employer may deduct "all the ordinary and necessary expenses paid or incurred during the taxable year in carrying on any trade or business, including—(1) a reasonable allowance for salaries or other compensation for personal services actually rendered."\(^59\) The employers that are likely to offer deferred compensation usually face few obstacles in deducting compensation expenses. Accordingly, this Article generally assumes the payment of compensation is fully deductible under § 162(a).

Section 162(m) does, however, limit the deduction by a publicly held corporation on amounts paid to its CEO and three other highest paid officers,\(^60\) as the corporation can deduct only $1,000,000 of annual salary paid to each of these four officers.\(^61\) A significant attraction of deferred compensation is avoiding the § 162(m) limit. A $10,000,000 salary for a public-corporation CEO is not deductible if paid currently. Yet the corporation and CEO might agree to defer $9,000,000 of the salary to the year after the CEO retires. At the time of payout, the CEO would be a former CEO and no longer subject to the limits of § 162(m).\(^62\) The CEO could be made whole with time-value-of-money adjustments, and the corporation could take a full deduction for the post-retirement payout.

In conceptualizing the IRS's net claim to compensation, this Article ignores the § 162(m) limit. Accounting for the § 162(m) limit

\(^{57}\) I.R.C. § 61(a).

\(^{58}\) The receipt of vested property and like-kind benefits also subjects the recipient to tax. I.R.C. § 83(a); Treas. Reg. § 1.61-2(d) (as amended in 2003); Treas. Reg. § 1.83-1(a) (as amended in 2003). Similarly, courts have held that an employer's payment of an employee's obligations "(for example, the employee's tax liability) is itself gross income. See, e.g., Old Colony Trust Co. v. Comm'r, 279 U.S. 716 (1929).

\(^{59}\) I.R.C. § 162(a).

\(^{60}\) The Code itself limits deductions for the "covered employees," defined to be the CEO and the four most highly compensated officers whose compensation must be reported under the Securities Exchange Act of 1934, 15 U.S.C. § 78. I.R.C. § 162(m)(3). In 2006, however, the SEC amended its disclosure rules to cover the CEO, CFO, and the three most highly compensated officers. In response to the SEC change, the IRS issued a notice stating that it would treat only the CEO and the three most highly compensated employees as covered employees. I.R.S. Notice 2007-49, 2007-1 C.B. 1429 (June 18, 2007).

\(^{61}\) I.R.C. § 162(m).

\(^{62}\) But see I.R.C. § 162(m)(5)(A)(ii) (disallowing deductions for deferred compensation over $500,000 for top executives of firms participating in TARP).
would unduly complicate the “special tax” ultimately proposed by this Article. Moreover, since § 162(m) arguably implements non-tax policies of improving corporate governance, rather than the tax policy of ensuring the IRS’s claim to compensation transactions, its reach is beyond the main concerns of this Article.

By assuming fully deductible compensation, it is possible to focus on the amount of the IRS’s net claim to compensation transactions, which will turn on the difference in marginal tax rates faced by employer and employee. If the employer and employee face the same marginal tax rate, then the IRS has no claim to the compensation. If, however, the employer faces a lower tax rate, the IRS has a positive net claim. Consider the following examples:

Example 2: Emily is employed by Ray Corp. at an annual salary of $1,100,000. Both Emily and Ray Corp. face a 35% marginal tax rate. Emily must pay tax in the amount of $350,000, but Ray Corp. gets a deduction worth $350,000. Thus, the IRS has no net claim to the compensation.

Example 3: Same as Example 2, except that Emily faces a 35% marginal tax rate and Ray Corp. only 20%. As before, Emily pays tax in the amount of $350,000. But Ray Corp. now has a deduction worth only $200,000. Thus, the IRS has a net claim to the compensation in the amount of $150,000.

Generalizing from these examples, the net claim of the IRS turns on the amount of compensation and the difference in tax rates between the parties. In Example 2, the tax rates were equal, and the IRS had no net claim. In Example 3, the compensation was $1,000,000, and the difference in rates was 15% (35% - 20%); thus, the IRS’s net claim was $150,000.

The IRS would have a net liability from compensation if the employee has a lower tax rate than the employer. This Article, dealing with the compensation of executives, makes the conservative assumption that paying compensation is either revenue-neutral or revenue-producing. Executives will typically be at the highest marginal tax rate of 35%, which is also the highest corporate tax rate. If both employer and employee are at the 35% rate, then compensation is revenue neutral. The corporation may, however, be at a lower marginal tax rate than its executives because it is not very profitable, or because it has net operating losses that absorb current income.

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63 Examples of the corporate governance scholarship surrounding § 162(m) are given supra note 3.
64 See supra note 42.
3. IRS’s Interest Claim

Simple deferred compensation plans can be analogized to a formal loan between the employer (as borrower) and employee (as lender). This Part briefly examines the taxation of interest, assuming a high-income, individual creditor and a corporate borrower. Interest paid or received on indebtedness follows a pattern similar to that of salary and other compensation—it is generally deductible by the borrower and taxable to the creditor. Like compensation income, interest income is taxed to individuals at a maximum 35% tax rate, and this Article generally assumes that the individual is subject to the 35% rate for all periods. As for the corporate borrower, the value of its interest deduction will depend on its marginal tax rate, which may be 35% or lower. As a result, the IRS’s net claim to a debt transaction is like its claim to a simple compensation transaction. Recall that with a compensation transaction, the IRS has a net claim based on the amount of compensation multiplied by the difference in tax rates between employer and employee. Similarly, the IRS’s claim to a debt transaction is based on the amount of annual interest multiplied by the difference in rates between the debtor and creditor.

Example 4: Emily loans $200,000 to Ray Corp. for five years at 5% (or $10,000) annual interest. Both Emily and Ray Corp. face a 35% marginal tax rate. Emily must pay tax in the amount of $3500, but Ray Corp. gets a deduction worth $3500. Thus, the IRS has no net claim to the interest payments.

Example 5: Same as Example 4, except that Emily faces a 35% marginal tax rate and Ray Corp. only 20%. As before, Emily pays tax in the amount of $3500. But Ray Corp. now has a deduction worth $2000. Thus, the IRS has a net claim to the compensation in the amount of $1500.

As with compensation transactions, the IRS’s net claim is based on the difference in marginal tax rates. When the tax rates are the same, the IRS has no net claim. When the creditor’s rate is higher than the debtor’s, then the net claim is equal to the amount of interest multiplied by the difference in marginal tax rates.

Even if cash interest payments do not actually change hands, borrowers and lenders usually recognize imputed interest every year under the original issue discount (OID) rules. The most basic form of OID is derived from zero coupon bonds.

Example 6: Emily loans $200,000 to Ray Corp. for five years. No

65 I.R.C. § 163(a).
interest is due until the end of five years, at which time Ray Corp. will repay Emily $200,000, plus accumulated interest of $50,000. The marginal tax rates of Emily and Ray Corp. are 35% and 20%, respectively. Because of the OID rules, Emily and Ray Corp. must recognize interest (income and expense) of about $10,000 every year over the five years of the loan.\textsuperscript{68} The IRS will receive its net claim of about $1500 every year.

Regardless of the operation of the OID rules, the IRS will have a net claim of $7500 to the interest on the debt, based on 15\% of the $50,000 interest that passes from Ray Corp. to Emily. The OID rules simply coordinate the timing of the net claim, in effect placing both Emily and Ray Corp. on the accrual method of accounting for interest. Without this coordination, Emily (otherwise on the cash method) would have waited until the final payment before being taxed on $50,000 interest. Yet Ray Corp. would have received the benefit of deductions over the course of the loan. Thus, the IRS would face the liability of Ray Corp.'s interest deductions before it could tax Emily's corresponding interest income. The OID rules prevent this temporal mismatch, forcing both Emily and Ray Corp. to recognize annual interest.

4. IRS’s Forward-Contract Claim

Some types of deferred compensation provide investment returns based on the performance of employer equity or other non-debt investments.\textsuperscript{69} Because the employee does not actually own the employer equity or other investment, the employee essentially holds a derivative. As explained below,\textsuperscript{70} the relevant derivative is a forward contract, which is a “contract that obligates the holder to buy or sell an asset for a predetermined delivery price at a predetermined future time.”\textsuperscript{71} The forward price is the “delivery price in a forward contract that causes the contract to be worth zero.”\textsuperscript{72} The following example illustrates a forward contract:

Example 7: In 2009, Emily and Ray Corp. enter into a forward contract under which Emily agrees to buy 10,000 shares of Ray Corp. stock in 2019. Emily agrees to a delivery price of $2,000,000. The current value of Ray Corp. stock is $100 per share, and the prevailing interest rate is 7.2\%, compounded annually. The forward

\textsuperscript{68} The annual interest would not be exactly $10,000 per year. Precise methodology for calculating OID can be found at Treas. Reg. § 1.1272-1(b)(1) (1996).
\textsuperscript{69} See supra Part V.B.
\textsuperscript{70} See id.
\textsuperscript{71} JOHN C. HULL, OPTIONS, FUTURES, AND OTHER DERIVATIVES 781 (7th ed. 2009).
\textsuperscript{72} Id.
price of 10,000 Ray Corp. shares, deliverable in ten years, is $2,000,000.\footnote{The current (spot) price of 10,000 shares is $1,100,000. The forward price for a non-dividend-paying stock is the future value of the spot price. See id. In our case, that future value $1,000,000 \times 1.072^{10} = \$2,000,000.} Since the delivery price is the forward price, Emily pays nothing to enter into the contract.

Since Ray Corp. is dealing in its own stock, it is functionally tax-exempt with respect to its gain or loss under the contract.\footnote{See I.R.C. § 1032 (West 2010).} The IRS’s net claim will turn completely on Emily’s tax consequences. To simplify matters, assume that Emily and Ray Corp. agree that they will settle the contract in cash in 2019, meaning Emily will not actually buy Ray Corp. stock. So if the stock is worth less than $2,000,000 in 2019, Emily will pay the difference in cash; if it is worth more, Ray Corp. will do so. Because the contract is cash-settled, Emily will be forced to recognize all gain or loss for tax purposes in 2019.

The forward contract will be a capital asset in Emily’s hands, producing long-term capital gain or loss.\footnote{See David H. Shapiro, Tax Management Portfolio 188-1st: Taxation of Equity Derivatives, at II.B.3.a (“Cash-settlement payments should also be capital gain and loss to the respective recipient and payor.”).} Emily’s gain would be taxed at the 15% rate,\footnote{See I.R.C. § 1211(b).} but it is difficult to generalize about the value of Emily’s losses because taxpayers are limited in their use of capital losses.\footnote{See id.} This Article assumes, however, that any losses Emily incurs produce a deduction worth 15% of the loss. Though this is an assumption made in order to facilitate a clean analysis, it is not unreasonable, because long-term capital losses can always be used to offset long-term capital gains.\footnote{This account is consistent with the “Domar-Musgrave” theory, which holds that taxpayers can avoid taxes levied on risky assets. See infra Part II.C.}

Under this assumption, the IRS essentially owns 15% of Emily’s forward contract. It enjoys 15% of any gain and is responsible for 15% of any loss. From an ex ante perspective in 2009, this 15% share is arguably worth nothing. After all, Emily paid nothing to enter into the contract, and 15% of nothing is nothing. In 2019, of course, the IRS may actually gain or lose depending on the performance of Ray Corp. In 2009, however, the IRS has nothing of inherent value.\footnote{See id.}

As explained below, ignoring the IRS’s claim to the forward-contract element of deferred compensation greatly simplifies the normative proposals of this Article. Based on the foregoing analysis, doing so does not prejudice the IRS, because its forward-contract claim is not inherently valuable. Admittedly, this conclusion is based on the
assumption that taxpayers can fully use their capital losses against
capital gains and that the IRS’s 15% claim should be valued in the same
manner as a single investor’s. Because of these limitations, this Article
does not argue that the IRS should be out of the business of taxing
forward contracts per se. Rather, it argues that ignoring the forward-
contract element of deferred compensation contracts is an acceptable
compromise, made to further the development of a normative proposal
that will ensure that the IRS receives its claim to the investment income
inherent in deferred compensation.

II. PRIOR PROPOSALS REGARDING THE TAXATION
OF DEFERRED COMPENSATION

A. Annually Tax Investment Income Associated
with Deferred Compensation

Some scholars have likened deferred compensation to an
investment conduit by which the employee can essentially have her
investment income taxed at the employer’s tax rate.\(^8\) This Article
refers to this view as the “conduit theory” of deferred compensation.
The employer acts as something of a conduit when it sets funds aside in
a “rabbi trust”—namely, a trust securing payment of deferred
compensation benefits. The rabbi trust avoids the economic benefit
doctrine by subjecting the assets to the claims of the employer’s general
creditors in the event of bankruptcy or insolvency. Because the
employer retains a benefit from the potential payment of its general
creditors, the trust is a “grantor trust” and disregarded for federal
income tax purposes.\(^8\)

Example 8: In 2008, Emma, a corporate executive, and her
employer, Rex Corp., are negotiating Emma’s 2009 compensation.
Emma and Rex Corp. agree that Emma will defer $100,000 of her
2009 compensation, and Rex Corp. will set those funds aside in a
rabbi trust for Emma’s benefit. Rex Corp. is a functionally tax-
exempt U.S. corporation, whereas Emma pays tax at the 35% bracket. Rex Corp. agrees to invest the assets of the rabbi trust in
taxable bonds that pay annual, pre-tax interest of 7.2%. At the end
of ten years, Rex Corp. pays Emily the balance of the trust, which
has grown to $200,000.\(^8\) In 2019, Rex Corp. pays $200,000 to

\(^8\) See Polsky & Yale, supra note 6, at 607 (“The standard for neutrality is what would have
occurred had the employee been paid cash and invested for her own account outside of the
deferred compensation context.”).
\(^8\) See Kathryn J. Kennedy, A Primer on the Taxation of Executive Deferred Compensation
\(^8\) $100,000 \times 1.072^{10} = $200,000.
Emma, who keeps $130,000 after paying tax of 35%.

This example can be contrasted with what would happen if Emma took current compensation and invested in the bonds directly. Emma would pay tax of 35% tax in 2009 and have $65,000 of cash to invest in the bonds. Unlike tax-exempt Rex Corp., which enjoys a 7.2% rate of return after-tax, Emma’s return is reduced by 35% down to 4.68%. After ten years of direct investing, Emma’s $65,000 would grow to about $103,000. Thus, deferred compensation gives Emma about $27,000 more in 2019.

Essentially, the rabbi trust allows Emma to piggyback on Rex Corp.’s tax-exempt status while investing. Because of their different tax rates, Rex Corp. can earn 7.2% from the bonds, but Emma only 4.68%. The rabbi trust allows Emma to invest at Rex Corp.’s after-tax return of 7.2%. Deferral has nothing to do with the tax benefit.

The conduit theory has led scholars to call for a special tax to be levied on the investment income associated with deferred compensation. These scholars do not advocate abandoning deferral altogether, but rather taxing the investment component of deferred compensation on an annual basis. The purpose of such a tax would be to replicate the claim the IRS would have if the rabbi trust assets were taxable to the employee rather than the employer. However, these proposals are at tension with the economic benefit doctrine and the regulations under § 83. The doctrinal counterargument is that rabbi trust assets must be subject to the claims of the employer’s creditors, and that these claims prevent the employee from being taxed on the rabbi trust assets. This counterargument is not merely a doctrinal impediment to reform, as benefiting from a rabbi trust is substantively different from outright ownership of the trust assets because the employee faces the risk of employer insolvency. Instead, the employee is a creditor of the employer, rather than the owner of assets.

Moreover, not all deferred compensation is funded by rabbi trusts, and unfunded deferred compensation presents a serious challenge to the

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83 $65,000 x 1.0468^{10} = $103,000.
84 To confirm, suppose that Emma received $100,000 in 2009, paid her taxes of $35,000, and invested the remaining $65,000 in bonds that paid 7.2% after-tax. In ten years, her money would double, see infra note 112, and she would have $130,000. This is the same payoff that she received from the rabbi trust.
85 See Yale & Polsky, supra note 6.
86 See I.R.C. § 83.
88 Moreover, the rabbi-trust structure requires that the employee remain illiquid and unable to convert trust assets into consumption at will. Indeed, § 409A codifies employee illiquidity by restricting the ability of employees to withdraw funds from deferred compensation plans. Liquidity is not a necessary condition for taxing property transfers under section 83, which imposes tax when the property is either transferable or not subject to a substantial risk of forfeiture. See I.R.C. § 83(a)(1) (West 2010).
conduit theory. Professors Yale and Polsky respond by advocating a marked-to-market tax on deferred compensation. The problem with this approach is that it would force employers to value deferred compensation before actual payout, even though deferred compensation often has an ambiguous value. Once employers are forced to derive a value for deferred compensation, the logical next step is to abandon deferral altogether. Professor Halperin avoids the valuation problem through a proposal to mandate the use of rabbi trusts. Such a mandate would effectively force employers to fund deferred compensation just as they are required to fund qualified retirement plans. Mandated funding intrudes upon the contractual relationship between employer and employee, however, and serves no apparent non-tax goal beyond creating a pool of assets that may be taxed.

Ultimately, this Article proceeds without concerning itself with rabbi-trust funding. If rabbi-trust funding were relevant, the appropriate response would be to broaden § 83 and the economic-benefit doctrine in order to reach it, essentially leading to accrual accounting for deferred compensation. The approach of this Article, however, is to suggest minimal changes to current law that would eliminate the tax advantage of deferred compensation. First, though, it is necessary to clarify what the tax advantage really is, and the conduit theory points in the right direction. There is a tax advantage to deferred compensation that exists when extended from a low-tax employer to a high-tax employee. That advantage should not be measured by reference to rabbi-trust funding, whether real or hypothetical, but rather by reference to the contract that exists between the employer and the employee.

B. Place Executives on the Accrual Method of Accounting

The most direct way to eliminate the tax advantages of deferral is to eliminate deferral altogether by placing executive-level employees on the accrual method of accounting. This approach contrasts with current law, which allows deferral for a select class of arrangements. Professor Michael Doran writes:

Accrual-based taxation, which follows directly from the Haig-Simons definition of income, presents the correct result as a matter of tax policy. That approach treats deferred compensation—regardless of whether it is “good” or “bad” (in the sense of satisfying

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89 See Yale & Polsky, supra note 6, at 610.
90 See infra Part II.B.
91 See Halperin, supra note 4, at 549.
92 Cf. I.R.C. §§ 430-432 (establishing funding requirements for defined benefit plans).
93 See infra Part II.B.
or not satisfying an arbitrary set of statutory requirements)—just like current compensation. In other words, accrual-based taxation eliminates the possibility of a tax preference for deferred compensation.94

Presumably, certain technical details would have to be dealt with, like the treatment of investment earnings and the exact timing of income-inclusion when the employee is not vested.

Thirty years ago, Congress quashed an IRS attempt to tax deferred compensation plans that were elective on the part of the employee.95 Political sentiment is different today, and Congress made nascent moves toward accrual accounting for deferred compensation with the passage of I.R.C. § 457A in 2008.96 Section 457A applies to a very limited class of deferred compensation plans, namely those offered by foreign corporations and partnerships with tax-exempt investors. Still, the existence of the statute shows some willingness on the part of Congress to put deferred compensation on the accrual method.

There are, however, objections to accrual accounting. The accrual method of accounting, as set forth in Treasury regulations, imposes tax “when all the events have occurred which fix the right to receive such income and the amount thereof can be determined with reasonable accuracy.”97 The first prong—fixed right to receive—is not a serious problem. The second prong—amount determined with reasonable accuracy—is a problem. The ultimate amount of payment under a deferred compensation plan might turn on several contingencies, like investment performance and employee mortality. Dealing with these contingencies is possible,98 but policymakers should be aware that

95 Compare Prop. Treas. Reg. § 1.61-16, 43 Fed. Reg. 4638, 4639 (Feb. 3, 1978) (proposing regulations that would immediately tax compensation deferred at an employee’s election), with Revenue Act of 1978, Pub. L. No. 95-600, § 132(a), 92 Stat. 2763, 2782 (negating the proposed regulations by mandating that deferred compensation be taxed according to “the principles set forth in regulations, rulings, and judicial decisions relating to deferred compensation which were in effect on February 1, 1978”).
97 Treas. Reg. § 1.451-1(a) (as amended in 1999).
98 Congress used a sledgehammer to deal with these contingencies in § 457A. Employees subject to § 457A can defer tax when the amount of compensation is “not determinable,” but must augment the ultimate tax owed with interest and a 20% additional tax. I.R.C. § 457A(c) (West 2010). Their approach to the Social Security and Medicare (i.e., FICA) taxes is somewhat more nuanced. FICA generally applies to deferred compensation at the time it is earned. See Treas. Reg. § 31.3121(v)(2)-1(e)(1) (1999). However, tax is deferred if the amount deferred is not “reasonably ascertainable.” See Treas. Reg. § 31.3121(v)(2)-1(e)(4)(i). FICA applies only to the compensation (i.e., wage) component of deferred compensation. It does not apply to investment earnings on the amounts initially deferred. In this sense, early taxation is a good thing under FICA. The problem with extending the FICA approach to the income tax is that deferral for the income tax is typically desired by employers and employees, who would have an incentive
accrual method of accounting needs adjustment to handle long-term, contingent promises like deferred compensation.99

There are other obstacles to accrual accounting as well. None are thoroughly persuasive, but they might still be raised in political discourse. Since payment of deferred compensation is contingent upon the solvency of the employer, employees might pay tax on amounts they never actually receive.100 More significantly, employees receiving large awards of deferred compensation might face significant liquidity constraints. Some might fear that accrual accounting would give employers an excuse to pay excessive executive compensation in the form of “gross ups” to cover the accelerated tax bills. Finally, accrual taxation would lead to even more compensation being rendered nondeductible under limits found in § 162(m) of the Code.

Accrual taxation may well be ideal, and the difficulties listed above may well be surmountable. A thorough proposal on subjecting deferred compensation to accrual taxation is a worthwhile and timely task, especially in light of congressional efforts to subject limited forms of deferred compensation to accrual taxation. Nevertheless, this is a route not taken by this Article, which instead takes the incremental path of proposing a system of taxing deferred compensation that replicates the results of accrual taxation without triggering the practical difficulties of immediate taxation.

C. **Do Nothing**

In an apparent about face from a prior article, Professor Ethan Yale recently argued that the tax advantage of deferred compensation is relatively meager and that further legal reform might not be justified.101 Professor Yale’s arguments are based on the “Domar-Musgrave theory,” which essentially bifurcates investment returns into risk-free and risky elements.102 Under the right assumptions, taxpayers can avoid
taxation of the risky element of all returns to capital. Taxpayers cannot, however, avoid the taxation of the risk-free element. This element, though, is relatively meager according to the Domar-Musgrave adherents, especially when one excludes the inflation of the nominal interest. Under Domar-Musgrave, then, deferred compensation merely allows employees and employers to avoid the tax on this meager risk-free element, which is not worth protecting according to Professor Yale.

Deferred compensation presents problems, however, for the Domar-Musgrave theory. The theory holds that taxpayers can avoid the taxation of risky returns by increasing their exposure to risk, a point illustrated by Professor David Weisbach with a simple wager on a coin flip. If Heads, the taxpayer wins $100; tails, the taxpayer loses $100. If the IRS imposes a 50% tax on wagers (allowing the taxpayer to deduct any losses), then the initial bet becomes $50 winnings for a heads and $50 losses for tails. Clearly, though, the taxpayer can avoid the impact of this tax by simply doubling her bet. In the end, the taxpayer achieves the $100 gain or loss, regardless of taxes.

However, introducing counterparties complicates this analysis considerably. The taxpayer is gambling with someone who presumably has some tax consequences. Now, if the counterparty also faces a 50% tax rate, then taxes are truly meaningless as they produce no net revenue for the government. The gamble is a zero-sum game, and the tax from one side's winnings will be offset by the deduction from the other side's losses. If the counterparty faces a different rate, however, then the parties cannot adjust the gambling contract so that both of them avoid the effect of taxes. As an extreme example, suppose that one party pays tax of 50%, and the other is tax exempt. The 50% taxpayer will want to double her bet to adjust for taxes, but the tax-exempt party has no reason to adjust at all. In a fluid market, of course, gamblers can just find someone willing to gamble on coin tosses at the desired level.

But employment relationships are not so fluid. An executive taxed at 50% may want to double her deferred compensation to avoid taxes, but a functionally tax-exempt employer will want to make no adjustment at all. The executive will be unlikely to abandon the firm-specific human and financial capital she has accumulated just to find an employer that will make the proper adjustments. And because nonqualified deferred compensation is long-term with idiosyncratic terms (like non-compete agreements), the employee cannot turn to derivatives markets to adjust for the taxation of capital income.

Moreover, the Domar-Musgrave result may not be strong enough to warrant abandoning the taxation of capital income from deferred compensation if the current income taxation of capital returns is
otherwise maintained. The Domar-Musgrave literature typically excludes inflation gains from taxation because they are not economic income, even though they clearly constitute taxable income under current law.\textsuperscript{104} Once inflation gains are taxed as they are under current law, then the risk-free looks far more substantial. By one reckoning, the risk-free rate after inflation was a mere 0.5% from 1929 to 1989, but inflation was 3.1%.\textsuperscript{105}

There is also an issue about the way in which the risk-free rate is taxed. Professor Yale views deferred compensation as being akin to a capital asset, taxed only upon realization. In contrast, this Article views deferred compensation as essentially a debt contract that should give rise to annual tax consequences at ordinary rates. This different methodology makes a significant difference in valuing the tax benefit that Professor Yale dismisses as being meager. For example, using an illustration from Professor Yale's article, the tax benefit of $100 of compensation deferred over ten years is $3.60 according to Professor Yale's method.\textsuperscript{106} Using the same assumptions as Professor Yale but changing only the methodology, this Article's approach would value the tax benefit at $9.10.\textsuperscript{107}

This Author is sympathetic to many of Professor Yale's concerns, particularly his criticism of the complexity of recent reform efforts, like § 409A.\textsuperscript{108} Reform can, however, result in simplification. By eliminating the tax benefit of deferred compensation, Congress could also eliminate the burdensome regulatory regime found in § 409A of the Code and allow deferred compensation to be regulated by the historical doctrines of constructive receipt and economic benefit.

D. Tax Payments at the Highest Marginal Tax Rate

In a prior article, this Author argued that Congress should tax deferred compensation at the highest marginal rates for individuals. The rationale for this proposal was that deferred compensation gives executives an inappropriate method by which to engage in income

\textsuperscript{104} See id. at 31.


\textsuperscript{106} See Yale, supra note 6, at 26 (describing the risk-adjusted tax benefit for ten years of deferral as 0.036).

\textsuperscript{107} Professor Yale assumes an interest rate of 4%, an employee-level tax of 35%, and a corporate-level tax of 0%. See id. This Article assumes that the interest rate is before tax, implying an after-tax rate of 2.6%. The present value of the special tax proposed in this Article, levied on an initial deferral of $100, would be $2.6\% \times 10 \times (35\% - 0\%) \times $100 = $9.10.

\textsuperscript{108} Cf. Yale, supra note 6, at 27 (noting "the staggering complexity of recent legislative forays into this domain (most significantly recently enacted IRC § 409A)").
averaging. An executive earning compensation in a high tax bracket (say 35%) might expect to face a lower bracket (say 28%) in retirement, and deferred compensation allows the executive to have the lower bracket apply to compensation earned in higher-bracket years. Allowing ad hoc income averaging to corporate executives is inconsistent with vertical equity (because lower paid workers typically cannot participate in deferred compensation) and with horizontal equity (because the ability to defer compensation depends on the existence and willingness of the employer to accommodate the employee’s tax planning). Finally, it is inefficient because deferred compensation may crowd out other investments and draw resources into socially unproductive tax planning. In short, Congress should not tolerate ad hoc income averaging under the current tax system, even if a comprehensive system for averaging is desirable.109

This Article is a refinement and extension of the prior article; it describes deferred compensation as having two components—compensation and investment. Current law adequately taxes the compensation component if the employee’s tax bracket does not change. When the employee’s tax bracket does change, current law fails. To remedy that failure, the prior article argued that all deferred compensation payments should be taxed at a single rate, namely the highest marginal rate for individuals.

However, the prior article’s proposal only cures the failure of current law to tax the compensation component; this Article addresses the investment component of deferred compensation as well. To keep the present analysis as simple as possible, the remainder of this Article will assume that the employee and employer do not face changing tax rates over time, facilitating a focus on the failure to tax the investment element of deferred compensation.

III. HOW CURRENT LAW FAILS TO TAX THE INVESTMENT ELEMENT OF DEFERRED COMPENSATION

A. Bifurcating Deferred Compensation

This Article’s model is to evaluate current law by reference to the compensation and investment components of deferred compensation. These components are identified by determining actual yet separate compensation and investment transactions that replicate the employee’s cash flows from deferred compensation. The separate transactions give

rise to their own tax treatment, which in the aggregate provide a normative baseline by which to measure the taxation of deferred compensation. Thus, in determining whether deferred compensation is tax-advantaged, the question to ask is whether deferred compensation results in lower taxes than the equivalent compensation-investment combination. The following example is used to describe how deferred compensation can be bifurcated.

Example 9: It is 2008, and Ray Corp. is negotiating compensation with a senior executive, Emily. In addition to a base level of compensation, Ray Corp. is willing to either (a) pay Emily additional compensation of $100,000 in 2009, or (b) promise to pay Emily $200,000 in 2019 (in lieu of the $100,000 of additional compensation).

The offer of deferred compensation gives Emily a choice between pre-tax income of $100,000 today or $200,000 in the future. If Emily pays tax at the 35% rate, her after-tax choice is between $65,000 today\(^{110}\) and $130,000 in ten years.\(^{111}\) Thus, deferred compensation gives Emily the ability to double her money, on an after-tax basis, within ten years. This deal is the equivalent of giving her after-tax interest of about 7.2%, compounded annually.\(^{112}\)

The investment component from the example is essentially debt that Emily has extended to Ray Corp. If this de facto debt were formal debt, Emily would have to pay tax on the interest that accrues, even if she is a cash-method taxpayer.\(^{113}\) From Emily’s perspective, then, her after-tax return of 7.2% is equivalent to a before-tax return of about 11%.\(^{114}\) The before-tax interest rate of 11% is the key to dividing the actual deferred-compensation contract into hypothetically separate compensation and debt components. This is done by assuming that the following occurred.

Compensation Component: Ray Corp. pays current (2009) compensation to Emily of $100,000, leaving Emily with $65,000 after-tax.

Debt Component: Emily loans the after-tax proceeds of $65,000 back to her employer, Ray Corp., for ten years at about 11% annual interest. Ray Corp. pays Emily enough cash interest to cover her tax bill on the interest income (3.8%) and adds the remaining interest (7.2%) to principal. Thus, Emily receives no net cash while the loan is outstanding. In 2019, Ray Corp. pays Emily principal and capitalized

\(^{110}\) $100,000 less 35% tax of $35,000 = $65,000.

\(^{111}\) $200,000 less 35% tax of $70,000 = $130,000.

\(^{112}\) $65,000 \times (1 + 0.072)^{10} = $130,000. A more precise estimate of the interest rate is given by \(2^{\frac{10}{10}} - 1 = 7.177\%\).

\(^{113}\) See supra notes 67-68 and accompanying text.

\(^{114}\) As always, this Article assumes that Emily pays tax at the 35% rate. Using the more precise estimate from note 112, the equivalent pre-tax rate is \((2^{10/10} - 1) / 0.65 = 11.042\%\).
interest of $130,000.

From Emily’s perspective, these two transactions are economically equivalent to the deferred-compensation transaction, because both yield after-tax cash of $130,000 in 2019.

As argued above, the tax treatment of the bifurcated transaction should be the normative baseline in judging whether current law properly taxes deferred compensation. Thus, it is possible to judge the adequacy of current law by comparing how the IRS fares with deferred compensation versus the bifurcated transaction. Ideally, the IRS’s net claim should be the same from the two economically equivalent transactions. The next two subparts will show that current law adequately taxes the wage component of deferred compensation, but fails to tax the debt component at all.

B. The Compensation Element of Deferred Compensation

Returning to Example 9 above, this Article will now specify Ray Corp.’s tax rate.

Example 10: It is 2008, and Ray Corp. is negotiating compensation with a senior executive, Emily. Ray Corp. will pay Emily additional compensation of $100,000 in 2009, or promise to pay Emily $200,000 in 2019 (in lieu of the $100,000 of additional compensation). The parties choose the deferred compensation. Emily faces a marginal tax rate of 35%, but Ray Corp. faces a rate of only 20%.

Because of the difference in tax rates, payments from Ray Corp. to Emily result in net revenue to the IRS. Ray Corp. gets a deduction worth twenty cents for every dollar paid, but Emily must pay tax of thirty-five cents for every dollar received. On a net basis, then, the IRS gets fifteen cents of every dollar paid.

So, if there was no deferral, and Ray Corp. paid Emily $100,000 in 2009, the IRS would get an immediate claim of $15,000. If instead Ray Corp. and Emily deferred the 2009 compensation, the IRS’s claim would be $30,000 (i.e., 15% of $200,000) in 2019. Just like Emily, the IRS sees its money double from 2009 to 2019. The IRS is “due” $15,000 in 2009, but it gets $30,000 in 2019 if the compensation is deferred.

115 See infra Part III.A.
After-Tax Consequences of Current 2009 Compensation

<table>
<thead>
<tr>
<th></th>
<th>Emily</th>
<th>Ray Corp.</th>
<th>IRS</th>
</tr>
</thead>
<tbody>
<tr>
<td>2009 Compensation</td>
<td>$100,000</td>
<td>($100,000)</td>
<td></td>
</tr>
<tr>
<td>2009 Tax</td>
<td>($35,000)</td>
<td></td>
<td>$35,000</td>
</tr>
<tr>
<td>2009 Deduction</td>
<td></td>
<td>$20,000</td>
<td>($20,000)</td>
</tr>
<tr>
<td>2009 Net</td>
<td>$65,000</td>
<td>($80,000)</td>
<td>$15,000</td>
</tr>
</tbody>
</table>

After-Tax Consequences of Deferred 2019 Compensation

<table>
<thead>
<tr>
<th></th>
<th>Emily</th>
<th>Ray Corp.</th>
<th>IRS</th>
</tr>
</thead>
<tbody>
<tr>
<td>2019 Compensation</td>
<td>$200,000</td>
<td>($200,000)</td>
<td></td>
</tr>
<tr>
<td>2019 Tax</td>
<td>($70,000)</td>
<td></td>
<td>$70,000</td>
</tr>
<tr>
<td>2019 Deduction</td>
<td></td>
<td>$40,000</td>
<td>($40,000)</td>
</tr>
<tr>
<td>2019 Net</td>
<td>$130,000</td>
<td>($160,000)</td>
<td>$30,000</td>
</tr>
</tbody>
</table>

Because the IRS gets the same deal as Emily, it is given the full value of its claim to the compensation element of deferred compensation. Implicit in this assertion is the unorthodox step of measuring the IRS's time-value-of-money claim using an after-tax rate of return agreed to by private parties. Ordinarily, the IRS pays and receives interest according to rates set by statute.\textsuperscript{116} As a normative matter, however, an arms-length rate set by private parties is a superior measure. Indeed, the market rate of return implied by Emily and Ray Corp.'s contract should reflect the risks that Ray Corp. will not pay Emily in 2019, in which case the IRS (like Emily) will receive nothing from its compensation claim. In short, the IRS is deferring its compensation claim on the same terms as Emily, making it entitled to the same after-tax return that Emily receives.

Even if the IRS's claim is valued according to the return agreed upon by Emily and Ray Corp., using the after-tax return of 7.2% might seem inappropriate. Why should the IRS be limited to the after-tax return when it is functionally tax exempt? The answer lies in the fact that the IRS would bear an implicit "tax" if it were actually in the business of lending money. Recall that the IRS is deferring its 2009

\textsuperscript{116} See I.R.C. §§ 6601, 6611, 6621 (West 2010) (describing interest paid and received by the IRS on overpayment and underpayment of taxes); see also Rev. Rul. 2008-10, 2008-13 I.R.B. 676 (announcing rates for second quarter of 2008).
claim of $15,000 to 2019. Now, if Emily could borrow $15,000 from
the IRS for ten years to finance her debt investment in Ray Corp., she
would presumably be entitled to an interest deduction.\footnote{In this case, this Article assumes that Emily has borrowed these funds in order to make her investment in Ray Corp. If that is the case, the interest is deductible as investment interest. See I.R.C. § 163(d)(3)(A).} Were Emily
to pay deductible interest of 11\% to the IRS, the IRS would keep only
7.2\% on a net basis, because Emily would take a deduction that reduces
her net interest expense from 11\% to 7.2\%.\footnote{\footnotetext{11\% less the 35\% tax is 7.2\%.}} The difference of 3.8\% burdens the IRS because it reduces other revenue the IRS would receive
from Emily.\footnote{It is possible to establish the appropriateness of using the 7.2\% rate through another method. Ray Corp.'s equivalent before-tax rate is 9.0\% because 9.0\% less 20\% is 7.2\%. Were the IRS to pay taxable interest of 9.0\% to Ray Corp., the IRS would face a net payment of only 7.2\%. Because the 9.0\% interest is taxable to Ray Corp, 20\% of the payment goes to the IRS as tax revenue.} Thus, the after-tax return earned by Emily of 7.2\% is the
appropriate rate of interest to measure the IRS's compensation claim.

Under this analysis, then, the IRS does in fact get its proper share
of the compensation element of deferred compensation. Ideally, the
IRS would receive its claim to the compensation element upon initial
deferral (2009 in the example). Instead, the IRS gets an equivalent
amount when deferred compensation is actually paid (2019 in the
example). Although there may be other plausible approaches to valuing
the compensation element, the one given above has the advantage of
simplicity. In fact, it is not even necessary to identify the actual after-
tax interest rate used by Emily and Ray Corp. or the amount of 2009
compensation deferred. That rate is implied by the deal struck by the
private parties, and the IRS will always be made whole at the time of
ultimate payment.\footnote{The IRS does lose, however, if the employee's tax rate falls after the initial deferral. \textit{Cf} Chason, supra note 6.} All that is needed is to ensure that the payment of
deferred compensation is taxed as it is under current law.

C. \textit{The Investment Element of Deferred Compensation}

Recall that the normative baseline for taxing deferred compensation is based on what the IRS would receive if the parties
structured their transaction as an equivalent combination of current
compensation followed by a debt (investment) transaction. As
discussed, current law gives the IRS its claim to the compensation element of deferred compensation, but does not go any farther. Thus, it
fails to give the IRS any claim at all to the investment element, which is
inherently valuable. To see what the IRS loses under current law,
consider again the example of deferred compensation and the economically equivalent transactions, which produce the same cash flows and economic risks for Emily as does deferred compensation. Because Emily is indifferent between deferred compensation and the equivalent transactions, any additional taxes from the equivalent transaction are borne by Ray Corp. That is consistent with the ultimate proposal of this Article to levy a special tax on the employer only.121

Recall that in Example 10, deferred compensation offers Emily a $200,000 payment in 2019 in lieu of a $100,000 payment in 2009. Assuming that Ray Corp. pays tax at a 20% rate and Emily at 35%, the investment (debt element) can be determined by the following economically equivalent transactions:

Example 11: The following transactions are, from Emily’s perspective, economically equivalent to the deferred compensation described in Example 10:

Compensation Element: Ray Corp. pays Emily $100,000 in compensation. After tax, Emily keeps $65,000.

Investment (Debt) Element: Emily loans $65,000 back to Ray Corp. at a taxable rate of about 11%, for a period of ten years. After tax, this 11% rate is 7.2%; that doubles Emily’s money in ten years and she receives $130,000 in 2019. This amount is what Emily would have netted had she received a taxable $200,000 payment of deferred compensation in 2019.

As discussed above, current law gives the IRS its proper share of the compensation element. Even though the IRS must wait to receive its share until 2019, it is adequately compensated. The IRS’s other claim is to the debt component of the equivalent transaction, and the IRS receives nothing for this claim under current law. The following chart describes what the IRS should be receiving. Its right-hand column of shows the cash flows to the IRS from the investment (debt) element in Example 11:

121 See infra Part IV.B.
Table 1

<table>
<thead>
<tr>
<th>Year</th>
<th>Loan Balance (grows at ~7.2%)</th>
<th>Pretax Interest (~11%)</th>
<th>Emily's Tax on Interest (35%)</th>
<th>Ray Corp.'s Deduction for Interest (20%)</th>
<th>Net IRS Claim</th>
</tr>
</thead>
<tbody>
<tr>
<td>2009</td>
<td>$65,000</td>
<td>$7,177</td>
<td>$2,512</td>
<td>$(1,435)</td>
<td>$1,077</td>
</tr>
<tr>
<td>2010</td>
<td>69,665</td>
<td>7,692</td>
<td>2,692</td>
<td>(1,538)</td>
<td>1,154</td>
</tr>
<tr>
<td>2011</td>
<td>74,665</td>
<td>8,245</td>
<td>2,886</td>
<td>(1,649)</td>
<td>1,237</td>
</tr>
<tr>
<td>2012</td>
<td>80,024</td>
<td>8,836</td>
<td>3,093</td>
<td>(1,767)</td>
<td>1,325</td>
</tr>
<tr>
<td>2013</td>
<td>85,768</td>
<td>9,471</td>
<td>3,315</td>
<td>(1,894)</td>
<td>1,421</td>
</tr>
<tr>
<td>2014</td>
<td>91,924</td>
<td>10,150</td>
<td>3,553</td>
<td>(2,030)</td>
<td>1,523</td>
</tr>
<tr>
<td>2015</td>
<td>98,522</td>
<td>10,879</td>
<td>3,808</td>
<td>(2,176)</td>
<td>1,632</td>
</tr>
<tr>
<td>2016</td>
<td>105,593</td>
<td>11,660</td>
<td>4,081</td>
<td>(2,332)</td>
<td>1,749</td>
</tr>
<tr>
<td>2017</td>
<td>113,172</td>
<td>12,496</td>
<td>4,374</td>
<td>(2,499)</td>
<td>1,874</td>
</tr>
<tr>
<td>2018</td>
<td>121,294</td>
<td>13,393</td>
<td>4,688</td>
<td>(2,679)</td>
<td>2,009</td>
</tr>
<tr>
<td>2019</td>
<td>130,000</td>
<td></td>
<td></td>
<td></td>
<td></td>
</tr>
</tbody>
</table>

Thus, the debt component of the equivalent transaction produces a series of positive, net claims for the IRS from 2009 through 2018. The IRS should be receiving these periodic amounts (or their lump-sum equivalent), regardless of whether the private parties structure their deal as deferred compensation or the equivalent compensation/debt combination. Because current law gives the IRS only its claim to the compensation component, it essentially negates the IRS’s claim to the debt or investment component of deferred compensation.

Note that the tax advantage of deferred compensation turns on the difference in the parties’ tax rates, precisely because it is this difference that gives value to the IRS’s claim to interest. If the employer and employee have the same tax rate, there is no advantage to deferred compensation, as interest passing between two equivalent-rate taxpayers produces no revenue for the IRS. If the employer has a lower rate, however, deferred compensation is advantageous because the benefit to the employee (tax-exempt interest) outweighs the burden to the

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122 Each period the loan balance increases by the after-tax interest rate. In the text, this is described as 7.2%, but a more precise estimate that will replicate the numbers in the charts is 7.177%. See supra note 112.

123 A more precise estimate of the interest rate that will replicate the numbers in the chart is 11.042%. See supra note 114.
employer (foregone interest deduction). In essence, deferred compensation allows the employer to give tax-exempt interest to the employee, so long as the employer forgoes its own interest deduction.

This result is consistent with other works that have viewed deferred compensation as an investment conduit by which low-tax corporations invest on behalf of high-tax employees. The tax benefit is proportionate to the difference in tax rates between the parties. That being said, there are two advantages to the current approach. The first advantage is theoretical, in that it does not depend on the existence of a rabbi trust or other funding. Deferred compensation implies an investment contract between employer and employee. This contract—not any actual or hypothetical funding—is what should be taxed. The second advantage is pragmatic in that it allows for the development of a special tax levied on the payment of deferred compensation. As suggested earlier, the failure of current law to tax the interest component of deferred compensation creates unjustifiable tax planning opportunities. Remedying this failure is the goal of this Article.

IV. APPLYING A SPECIAL TAX UPON PAYMENT OF DEFERRED COMPENSATION

A. Goals of the Special Tax

Any proposal to cure the failures of current law must be administrable as applied to a wide range of taxpayers and deferred compensation arrangements. Moreover, any proposal should give employers and employees maximum freedom in structuring their economic deals. Thus, Congress should neither attempt to outlaw deferred compensation nor encourage it. Instead, Congress should tax deferred compensation according to the compensation and investment components that replicate the cash flows the employee receives from deferred compensation. Using simple debt as a prototypical investment transaction, Part III of this Article demonstrated how current law fails to tax the investment component and reiterated the call made by other scholars to impose a special tax on deferred compensation.

Debt is the motivating example in the development of the special tax, but this Article will extend the debt model to a variety of deferred compensation plans that do not have debt as their investment component. For now, though, the task is to develop a special tax that

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124 See supra Part II.A.
125 See supra note 13 and accompanying text.
126 See supra Part III.B.
gives the IRS its appropriate claim to the interest that passes from employer to employee in a debt-based deferred compensation plan.

This tax is a special tax on the employer, levied at the time of actual payment, which equals revenue that the IRS should receive from the interest inherent in deferred-compensation contract. There are two design constraints on this special tax: (1) that it be imposed on the employer only, and (2) that it be imposed at the time when actual payment is made under the deferred compensation contract. These considerations are explained in more detail as follows.

B. **Taxing the Employer Only**

Taxing the employer is justified because the employer is almost certainly in a better administrative position to calculate and pay the tax than are individual employees. Moreover, the goal of most deferred compensation arrangements is to prevent employees from facing any tax consequences before the time of final payment. Levying the special tax on the employee would probably prompt employers to provide additional compensation to the employee to cover the extra tax bill. So, levying the special tax on the employer is consistent with the goals of the private parties and allows them to avoid the unnecessary expense of contractually shifting the incidence of the tax to the employer. There is nothing wrong with facilitating this goal, so long as the IRS's net claim is not affected.

The employer’s role is not limited to being a tax proxy or withholding agent for the employee. The employer is also the actual debtor, accruing an interest expense under the deferred compensation contract. Current law does not allow an interest deduction, precisely because the interest income is not taxable to the employee. If interest income becomes taxable, then the employer’s interest expense should be deductible.

The employer’s two roles (proxy for the employee and debtor) dictate the tax rate to be applied for the special tax. Deferred compensation is concentrated almost entirely on highly paid employees. Under the reasonable assumption that all beneficiaries of

127 See Albertson’s, Inc. v. Comm’r, 95 T.C. 415 (1990) (holding for Commissioner), aff’d, 42 F.3d 537 (9th Cir. 1994).

128 A. Thomas Brisendine et al., Tax Management Portfolio 385-4th: Deferred Compensation Arrangements § IX.A. ("Strange as it may seem at first glance, unfunded deferred compensation plans for rank-and-file employees are illegal, even where the employer's intention is to confer a benefit that it would not otherwise provide."). Deferred compensation, being an unfunded ERISA retirement plan, can be established only for "a select group of management or highly compensated employees." Employee Retirement Income Security Act of 1974 (ERISA), § 301(a)(3), 29 U.S.C. § 1081 (2006). So-called excess benefit plans under
deferred compensation are executives paying the top marginal rate, the
top rate applies when taxing the employer as proxy for the employee.
Since the employer is the actual debtor, it should simply take an
income-tax deduction for the interest expense it incurs. So if the
employer also faces the top marginal rate, the two components will
offset one another. This is as it should be, because the IRS ordinarily
has no claim to interest passing from taxpayers at the same marginal
rate. As the employer’s tax rate falls, the IRS’s debt claim will grow
larger. At the extreme, the IRS’s debt claim is worth a full 35% of
interest paid if the employer is tax exempt.

C. Taxing Deferred Compensation Only upon Payment

The proposed special tax has another design constraint—it is levied
only when the employer makes an actual payment to the employee.
This timing rule is inconsistent with the usual taxation of debt, which is
subject to annual taxation as interest passes between the parties. One
rationale for imposing the tax on the back end is to avoid taxpayer
resistance against paying tax on “phantom” income. Another is that it
avoids difficult issues that would arise if the employer defaulted on its
defered compensation obligation. Had the employer taken periodic
interest deductions, it would arguably have cancellation of indebtedness
income upon default. Conversely, the employee (or the employer, as
proxy) could conceivably claim a loss deduction after paying tax on the
interest.

Perhaps most importantly, a back-end tax avoids the cumbersome
task of periodically valuing the deferred compensation obligation. An
annual, periodic tax would require that a value be placed on the promise
starting at the time of initial deferral. Yet the value of the initial
promise may be difficult to discern, particularly if the contract is not
structured as debt. Deferred compensation is often structured to give
employees a payout that is dependent upon the employer’s profitability
or the performance of external investments (like a stock market index).
The ultimate payment in deferred compensation is known, because that
is what the Code currently taxes. Even if structured as debt, deferred
compensation plans may not have clear values before the time of actual
payment. The parties simply might not oblige the IRS with the initial

ERISA § 3(36) can be offered outside this “select group,” but they are quite narrow and rare in
practice. See BRISENDINE, supra, § IX.A. (noting that excess benefit plans are not a common
refuge from the requirements of ERISA); id. § II.G. (“An excess benefit plan must be maintained
‘solely’ for the purpose of providing benefits in excess of the [IRC] § 415 limits and the
limitation will, in all likelihood, be construed narrowly.”).

129 See supra notes 67-68 (discussing original-issue discount).
value of the contract as Emily and Ray Corp. have done in the examples. For example, an employer might promise to pay $200,000 in 2019 without declaring the 2009 value of the promise. A back-end tax, as proposed here, can be levied in 2019 based on the $200,000 payment without knowing the initial value of the promise.130

Because the special tax applies only upon ultimate payment of deferred compensation, it must be levied on the future value of the investment component that is implicit in the deferred compensation contract. This Article will term this future value the “lump-sum interest,” as interest-bearing debt is the motivating example for the special tax. Ordinarily, interest is taxed as it accrues, but the special tax will wait until completion of the contract. The employer would pay a nondeductible tax on the lump-sum interest at the highest rate for individuals (currently 35%). The assumption that all employees accruing deferred compensation are taxed at the 35% rate is close to reality,131 and is necessary to administer a special tax on payment to the employee. The 35% tax on the lump-sum interest amount reflects the value of the tax that should have been collected from the employee over the course of the deferred-compensation contract. The employer pays this tax as proxy for the employee.

At the same time it pays this tax, the employer can take a deduction for the lump-sum interest. This amount reflects the future value of the deductions that the employer should have been taking over the course of the contract. Ideally, the employer would have been deducting interest throughout the life of the contract, and the lump-sum deduction at the end may yield different results because the employer’s tax rate may vary from year to year. Corporations do, however, have substantial (although imperfect) income averaging through the use of net operating losses,132 which stabilize the marginal tax rate—measured in economic terms—that corporations pay. Also, it is likely that employers have fairly stable annual expenses related to deferred compensation, suggesting that the actual interest incurred under deferred compensation is close to the lump-sum interest deducted under the special tax proposal. In summary, and as with the assumption that all beneficiaries of deferred compensation pay a tax of 35% tax, granting the interest deduction in the year of actual payment does not perfectly capture the results from taxing annual interest. Yet it is a close approximation that achieves an administrable result.

130 See supra Part III.A.
131 See supra notes 43-48 and accompanying text.
D. Calculating Lump-Sum Interest

In order to calculate the lump-sum interest, it is first necessary to identify the periodic interest that should be subject to tax. Example 11 above describes the periodic interest passing from Ray Corp. to Emily, but it is important to describe this interest in more conceptual terms. As a practical matter, it is possible to identify the periodic interest by the after-tax interest rate implied by the parties’ transaction and the before-tax amount of compensation deferred.\textsuperscript{133} In the prior example, the before-tax interest rate implied by the parties was about 7.2%, and the before-tax deferral was $100,000. Thus, about $7200 of interest should be taxed by the IRS in the first year of deferral (2009), as confirmed in Example 11.

Because interest is being capitalized, the amount of interest grows every year; the growth rate is the same as the interest rate, or 7.2%. Thus, in the second year of deferral (2010), about $7700 in interest is incurred, and subsequent years’ interest has the same growth rate. The chart in Table 1 confirms the accuracy of these estimates. Thus, the IRS’s claim can be described as a growing annuity that starts at $7200,

\textsuperscript{133} Conceptually, this approach commits two wrongs that do make a right. The IRS’s debt claim is based on the before-tax interest rate implied by the private parties’ transaction and the after-tax amount of compensation deferred. The reason for using the before-tax rate of interest should be obvious, as the Code imposes tax on, and often allows deductions for, private-party interest. Using the numbers from the example, the before-tax interest rate is about 11% (“grossed up” from 7.2%). The reason for using this before-tax rate is a bit cumbersome because the interest rate implied by the transaction is an after-tax return, but the special tax should be based on a before-tax return. Theoretically, then, the special tax works only if the implicit interest is appropriately “grossed up.”

Recall that in the example, Ray Corp. is providing an after-tax return of about 7.2%, which doubles Emily’s money over ten years. If the goal is to give an employee a 7.2% after-tax return, then the tax cannot be based on interest of 7.2%. Instead, it is necessary to increase the taxable interest rate to 11%; after the imposition of a 35% tax on interest of 11%, the employee is left with 7.2%. In essence, the special tax proposed in this Article would allow the employee to keep the 7.2% of interest “tax free,” but force the employer to pay tax on the grossed up (11%) interest as the employee’s proxy or withholding agent. This yields precisely the same result for the IRS as if Emily herself were personally taxed on interest of 11%. Emily keeps 7.2% as capitalized interest, and the remaining 3.8% represents a claim held by the IRS.

Fortunately, it is not necessary to gross up the interest rates directly when calculating the special tax. Recall in the example that deferred compensation is bifurcated into a wage and debt transaction, using Emily’s 35% marginal tax rate in both transactions. In the wage transaction, it was assumed that Ray Corp. paid her $100,000, but that Emily paid $35,000 of cash. So, Emily loans $65,000 to Ray Corp. in the debt transaction, in which the before-tax rate of 7.2% was grossed up to 11%. In short, the special tax on after-tax compensation ($65,000) and before-tax interest (11%) is conceptually based. It is possible to equivalently base the special tax on before-tax compensation ($100,000) and after-tax interest (7.2%). Either method produces the same amount of taxable interest. The second method is more administrable, however, as it allows for the calculation of the amount of taxable interest implied by the deferred compensation contract without knowing the employee’s marginal tax rate.
and is subject to a growth and interest rate of 7.2%, lasting for ten years. With this conceptual description of the interest rate, it is possible to use a future-value formula to find the 2019 value of these interest payments, which is about $135,000.\textsuperscript{134} Calculations relying on future-value formulas may be too unwieldy. For that reason, discussion of the formulas is left to the Appendix, while this Article proposes that the lump-sum interest be calculated in the following—hopefully more intuitive—manner.

**Interest Rate:** The mechanics of determining the lump-sum interest rate become simpler if the interest rate is adjusted slightly. In the example, before-tax interest rate implied by the private parties is about 7.2%, using annual compounding.\textsuperscript{135} A continuously compounded interest rate allows for a simpler calculation. In Example 12, the equivalent continuously compounded interest rate is 6.9%.\textsuperscript{136}

**Lump-Sum Interest:** With the change to a continuously compounded interest rate, it is possible to drop the future-value formulas and value the lump-sum interest through an equivalent yet more intuitive process. Under this process, the lump-sum interest equals the product of:

- the final pre-tax payment ($200,000),
- the continuously compounded interest rate (6.9%), and
- the number of years that the deferred compensation contract was outstanding (10 years).

These steps look remarkably like the way one computes simple, uncompounded interest. Yet it produces essentially the same result as the more sophisticated future-value formula. In the example, this yields a lump-sum interest of $200,000 \times 6.9\% \times 10 = $138,000, roughly the same result derived above.\textsuperscript{137} The difference is due to the switch from annual to continuous compounding.

The remaining steps are straightforward. The employer deducts the lump-sum interest in the year of payment, but must pay a nondeductible special tax on the lump-sum interest at the same time. In

\textsuperscript{134} The future value of a growing annuity is \( A \times n \times (1+i)^{-1} \), where \( A \) is the initial annuity, \( n \) is the number of years, and \( i \) is the interest (and growth) rate. See Wikipedia, Time Value of Money, http://en.wikipedia.org/wiki/Time_value_of_money#Future_value_of_a_growing_annuity (last visited Apr. 15, 2010) ("Where \( i = g \)"). So, the future value is $7200 \times 10 \times (1.072)^{-1} = $134,613.

\textsuperscript{135} Careful readers may detect an apparent inconsistency. Earlier, this Article proposed that the special tax should be based on the before-tax rate of interest, whereas here this Article bases the calculation on the after-tax rate of interest. This is true, although Step Two compensates for this by assuming that the implied loan is of the before-tax amount of $200,000. These two "wrongs" essentially cancel each other out, and allow for simpler computational steps. Readers who desire a more rigorous explanation should consult the Appendix.

\textsuperscript{136} Recall that a 7.2% rate doubles money over ten years with annual compounding. A 6.9% rate does the same with continuous compounding as \( e^{10 \times 0.069} = 2 \). A more precise estimate is \( \ln(2) / 10 = 6.9315 \).

\textsuperscript{137} See supra note 134 and accompanying text.
the example, Ray Corp. gets a 2019 deduction worth $138,000 \times 20\% = $27,600, but must pay a 2019 special tax of $138,000 \times 35\% = $48,300. The net claim of the IRS is the difference between the two, which is $20,700 in the example.  

Note that the special-tax regime will not always produce revenue for the IRS. If the employer pays tax at the 35\% tax rate, the value of its deduction will precisely offset the cost of the special tax. Earlier in this Article, it was shown that differences in the tax rates between employer and employee create a tax advantage for deferred compensation. The special tax proposed in this Article curtails that advantage, without burdening further deferred compensation.

V. APPLYING THE SPECIAL TAX TO DIVERSE DEFERRED COMPENSATION ARRANGEMENTS

The previous Part proposed a special tax that would apply to a simple, debt-based, deferred-compensation arrangement. Such simple arrangements are found in practice, but so too are others not easily classified as straight debt. The goal of this Part is to extend the special tax to the fullest possible array of deferred compensation arrangements used in practice.

A. Statutory Versus Contractual Interest Rates

In the prior example, the actual contractual rate of interest was used to calculate the lump-sum interest amount. Determining the actual contract rate of interest may not always be feasible. For example, the deferred compensation may be expressed simply as a promise to pay an amount in the future (e.g., $200,000 in 2019). It is not possible to extrapolate the implied interest rate without knowing the equivalent amount of current compensation (e.g., $100,000 in 2009).

Moreover, the private parties cannot be expected to provide reliable information about the equivalent amount of current compensation. Because the special tax depends on the interest rate, the parties would have an incentive to manipulate any information they provide in order to depress the interest rate implicit in deferred compensation.

Example 12: Emily and Ray Corp. purport that Emily is deferring $180,000 in 2009 in exchange for a payment of $200,000 in 2019.

138 $48,300 - $27,600.
The interest rate implied by the parties’ contract is about 1%.\textsuperscript{139} If the form of Emily and Ray Corp.’s contract were respected, the special tax would result in a net tax cost to Ray Corp. of $3000.\textsuperscript{140} In contrast, Example 11 assumed a $200,000 payment in 2019 but a 6.9% interest rate. This higher interest rate resulted in a net tax on Ray Corp. of $27,000.\textsuperscript{141} The variance comes from the fact that the special tax is directly proportionate to the assumed interest rate.

Another difficulty would arise from contractual rates that vary over time despite very good information about the initial value of the deferred compensation. A common deferred compensation arrangement has the employee electively defer salary or bonus payments, and the employer would then credit the deferred compensation to a notional account, which would be periodically adjusted for interest credits. Yet the interest credits might not be fixed, being based instead on an adjustable rate like the prime interest rate or LIBOR.\textsuperscript{142} Taxing the exact amount of interest would require the employer and the IRS to track interest as it fluctuates, a task tantamount to imposing the tax on a periodic basis. Indeed, a periodic tax may work well when an employer sets aside an identifiably account for an employee and credits it with a reasonable rate of interest. In other contexts, however, a periodic tax will not work so well.\textsuperscript{143} For the sake of uniformity, this Article’s proposal would subject all deferred compensation plans to the special tax only upon actual payment, rather than periodically.

To avoid the difficulty of varying interest rates or employer manipulation, the special tax should be based on a statutory rate of interest. The Internal Revenue Code commonly uses statutory rates in imputing interest to transactions, with perhaps the closest parallel being the taxation of loans between employer and employee bearing below-market interest.\textsuperscript{144} The solution of § 7872 is to impute interest to below-market loans at a statutorily prescribed, “applicable Federal rate,”\textsuperscript{145} or AFR. For example, the long-term AFR for December 2008 is 4.45%,\textsuperscript{146} implying an after-tax interest rate of about 2.9%.\textsuperscript{147} There are potential

\textsuperscript{139} A closer estimate is 1.06% as $180,000 \times 1.0106^{10} = $200,000.

\textsuperscript{140} The lump-sum interest is 1% \times 10 \times $200,000 = $20,000. The 35% proxy tax would be $7000. The deduction, assuming a 20% rate, would be worth $4000. The difference between the two, $3000, is the IRS’s net claim.

\textsuperscript{141} See supra note 138 and accompanying text.

\textsuperscript{142} LIBOR is the London Interbank Offer Rate and is a short-term rate used by banks borrowing from one another and to value derivative contracts. See BODIE ET AL., supra note 40, at 551.

\textsuperscript{143} See supra Part II.A.

\textsuperscript{144} I.R.C. § 7872(c)(1)(B) (West 2010).

\textsuperscript{145} I.R.C. § 7872(f)(2).


\textsuperscript{147} The 4.45% rate is reduced by 35% to arrive at the equivalent after-tax rate. The AFR represents a before-tax interest rate because the interest imputed by § 7872 is includible to the
objections to using a discount AFR in calculating the special tax in light of the nature of deferred compensation and common employer practices.

One reason that AFR may not be appropriate for levying the special tax is that it is based on the cost of borrowing to the United States government. Deferred compensation is long-term corporate, not government, borrowing, and is analogous to a bond or debenture. Investment-grade corporate bonds carry a higher rate of interest than U.S. government debt, reflecting their lower liquidity and higher risk of default. The Code already uses corporate-bond yields to determine funding levels for qualified retirement plans, and those yields could serve as the basis for the special tax. By way of comparison to the 4.45% AFR noted above, the “composite corporate bond rate” for November 2008 was 7.72%.

The interest rate used above was the after-tax return implied by the deferred compensation plan. Presumably, then, the statutory rate for levying the special tax should similarly be reduced to an after-tax rate. After all, the yield on corporate bonds is taxed as ordinary income. Yet deferred compensation often bears rates of return above what could be achieved in the market. The method of granting above-market returns can be express, such as when firms promise interest rates that are objectively higher than any market index, or when employers offer investment returns that replicate the tax-exempt returns of their 401(k) plans. In short, employers frequently augment the investment return on deferred compensation, providing after-tax returns that are the same or higher than market-based before-tax returns.

One might argue that the augmented return is actually “camouflage compensation” and thus not appropriately taxed as interest. However, the camouflage compensation is being structured as interest in this example, making it appropriate to tax it as such. Moreover, the additional return may well be a default premium that the employee enjoys. A cornerstone of deferred compensation, the economic benefit

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lender and potentially deductible by the borrower. See BITTKER & LOKKEN, supra note 17, ¶ 55.3.2 (“The lender has gross interest income equal to the forgone interest, and the borrower has an interest deduction in like amount if all of the limitations on deductions for interest are satisfied.”).

149 See BODIE ET AL., supra note 40, 477, 496.
150 See I.R.C. § 430(h)(2)(C).
152 See LUCIAN BECHUK & JESSE FRIED, PAY WITHOUT PERFORMANCE 102 (2004).
154 Cf. BECHUK & FRIED, supra note 152 (arguing that deferred compensation is a method of camouflaging excess compensation of executives).
doctrine provides that the employee must bear the risk of default if the employer becomes insolvent or bankrupt, even if the employer sets aside funds for the employee. Similarly, the fact that deferred compensation is illiquid may also justify premiums above market rates. Thus, this Article would tentatively propose using a long-term, before-tax market rate of interest to calculate the special tax, while recognizing the need for greater study into common employer practices.

B. Phantom Stock and Other Non-Debt Deferred Compensation

Up to this point, this Article has assumed that the investment component of deferred compensation is functionally debt. However, the investment component of deferred compensation is often structured to replicate an equity investment, such as employer stock. Part V.B will extend the special-tax analysis to non-debt deferred compensation, arguing that the special proposed above can be applied to equity-based arrangements without modification.

If the investment component is in employer equity, the arrangement is known as “phantom stock,” which replicates the benefits of outright ownership of employer equity. For example, an employer might promise to pay an employee the value of a thousand shares of employer stock, ten years after the initial promise. Note that the employee does not actually own the stock, nor does she have the right to acquire any actual stock. The employer has simply made an unfunded promise to pay a future amount, determined by reference to the value of its stock at the time of payment.

Example 13: In 2009, Ray Corp. promises to pay Emily the value of 10,000 shares of its common stock in 2019. In 2009, Ray Corp.’s stock is worth $100 per share, and in 2019 it is worth $400 per share.

Ray Corp. has not delivered any shares (i.e., property) to Emily in this example. Under the doctrines of constructive receipt and economic benefit, it has made an unfunded promise to pay in the future, resulting in no tax consequences until 2019. At that time, Emily will receive a $4,000,000 pretax payment, leaving her with $2,600,000 if she is a 35% taxpayer. At the same time, Ray Corp. will pay $4,000,000 pretax, costing it a net $3,200,000 if it is a 20% taxpayer.

Previously in this Article, the special tax was developed with the assumption that deferred compensation contains a debt component.

155 See supra note 18 (describing the economic benefit doctrine, which subjects employees to immediate taxation when they no longer face a risk of employer default).
156 See BRISENDINE ET AL., supra note 128, at 11E ("A phantom stock plan is yet another form of incentive compensation, under which an employee is awarded the right to receive a fixed payment equal to the value of a specified number of shares of employer stock.").
Remediing the failure of current law to tax this debt component was the goal of the special tax. Now, however, it is necessary to address a deferred compensation arrangement that contains an equity—not debt—component. Fortunately, a good argument can be made to apply the special tax in an essentially unaltered form even when the investment component is not structured as debt. At an intuitive level, a uniform approach seems not only fair but also easily administrable, removing the problematic debt/equity distinctions from the world of deferred compensation.

More formally, it is possible to think of phantom stock as having a variable payment but otherwise being "debt like." Phantom stock is not actual ownership of equity, but instead a promise by the employer to pay an amount in the future. Unlike ordinary debt, however, the ultimate payment is not a fixed amount based on interest rates. Instead, it is based on the performance of the employer’s stock.

Indeed, financial and tax theory both support the idea of treating fixed and variable payments equally. The taxation-of-risk literature demonstrates that the tax burden on risky investments is the same as that on risk-free investments.157 Similarly, the method for pricing forward contracts from financial economics assumes that risky and risk-free payoffs have equivalent value.158 Since the risky payoff of phantom stock is equivalent to the fixed payoff of ordinary deferred compensation, it is appropriate to use the special-tax model developed above to tax phantom stock.159

However, these theories do have real-world limitations. For example, the taxation-of-risk literature assumes that a single, flat rate of tax applies to all risky investments, and that all losses are fully usable at that rate.160 In contrast, the Internal Revenue Code has multiple rates161 and does not allow for full usability of losses.162 These real-world limitations are almost wholly unfriendly to taxpayers when compared with the idealized world of theory.163 Accounting for these limitations in the special tax would, however, be infeasible from an administrative perspective.164 A practical special tax, based on these theoretical

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158 See HULL, supra note 71, at 103-04.
159 This point is made in somewhat more detail infra Appendix, Part II.
161 See I.R.C. § 1(h) (describing several rates applicable to capital gains) (West 2010).
162 See I.R.C. § 1211.
163 One taxpayer-friendly intrusion from the real world is the step up in basis that applies to inherited property. See I.R.C. § 1014. The step up does not apply to phantom stock and other deferred compensation because it is income in respect of a decedent. See I.R.C. § 1014(c).
164 Phantom stock can be re-characterized as ordinary deferred compensation combined with a forward contract to purchase the stock. Cf. Yale & Polsky, supra note 6, at 616 (equating phantom stock plans with a combination of current compensation, debt, and forward contract).
models, may well under-tax the investment component of phantom stock, as it will not account for these taxpayer-unfriendly elements of the Code. However, the Code does not currently tax the investment component at all. While the special tax proposed here may not fully tax the investment component of phantom stock, it does not result in over-taxation and is an improvement over current law.

The mechanics of applying the special tax to phantom stock are the same as before. It is first necessary to identify the appropriate interest rate. In prior examples, a rate of 6.9%, compounded continuously, was used. Next, the product of the interest rate (6.9%), the duration of the contract (ten years), and the final value of the contract ($4,000,000) arrives at a lump-sum interest amount of $2,760,000.\(^{165}\) Ray Corp. then pays a special tax on the lump-sum interest at the highest marginal rate. At a 35% rate, the tax is $966,000. Ray Corp. then deducts the lump-sum interest. If Ray Corp. is at the 20% rate, the deduction is worth $552,000. On a net basis, Ray Corp. must pay $414,000 of extra tax to the IRS.

C. Measuring the Duration of Deferred-Compensation Contracts

The proposed special tax turns on three inputs: an interest rate, the amount actually paid to the employee, and the duration of the contract. This Article has already studied the first two inputs,\(^{166}\) but it has taken the duration of the contract for granted in prior examples. However, the duration of the contract is worthy of additional consideration given its ambiguous nature in some arrangements.

The special tax relies on the idea that the employee "earns" the right to compensation before it is actually paid. The cash-method of accounting, however, allows the employee to defer the tax consequences of compensation until actual payment. A byproduct of this deferral is that current law fails to tax the investment income that accrues from the time the compensation is earned until it is paid, and the special tax attempts to remedy this failure by imposing an additional tax at the time of actual payment. The duration of the contract, which is needed to levy the special tax, is the period between the earning and the payment of compensation.

One problem in measuring the duration of the contract arises when an employee has not perfected the right to future payment. For example, future payment might be contingent upon the employee's

\(^{165}\) 0.069 \times 10 \times 4,000,000 = 2,760,000.

\(^{166}\) See supra Parts IV.D, V.A.
continued service or the employer’s profitability. The Code and regulations already have rules that measure just this issue under § 83. Section 83 taxes the transfer of property when rights to the property are “substantially vested,” meaning that the property is either transferable or not subject to a “substantial risk of forfeiture.”\textsuperscript{167} A substantial risk of forfeiture exists when rights in the property are conditioned upon the employee’s future performance of substantial services or the employer’s future profitability.\textsuperscript{168} Section 83 applies by its terms to transfers of property, not to unfunded promises. Nevertheless, the “substantial risk of forfeiture” concept can be readily applied to promises to determine when they are earned by the employee.

A more mechanical problem arises when an employee accrues benefits under a single plan of deferred compensation over multiple years. For example, an employee might defer compensation into a single account over several years, much in the same way that employees defer compensation into 401(k) plans. Over the years, the account will (hopefully) grow from investment performance and additional deferrals. Future payments will have been earned over several years, making the measurement of contract duration difficult—yet possible with the competent use of a spreadsheet program.

Measuring contract duration for defined benefit plans, is even more difficult, though, as illustrated by the following example:

Example 14: In 2009, Ray Corp. promises to pay Emily an annual annuity upon reaching age sixty-five equal to 2% of her average annual compensation multiplied by her years of service. In 2019, Emily retires at age sixty with an average annual compensation of $1,000,000 and twenty years of service, entitling her to an annuity of $400,000 per year, starting at age sixty-five. In 2024, Emily starts receiving her benefit of $400,000 per year.

There is no easy way to know the contract duration in 2019 when Emily retires. The special tax was originally designed to apply to discrete annual promises. To apply the special tax to defined-benefit plans would require the disaggregation of the $200,000 pension into ten separate promises. Doing so is theoretically possible if it is possible to examine the benefit that Emily has accrued every year,\textsuperscript{169} though it would require resorting to actuarial assumptions about the value of her benefits.

\textsuperscript{167} Treas. Reg. § 1.83-3(b) (as amended in 2005).
\textsuperscript{169} For example, suppose Emily has an average compensation of $1,000,000 throughout her tenure at Ray Corp. In 2009, with ten years of service, her earned benefit is $200,000 per year at age 65. Every year to follow she earns an additional year of service and an additional $20,000 benefit. It is possible to view the initial $200,000 and the subsequent $20,000 benefits as discrete promises, each having a unique duration. This is a plausible approach, but not a recommended one for reasons of administrability.
However, this Article proposes a simpler solution, which is to treat all benefits as having been earned ratably while employed. Thus, when Emily retires in 2019, the duration of her contract is five years—that is, half of the ten-year period over which she earned benefits. In 2019, Emily has already earned all of her benefits, meaning no special convention is necessary in order to handle the additional five-year period from 2019 to 2024. Thus, the duration of her contract in 2024 is ten years (i.e., the sum of the two five-year periods). Payments made in 2024 have a duration of ten years, payments in 2025 have a duration of eleven years, and so on.

This assumption of ratable accrual can be extended to all deferred compensation earned by a particular employee, at a particular employer. Employees will often earn deferred compensation under several different arrangements with a single employer. Rather than forcing the employer to track the duration of every deferred compensation arrangement, this Article proposes that all deferred compensation arrangements of a single employee be aggregated.

Example 15: Emily started working for Ray Corp. in 1989. From her promotion to Vice President in 2000 until her retirement in 2010, Emily accrues benefits under several deferred compensation plans maintained by Ray Corp. In 2020, Ray Corp. pays Emily a total of $200,000 under several of its deferred-compensation plans.

This proposal would treat all plans benefiting Emily as a single plan. When Ray Corp. pays Emily in 2020, a contract duration of fifteen years is assumed. The clock starts in 2000, when Emily starts earning benefits. But since it is assumed that Emily earns benefits ratably while employed, the period from 2000 to 2010 results in an average contract duration of five years (i.e., one half of the ten-year period of accrual). Since no benefits accrue after Emily’s retirement, the period from 2010 to 2020 adds ten years to the contract duration.

The total duration of fifteen years can then be used to calculate the special tax. If the interest rate is 6.9%, the lump-sum interest is $207,000.\footnote{15 \times 6.9\% \times \$200,000 = \$207,000.} As before, Ray Corp. pays a special tax on this amount at the highest marginal rates for individuals and also deducts this amount as an interest expense in 2020. Assuming the same rates as before, the net effect is an additional tax liability for Ray Corp. of $31,050 in 2020.\footnote{\$207,000 \times (35\% - 20\%) = \$31,050.}
CONCLUSION

Conceptually, deferred compensation is composed of compensation and investment components. Current law adequately taxes the compensation component, but it fails to tax the investment component, creating tax-planning opportunities and all the efficiency and distributive problems that ensue. The remedy is to tax the investment component, achieved by imposing a "special tax" upon employers when they pay deferred compensation.

The special tax proposed in this Article is focused on the taxation of the employer. In another article, this Author proposed a modest reform for the taxation of the employee under which the employee would always pay tax on deferred compensation at the highest marginal tax rate, thereby avoiding the problem of deferring compensation from high- to low-bracket tax years. These two proposals (the special rate for employees and the special tax on employers) would effectively neutralize any tax advantage for deferred compensation.

Negating the tax advantages of deferral has not, however, been the goal of past legislation. Section 409A, as described above, negates no advantage of deferral. Instead, § 409A simply narrows the field of compensation contracts that can actually achieve deferral. The complexity of § 409A is well known, as is the fact that it fails to achieve any discernable tax or non-tax policy. Thus, the additional tax proposed in this Article need not be an additional burden on employers who maintain deferred compensation plans, as future reforms should eliminate not only the tax advantages of deferred compensation, but its unnecessary regulation as well.

172 See supra note 13 and accompanying text.
173 See supra note 24 and accompanying text.
174 Future research on deferred compensation will hopefully shed more light on whether low-tax corporations actually use it to avoid taxation. Getting information about the tax status of publicly traded employers is actually feasible. See John Graham, Duke University, Tax Rate Order Form, http://faculty.fuqua.duke.edu/~jgraham/taxform.html (last visited Mar. 25, 2010) (providing an order form for simulated tax rates, which are "a sophisticated estimate of the corporate marginal tax rate for over 10,000 firms from 1980 through present"). The challenge, though, is in obtaining data on the actual usage of deferred compensation. Historically, financial accounting required no accounting for the grant of executive stock options beyond footnote disclosures and no separate accounting at all for other types of deferred compensation. More recently, the SEC has started requiring firms to disclose total pay packages (deferred and current) to their top executives. This information is useful and has been analyzed empirically. See Rangarajan K. Sundaram & David Yermack, Pay Me Later: Inside Debt and Its Role in Managerial Compensation (N.Y.U. Working Paper No. CLB-06-003, 2005), available at http://ssrn.com/abstract=1291026. The problem with this research, though, is that top executives are themselves subject to a different system of taxation than rank-and-file executives. The tax code essentially forces public corporations to defer the compensation of top executives in order to
APPENDIX: BASIS FOR SPECIAL TAX

This Appendix will give more rigorous support for the claim that the proposed special tax equals the IRS’s claim to the interest component of deferred compensation. Assume that the employer is willing to pay the employee $C_0$ currently, but instead defers the payment for $N$ years and agrees to pay $C_N$ instead. Also, assume that $t_{ee}$ is the employee’s marginal tax rate and that $t_{er}$ is the employer’s marginal tax rate.

As a preliminary matter, note that interest rate $r$ links current and deferred compensation such that $C_N = C_0 e^{rN}$. The rate $r$ is an after-tax rate, because it also links the after-tax value of current and deferred compensation. From the perspective of the employee, the equivalent before-tax interest rate is $r/(1 - t_{ee})$.

I. HOW CURRENT LAW ADEQUATELY TAXES THE COMPENSATION COMPONENT

This Article bifurcates the deferred compensation contract into wage and debt components. Current law adequately taxes the wage component. Ideally, the IRS would currently receive a wage component of $C_0(t_{ee} - t_{er})$. Instead, the IRS receives $C_N(t_{ee} - t_{er})$ in period $N$. Because $C_N = C_0 e^{rN}$ is simply the future value of $C_0$, the IRS is kept whole with respect to the wage component.

II. HOW THE PROPOSED SPECIAL TAX ADEQUATELY TAXES THE DEBT COMPONENT

To address the current law’s failure to tax the debt component of deferred compensation, this Article proposed a special tax on the payment of deferred compensation. The tax is levied on the product of the amount actually paid ($C_N$), the after-tax interest rate implied by the parties’ deal ($r$), and the duration of the contract ($N$). The IRS will receive tax at a rate equal to the employee’s tax rate ($t_{ee}$), but must also grant a deduction to the employer. Thus, according to this Article’s

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175 That is to say, $C_0(t_{ee} - t_{er}) = C_0 e^{rN}(1 - t_{ee})$.
176 See supra Part IV.D.
proposal, the IRS should receive a net claim equal to \( C_NrN(t_{ee} - t_{er}) \).

The special-tax proposal uses continuous compounding. Let \( r \) be the continuously compounded after-tax interest rate implied by the deferred compensation contract. Thus, \( C_0e^{Nr} = C_N \). The equivalent debt/compensation combination is constructed much as before. The employee receives \( C_0 \) in the current period, pays tax, and loans the after-tax proceeds to the employer. Thus, the initial loan is \( C_0(I - t_{ee}) \) and bears formal interest of \( r / (1 - t_{ee}) \). As before, the employer pays cash interest to the employee to cover her tax bill, but capitalizes the rest. The loan, therefore, grows at a rate of \( r \). Thus, at any particular time = \( x \), the outstanding loan balance will be \( C_0(I - t_{ee}) e^{rx} \). The amount of interest on this loan over a small period of time \((dx)\) is:

\[
C_0(I - t_{ee})e^{rx}\left(r/(1 - t_{ee})\right)dx = C_0e^{rx}rdx
\]

On a net basis, the IRS collects tax of \((t_{ee} - t_{er})\) on this amount, which must be increased to reflect the time-value of money, as the IRS is paid only at the end of the loan (time = \( N \)). Therefore, the periodic tax payments are increased by a factor of \( e^{(N-x)r} \). Thus, the IRS’s entire claim to the interest on the loan, payable at the end of the loan, will be:

\[
\int_0^N C_0e^{rx} e^{(N-x)\left(t_{ee} - t_{er}\right)}dx = \\
\int_0^N C_0e^{Nr} (t_{ee} - t_{er})dx = \\
C_0e^{Nr} (t_{ee} - t_{er})N = \\
C_NrN(t_{ee} - t_{er})
\]

III. THE SPECIAL TAX IN PRESENT VALUE TERMS

Since this Article proposes to levy the special tax upon payment of deferred compensation, the tax is expressed in future value terms. Some readers might find the present value to be more significant. The transformation is simple, as \( C_0 \) is simply the present value of \( C_N \). Thus, for the continuously compounded model, the present value is:

\( C_0(t_{ee} - t_{er})Nr \)

It is also possible to conceptualize this amount as the tax advantage from deferred compensation under current law.

Phantom stock gives an employee an unsecured right to payment
based on the value of employer stock. In this Appendix, an employer’s stock is worth $S_j$ at time $= j$. So, a phantom stock plan payable on a single share of stock at time $= N$ would provide a pre-tax payment of $S_N$ or an after-tax payment of $S_N(I-t_{ee})$.

A critical insight of forward-contract pricing is to equate fixed and variable cash flows. From an ex ante perspective (i.e., at time $= 0$), the payoff from stock ($S_N$) is equivalent to the payoff from a debt of $S_0$ that grows over time to $S_0e^{rN}$. Thus, the after-tax payoff from phantom stock is financially equivalent to the after-tax payoff from a fixed deferred compensation obligation to pay $S_0e^{rN}$ at time $= N$. Because of this equivalence, it is possible to simply apply the special tax to phantom stock.

The special tax provides the IRS with a payoff based on the amount of the fixed obligation. Here, that payoff would be:

$$S_0e^{rN}rN(t_{ee} - t_{er})$$

Again, it is possible to simplify matters by invoking the equivalence of fixed and variable payments because the IRS would receive an equivalent based on the value of employer stock, or:

$$S_NrN(t_{ee} - t_{er})$$

Thus, the IRS is made whole if the special tax is applied to the payoff from phantom stock, $S_N$. 