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Reforming the Taxation of Deferred Compensation

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REFORMING THE TAXATION OF DEFERRED COMPENSATION*

ETHAN YALE** & GREGG D. POLSKY***

Executive pay is currently a topic of significant interest for policymakers, academics, and the popular press. On August 14, 2006, in reaction to widespread press reports and academic criticism of extravagant executive perquisites, the SEC proposed new regulations designed to change fundamentally the manner in which executive compensation is reported to shareholders. Despite all of this attention, one significant aspect of executive deferred compensation has gone virtually unnoticed—the federal tax rules governing this form of compensation are fundamentally flawed and must be extensively overhauled. These rules are flawed because they often create a significant incentive for companies and their executives to structure deferred, rather than current, compensation, thereby producing highly inefficient and inequitable results. This Article addresses potential legislative reforms that would remedy this problem by neutralizing the tax treatment of current and deferred compensation. While this neutrality goal, which was part of the recent proposals made by President Bush’s Advisory Panel on Tax Reform,¹ is easy to describe in general and conclusory terms, the devil is in the details. There has been little serious academic analysis of how to implement a set of tax rules that would create neutrality while avoiding undue complexity. This Article attempts to fill that void.

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INTRODUCTION

In recent years, the deferred compensation packages negotiated by corporate executives have been a topic of significant interest for academics, policymakers, and the popular press. Newspapers have

reported on extravagant deferred compensation packages,² most notably former New York Stock Exchange Chief Executive Officer Richard A. Grasso's \$140 million deal.³ In their illuminating book, *Pay Without Performance—The Unfulfilled Promise of Executive Compensation*, Professors Lucian Bebchuk and Jesse Fried decry the "camouflage benefits" of executive deferred compensation.⁴ They argue that captive boards of directors use these arrangements for the primary purpose of passing tax benefits to executives (to the company's tax detriment) under shareholders' radar screens.⁵ And in October of 2004, in an attempt to stymie some of the particular abuses uncovered in the Enron fiasco,⁶ Congress revised the federal tax laws applicable to executive deferred compensation for the first time since 1978.⁷

2. See, e.g., Riva D. Atlas, *Fannie Mae To Review Pay Packages of Ex-Officials*, N.Y. TIMES, Dec. 28, 2004, at C1 (reporting deferred compensation of \$8.7 million for former Fannie Mae CEO Franklin D. Raines); Riva D. Atlas, *Former Chief of Putnam To Receive \$78 Million*, N.Y. TIMES, June 11, 2004, at C1 (reporting deferred compensation of \$55 million for former Putnam CEO Lawrence J. Lasser); Theo Francis, *Morgan Stanley's Retiring CEO May Leave with \$62.3 Million*, WALL ST. J., June 14, 2005, at A10 (reporting a \$62.3 million package for former Morgan Stanley CEO Philip Purcell); Timothy L. O'Brien, *Mayday? Payday! Hit the Silk! Golden Parachutes Glow Again*, N.Y. TIMES, Jan. 9, 2005, at C1 (reporting former Bank of America CEO Charles K. Gifford would receive \$3.1 million per year for life with survivor benefits of \$2.3 million per year for his spouse's life after his death); Andrew Ross Sorkin, *Prosecutors in Tyco Case Press Ex-Chief on Loans*, N.Y. TIMES, Apr. 29, 2005, at C2 (reporting deferred compensation of \$80 million for former Tyco CEO L. Dennis Kozlowski).

3. See Landon Thomas, Jr., *Big Board Chief Will Get a \$140 Million Package*, N.Y. TIMES, Aug. 28, 2003, at C1.

4. LUCIAN BEBCHUK & JESSE FRIED, *PAY WITHOUT PERFORMANCE* 105 (2004).

5. *Id.* at 105–06. Bebchuk and Fried also argue that the Securities and Exchange Commission's disclosure rules regarding deferred compensation are inadequate, making it difficult for shareholders to understand even the pretax cost of these arrangements to the company. *Id.* at 106–07.

6. In the Joint Committee on Taxation's investigation of Enron, it found that executives were able to "maintain," as a practical matter, "security and control" over their deferred compensation accounts through a variety of contractual devices and that such security and control was inconsistent with the tax deferral benefits received by the executives. See JOINT COMM. ON TAXATION, 108TH CONG., REPORT OF INVESTIGATION OF ENRON CORPORATION AND RELATED ENTITIES REGARDING FEDERAL TAX AND COMPENSATION ISSUES, AND POLICY RECOMMENDATIONS 40 (Comm. Print 2003) (Sup. Doc. No. Y4. T19/ 4:IN 8/3/v.1).

7. See I.R.C. § 409A (2000) (originally enacted as American Jobs Creation Act of 2004, Pub. L. No. 108-357, § 885(a), 118 Stat. 1418) (imposing rules that attempt to restrict the ability of executives to maintain security and control over deferred compensation accounts while deferring tax liability). Prior to the enactment of new I.R.C. § 409A, the tax rules applicable to executive deferred compensation had been unchanged since February 1, 1978, when Congress declared a moratorium on altering the tax rules then in effect. See Revenue Act of 1978, Pub. L. No. 95-600, § 132(a), 92 Stat. 2763, 2782. We do not consider in detail § 409A, since it does not attempt to address the fundamental tax

The focus has been on the corporate governance concerns posed by deferred compensation arrangements and the Enron-specific abuses; meanwhile a critical problem has been virtually ignored: the federal tax rules governing executive deferred compensation are fundamentally flawed and must be extensively overhauled. These tax rules are flawed because they often create a significant incentive for companies and highly paid executives to structure deferred, rather than current, compensation,⁸ producing inefficient and inequitable results.⁹

In this Article, we discuss potential legislative reforms that would remedy this problem by neutralizing the tax treatment of current and deferred compensation. While it is relatively easy to describe in general what such reforms would look like, the devil truly is in the details. Tradeoffs must be made between the neutral tax treatment of deferred compensation, on the one hand, and the practical necessity that any reform be reasonably administrable, on the other. We discuss the tradeoffs and suggest reforms that, in our view, best mediate between these two oft-conflicting objectives.

We should emphasize an important point about the scope of this Article at the outset. When we speak of “deferred compensation,” we are referring only to those arrangements typically known as “nonqualified” deferred compensation. “Qualified” deferred compensation arrangements, such as 401(k) plans, provide an intentional and explicit tax subsidy in exchange for meeting a number of detailed conditions.¹⁰ Most importantly for our purposes, there are significant limitations on the amount that can be contributed to, or distributed from, qualified plans with respect to a particular

problem discussed in this Article. Instead, the legislation modestly strengthened the preexisting tax rules in direct response to certain abuses uncovered in the fall of Enron. See Eric D. Chason, *Deferred Compensation Reform: Taxing the Fruit of the Tree in Its Proper Season*, 67 OHIO ST. L.J. 347, 349 (2006) (“Perhaps at the margin, fewer executives and corporations will bother passing through § 409A’s gates. For those who make it through, the economics are unchanged.”); Dana L. Trier, *Rethinking the Taxation of Nonqualified Deferred Compensation: Code Sec. 409A, the Hedging Regulations and Code Sec. 1032*, TAXES, Mar. 2006, at 141, 151 (noting that the legislation “appears to have been prompted by the Joint Committee on Taxation’s Report on Enron” and that, in enacting § 409A, “Congress left largely intact the ‘symmetrical’ regime of deferred compensation . . . [and] failed to address fully the policy concerns inherent in such a regime”).

8. See *infra* Part I.B.1.

9. See *infra* Part I.B.2.

10. See I.R.C. § 501(a) (providing that trusts meeting the requirements of § 401(a) are exempt from taxation); *id.* § 401(a), amended by Pension Protection Act of 2006, Pub. L. No. 109-280, 120 Stat. 780 (providing the conditions for qualification as an exempt trust). For a general discussion of qualified plans, see 3 BORIS I. BITTKER & LAWRENCE LOKKEN, *FEDERAL TAXATION OF INCOME, ESTATES, AND GIFTS* ¶ 61 (3d ed. 2001).

employee,¹¹ these plans must be available to a broad spectrum of employees,¹² and they must not “discriminate in favor of highly compensated employees.”¹³ These conditions make clear that, in creating the qualified plan rules, Congress intended a limited subsidy in favor of deferred compensation with a guarantee that the subsidy would also benefit rank-and-file employees.¹⁴ Nonqualified arrangements, the focus of this Article, consist of deferred compensation arrangements that fail one or more of the qualified plan conditions.¹⁵ Usually, these arrangements fail as qualified deferred compensation because they provide for employer contributions and distributions in excess of the statutory limits, and because they are maintained for the exclusive benefit of highly remunerated employees.

We proceed as follows. Part I describes how current law creates a bias in favor of deferred compensation compared with current compensation, and then explains why this bias should be eliminated. Part II describes two prior proposals for reform and explains that, although the two proposals may appear to be quite different, they really are very similar. In deconstructing these proposals, Part II makes clear that any reform must effectively deal with the two components of deferred compensation arrangements, the investment yield and the compensatory element. Part III analyzes how to formulate an appropriate tax on the investment yield. Part IV analyzes how to account properly for the compensatory element.

I. BACKGROUND

In this Part, we illustrate how current law treatment of deferred compensation often creates a tax bias in favor of deferred compensation. We then explain why the policymaker’s goal in reforming the deferred compensation tax rules should be to create a level playing field so that tax rules can be factored out of decisions relating to the structure and timing of compensation. Finally, we

11. See I.R.C. § 415, *amended by* Pension Protection Act of 2006, Pub. L. No. 109-280, 120 Stat. 780 (setting forth these contribution and distribution limitations).

12. See *id.* § 410 (providing minimum participation rules intended to ensure that the plans cover a broad spectrum of employees).

13. See *id.* § 401(a)(4) (prohibiting “discrimina[tion] in favor of highly compensated employees”).

14. See BITTKER & LOKKEN, *supra* note 10, ¶ 61.1.1, at 61-6 (“The policy of the qualified plan rules can be described as one of providing a tax subsidy to all employees, including highly paid employees and owner-employees, as a carrot to induce employers to provide retirement benefits for rank-and-file employees.”).

15. See *id.* ¶ 60.1, at 60-2 to 60-3.

explain that there is a tax bias in favor of alternative forms of deferred compensation—specifically, restricted stock and stock options—and analyze the effect that these alternative modes of compensation have on the case for reforming the taxation of nonqualified deferred compensation.

A. Current Law Treatment of Deferred Compensation

Consider the following example illustrating the tax advantages derived from deferred compensation under current law.

Example 1. Suppose a Rabbi is an employee of the Temple which he serves. The Rabbi is in the 40% marginal tax bracket. In partial consideration for services to be rendered during Year 0, the governing council of the Temple gives the Rabbi a choice between (a) a cash payment of \$10,000 in Year 0 or (b) an agreement obligating the Temple to provide a future cash payment of \$10,000 plus the investment return thereon. Under option (b) the Rabbi (or his designee) is to be paid on his death, disability, retirement, or termination. If the Rabbi chooses option (b), the Temple will set aside \$10,000 in a trust that will be managed, invested, reinvested, and ultimately paid to the Rabbi as called for by the agreement. Prior to payment, the assets of the trust will remain subject to the claims of the Temple's creditors. The trust assets may not be alienated or encumbered by the Rabbi.¹⁶

Ignoring tax consequences and assuming that all of the investment opportunities available to the Temple are also available to the Rabbi, the Rabbi should prefer option (a). To see why, suppose the Rabbi works for ten years before retiring and that the Trust earns

16. The taxpayer in our hypothetical is a Rabbi because, in possibly the most famous IRS private letter ruling ever issued, the Service ruled favorably on a deferred compensation arrangement for the benefit of a Rabbi. See I.R.S. Priv. Ltr. Rul. 81-13-107 (Dec. 31, 1980). Similar arrangements are now commonly known among the tax bar as "rabbi trust" arrangements. Trusts that qualify as rabbi trusts are effectively disregarded for federal tax purposes, as their income is reported by the employer. See Kathryn J. Kennedy, *A Primer on the Taxation of Executive Deferred Compensation Plans*, 35 J. MARSHALL L. REV. 487, 524-28 (discussing the qualification and tax consequences of rabbi trust arrangements).

We assume that the Rabbi is given the choice between options (a) and (b) before the year during which the services were to be performed to avoid the constructive receipt doctrine and the strictures of I.R.C. § 409A(a)(4)(B). Section 457 imposes additional requirements on nonqualified deferred compensation plans maintained by state and local governments and tax exempt organizations, see I.R.C. § 457; however, certain religious institutions, such as the Temple in this example, are specifically exempt from § 457, see *id.* § 457(e)(13).

a compound annual return of 7.2%. During the interval between Years 0 and 10, the \$10,000 trust corpus will have grown to \$20,000.¹⁷ By hypothesis, the Rabbi could have earned a 7.2% return himself for those ten years had he chosen option (a), in which case he would have netted the same \$20,000. By doing so, he would avoid the risk that the Trust assets might be seized by the Temple's creditors. Furthermore, the Rabbi would have ready access to the funds during the period of deferral, liquidity that would have been denied him under option (b).

When taxes are considered, the result is starkly different. Under current law, the trust's income is attributed to the Temple,¹⁸ which is tax exempt;¹⁹ the Rabbi will not have to report the income until he receives it.²⁰ Consequently, the aftertax investment opportunities available to the Temple are much better than those available to the Rabbi. If the pretax yield on the investment of choice is 7.2%, then the Temple's aftertax yield will be 7.2%, whereas the Rabbi's aftertax yield will be only 4.3% (7.2% reduced by the Rabbi's 40% marginal tax rate). This means that option (b) is far superior to option (a),²¹ as shown in the following table.

17. $\$10,000 \times (1 + 7.177\%)^{10} = \$20,000$.

18. See Treas. Reg. § 1.677(a)-1(d) (2006).

19. See I.R.C. § 501(c)(3) (exempting religious organizations from tax).

20. The Service will not attempt to apply either the economic benefit doctrine or the constructive receipt doctrine in the case of an unfunded, unsecured promise to pay, like the one in Example 1, see Rev. Rul. 60-31, 1960-1 C.B. 174, and such "unfunded and unsecured" promises are expressly not subject to I.R.C. § 83. See Treas. Reg. § 1.83-3(e). Furthermore, this arrangement is not subject to the limitations on deferred compensation plans of state and local governments and tax exempt organizations under I.R.C. § 457 given that church plans are excepted. See I.R.C. § 457(e)(13). The circumstances where deferral of the employee's tax liability is possible were narrowed by the American Jobs Creation Act of 2004, Pub. L. No. 108-357, 118 Stat. 1418, but none of the impediments to deferral added by the new law are implicated in this example. See I.R.C. § 409A.

21. Option (b) is clearly superior disregarding the risk of default by the Temple and the cost to the Rabbi of illiquidity during the deferral period. To perform a complete analysis, the Rabbi would have to consider these implicit costs and weigh them against the \$2,853 incremental aftertax income he receives in Year 10 under option (b). Typically, default risk and illiquidity do not impose significant costs on employees who participate in deferred compensation arrangements.

Table 1. Comparison of Current and Deferred Compensation When Employee's Investment Yield is Taxed, but Employer's is Not

	Option (a) Pmt. to Rabbi	Option (b) Pmt. to Trust
A. Year 0 Payment	\$10,000	\$10,000
B. Rabbi's Tax ($A \times .4$)	\$4,000	\$0 ^a
C. Year 0 Net ($A - B$)	\$6,000	\$10,000
D. Investment Yield	\$3,147 ^b	\$10,000 ^c
E. Year 10 Net ($C + D$)	\$9,147	\$20,000
F. Rabbi's Tax ($E \times .4$)	\$0 ^d	\$8,000
G. Year 10 Net ($E - F$)	\$9,147	\$12,000
a. No payment was received by the Rabbi in Year 0, so no tax is due. See <i>supra</i> note 20 and accompanying text. b. The investment grows at 4.3%, the aftertax rate available to the Rabbi. c. The investment grows at 7.2%, the aftertax rate available to the Temple. d. Income tax was paid on receipt of compensation in Year 0, so no tax is due in Year 10.		

The superiority of option (b) is solely attributable to the higher aftertax rate of return available to the Temple as compared with the Rabbi. It has nothing to do with deferral or acceleration of the Rabbi's obligation to pay taxes due on receipt of the compensation. Tax deferral is not advantageous to the Rabbi if the amount of tax due following the period of deferral is adjusted to account for the time value of money, as it is here.²²

Example 1 is an extreme case, given that the Temple's investment income is tax exempt and the Rabbi's is fully taxable. In less extreme cases—cases in which the employer is subject to a lower rate of tax than the employee because, for instance, the statutory rate applicable to the employer is lower or the employer is eligible for certain tax preferences for which the employee is not—the benefit of

22. Under option (a), the Rabbi receives \$10,000 currently, so the tax due is \$4,000. Under option (b), the Rabbi receives \$20,000 in Year 10, so the tax due is \$8,000, which has a present value of \$4,000 when discounted at the pretax rate of return. $\$8,000 / (1 + 7.2\%)^{10} = \$4,000$. Usually intertemporal comparisons are made by discounting at the aftertax rate of return available to the taxpayer; here, by selecting option (b), the Rabbi avoids tax on the investment yield, so the Rabbi's aftertax rate of return is the same as the pretax rate. Thus discounting at 7.2% is appropriate in this example.

From the government's perspective, deferring tax on the compensatory element effectively amounts to a loan of the tax liability deferred. Whether the government benefits by this arrangement depends on how the government's borrowing rate compares to the market rate. Daniel I. Halperin, *Interest in Disguise: Taxing the "Time Value of Money,"* 95 YALE L.J. 506, 531-32 (1986). Assuming, as is likely, that the government generally borrows at a lower rate than taxpayers can earn on invested funds, and ignoring the risk that the taxpayer may default, the government would gain by borrowing funds at the government rate to lend to the Rabbi. *Id.*

deferral is reduced, but it is not eliminated. The tax subsidy for deferred compensation when the employer's investment income is more lightly taxed than the employee's can only be eliminated if the tax rate applied to investment income earned on deferred compensation is set equal to the rate that would have applied had the deferred compensation been paid currently and the employee had made the investment directly.²³

It is worth noting that under current law, the top marginal rate for most players in the deferred compensation game—large public companies and their highly paid executives—are the same.²⁴ This historically anomalous symmetry lessens somewhat the urgency of reform (and might also lessen interest group resistance to reform, making this a propitious time for reform proposals). The benefits of reform are still significant, however, even when tax rates are symmetrical. The tax base for individuals and corporations is different (e.g., because of the dividends-received deduction). In addition, corporations or individuals may have net operating loss carryovers or capital loss carryovers. Accordingly, effective marginal tax rates may be vastly different even when, as now, statutory rates are the same.

B. Neutrality as the Policy Goal

1. Defining Neutrality

Academics and government officials agree that the central goal in reforming the deferred compensation tax rules should be to neutralize the tax treatment of current and deferred compensation.²⁵

23. If the employer's investment income is taxed at a higher rate than the employee's investment income, paying deferred compensation is *disadvantageous*. In such a circumstance, the employee would choose to be paid currently (option (a)).

24. Compare I.R.C. § 1(i)(2) (providing for a maximum marginal tax rate of 35% for individuals for taxable years beginning after 2003) with I.R.C. § 11(b)(1) (providing for a maximum marginal tax of 35% for corporations).

25. See Halperin, *supra* note 22, at 541 (proposing a "special tax on investment income" to eliminate the "unwarranted and unintended subsidy to high-income individuals" under current law); MICHAEL DORAN, URBAN-BROOKINGS TAX POLICY CTR., DISCUSSION PAPER NO. 18: EXECUTIVE COMPENSATION REFORM AND THE LIMITS OF TAX POLICY 1 (2004), available at http://www.urban.org/UploadedPDF/311113_TPC_dp18.pdf ("The proper tax policy goal [is] strict neutrality between current and deferred compensation."); *Enron Investigation: Hearing Before the S. Comm. on Finance*, 108th Cong. 1 (2003) (statement of Pamela F. Olson, Assistant Sec'y, Tax Policy, U.S. Dep't of the Treasury), available at <http://www.treas.gov/press/releases/js168.htm> ("[W]e recommend that Congress legislate directly rather than indirectly by trying to influence corporate governance and accountability decisions through the tax code. The

Commentators and policymakers have spoken and written about neutrality as though it is an unambiguous and self-defining concept.²⁶ This viewpoint is frequently justified, though not always. In the deferred compensation context, neutrality is generally gauged by comparing (a) the aggregate tax liabilities of the employee and the employer (adjusted to account for the time value of money) given a program of deferred compensation with (b) the tax liabilities of the same employee and the same employer (again, adjusted for the time value of money) given current compensation *followed by* a direct investment by the employee in whatever asset is necessary to put the employee in the same economic position she would have occupied had she bargained for deferred compensation. Neutrality is properly evaluated by examining the aggregate impact of the deferred compensation rules on the tax positions of both the employee and employer. Rules that appear to overtax the employee might actually be neutral if they undertax the employer by the same amount, and vice versa. The key point here is that the side of the compensation arrangement on which a tax burden is imposed or a tax benefit is conferred is irrelevant when evaluating the economic burden of the tax, since the parties can adjust the nominal pretax compensation to shift the tax benefits and burdens between themselves.²⁷ If the aggregate tax liability of the parties is the same under (a) and (b), the system is neutral; otherwise it is not.²⁸

Applying this standard is straightforward when there is only one nondeferred compensation transaction that can reasonably serve as the standard for comparison when gauging neutrality. But when there are two (or more) nondeferred compensation transactions that would allow the parties to replicate the economic results they would have achieved through deferred compensation, the analysis may become more difficult. If these alternative nondeferred compensation transactions are taxed alike then either (or both) of the

tax code should be neutral. If it is not, it is likely to influence or skew decisionmaking one way or the other with unfortunate unintended consequences.”).

26. See *supra* note 25.

27. See JONATHAN GRUBER, PUBLIC FINANCE AND PUBLIC POLICY 519–27 (2005) (“[T]he side of the market on which the tax is imposed is irrelevant to the distribution of the tax burden.”); Michael S. Knoll, *The Tax Efficiency of Stock-Based Compensation*, 103 TAX NOTES 203, 208 (2004) (“Whether a compensation mechanism is tax efficient should be determined from a joint contracting perspective rather than the employer’s or employee’s perspective alone.”).

28. This definition of neutrality is the same as the one used in Merton H. Miller & Myron S. Scholes, *Executive Compensation, Taxes and Incentives*, in FINANCIAL ECONOMICS: ESSAYS IN HONOR OF PAUL COOTNER 179, 184–85 (William Sharpe & Cathryn Cootner eds., 1982).

transactions can reasonably serve as the neutral standard. It is often the case, however, that investments—in particular, transactions involving financial products of the type implicated by this analysis—are taxed inconsistently,²⁹ or that the tax treatment of one or more of the alternative investments is indeterminate.³⁰ In such cases, a definition of neutrality that depends on matching the aftertax results of current compensation followed by a direct investment ultimately begs the question: Which of the alternative transactions should factor into the neutrality analysis?

Suppose, for example, that an employer is compensating its employee by promising her a future payment dependent on the employer's stock price. Suppose that, in lieu of a \$100 current salary payment, the employer promises to pay its employee in three years the value at that time of an amount of its stock that could be purchased today for \$100 (say 100 shares). This type of arrangement is typically called a "phantom stock plan."³¹ One way to view the nondeferred compensation analogue to this transaction is to imagine that the employer pays the employee \$100, and the employee then uses the net-of-tax salary to purchase \$65 worth of employer stock (sixty-five shares) from the employer. Under this scenario, the employer would get a \$100 deduction for the salary payment (and the employer's stock sale to the employee would not be taxed to the employer).³²

Another alternative would be to view the employer as paying the employee \$100, and the employee as loaning her \$65 net-of-tax salary to the employer for three years at a market rate of interest. To account for the employer stock-based aspect of the deferred compensation arrangement, the employer would be seen as selling a forward contract on its own stock to the employee. Under this scenario, the employer would get a \$100 deduction for the salary

29. See, e.g., *infra* notes 31–33 and accompanying text (providing an example of inconsistent taxation).

30. See, e.g., *infra* notes 167–70 and accompanying text (describing how the taxation of a nondeferred compensation analogue depends on the uncertain application of I.R.C. § 163(f)).

31. See A. Thomas Brisendine et al., *Deferred Compensation Arrangements*, Tax Mgmt. Portfolio (BNA) No. 383, at A-6 (2002).

32. I.R.C. § 1032 (2000). It appears at first that the employer has a different number of shares outstanding in the phantom stock plan (100 shares) than in the analogous nondeferred compensation transaction (sixty-five shares). If true, this would suggest that the two transactions are not analogous, precluding a meaningful comparison. However the employer paying phantom stock has an inchoate deduction that is worth thirty-five shares; considering the value of this deduction it has sixty-five shares outstanding in the phantom stock plan alternative on a net basis.

payment and an interest deduction for the three year employee-to-employer loan. Conversely, the employee would have \$100 of compensation income plus income from interest accruals on the employee-to-employer loan.³³

Which of the two nondeferred compensation analogues should serve as the neutral standard? There is a strong argument that the benchmark should be whichever alternative results in the lowest overall tax burden. As a first approximation, it is reasonable to assume that the parties will act in their mutual best interest by structuring their compensation contracts to minimize the present value of their aggregate tax liability. This implies that the appropriate standard is the latter transaction in cases where the employer's marginal tax rate exceeds the employee's, because the present value of the employer's incremental interest deductions will exceed the corresponding interest income taxed to the employee.

This conclusion is, however, objectionable at some level. If the employer's sale of a forward contract on its own stock and its borrowing are aggregated, it is as though the employer is effectively deducting dividend payments on its own stock,³⁴ a result that is inappropriate in a classical corporate income tax system that respects the debt-equity distinction. Nevertheless, taxpayers enter into very similar transactions outside of the deferred compensation context, and the tax treatment of these transactions has been validated, subject to elaborate safeguards, by a revenue ruling.³⁵ If the more aggressive transaction is objectionable because of fidelity to the debt-equity distinction, then the issue is not specific to deferred compensation; rather, it lies at the crossroads of corporate taxation and the taxation of financial instruments.³⁶

To sum up, in many, perhaps most, cases the presence or absence of neutrality will be uncontroversial. At the same time, however, neutrality as we have defined it presupposes that policymakers can identify a single nondeferred compensation analogue to the transaction in question and achieve neutrality by matching the tax

33. Settlement of the forward contract would not be taxable to the employer, *id.* § 1032, but the employee would realize gain or loss when the contract settles in three years. See 2 BORIS I. BITTKER & LAWRENCE LOKKEN, *FEDERAL TAXATION OF INCOME, ESTATES, AND GIFTS* ¶ 57.3.1. (3d ed. 2001).

34. DAVID C. GARLOCK, *FEDERAL INCOME TAXATION OF DEBT INSTRUMENTS* § 9.09[B] (4th ed. 2000).

35. *Id.*; Rev. Rul. 2003-97, 2003-2 C.B. 380.

36. See, e.g., Alvin C. Warren, Jr., *US Income Taxation of New Financial Products*, 88 J. OF PUB. ECON. 899, 904 (2004) (exploring how financial innovation undermines formal distinctions in the tax law, including the debt-equity distinction).

treatment of that transaction. As we have shown, this is not necessarily true.³⁷ Specifically, it is false when the alternative analogues up for consideration as the neutral standard are taxed in an inconsistent fashion. In such cases, it is not always clear what neutrality means.

We do not want to overstate the difficulties that are caused by a definition of neutrality that cannot be applied with precision in all cases. Even when it is difficult or impossible conclusively to resolve which potential nondeferred compensation analogue should serve as the standard for neutrality, it is still possible to identify deferred compensation tax reforms that promote (or defeat) neutrality. For instance, where a proposed change would decrease the disparity between the tax treatment of deferred compensation on the one hand, and the relevant set of nondeferred compensation analogues on the other hand, policymakers can confidently conclude that the proposed change is neutrality enhancing, even without settling on a single nondeferred compensation analogue to employ as the neutral standard.

2. The Benefits of Neutrality

Nonneutral tax treatment of deferred compensation is undesirable for two reasons: it is inefficient and inequitable. To illustrate the inefficiency, suppose that in a no-tax world, the Rabbi in Example 1 would prefer to be paid currently and that the Rabbi values his preference at \$100. So long as the deferred compensation saves taxes in excess of \$100, the Rabbi will forsake his preference to be paid currently, opting instead for deferred compensation, because this will maximize his well being. Suppose that by opting for deferred rather than current compensation, the Rabbi saves taxes with a present value of \$110. The Rabbi is better off by \$10, the excess of the tax savings over the value of the forsaken preference.

Society, however, is worse off. The \$110 of taxes that the Rabbi avoided would have imposed no direct burden on society provided the government would have spent the \$110 to provide services or transfer payments worth \$110. The tax would merely have caused a redistribution from the Rabbi to the government and ultimately to recipients of government services or transfer payments. But by causing the Rabbi to change his behavior, the tax imposes a substantial indirect cost—namely, the value of the Rabbi's forsaken

37. See *supra* notes 31–33 and accompanying text.

preference. This indirect cost, or deadweight loss, is the efficiency cost of nonneutral tax treatment of deferred compensation.³⁸

The inequity of nonneutral tax treatment of deferred compensation stems from its distributional effects. Nonqualified deferred compensation is provided almost exclusively to highly paid employees.³⁹ Rank-and-file employees earning low or moderate salaries are seldom offered the opportunity to be paid deferred compensation. Thus, to the extent tax rules favor nonqualified deferred compensation, they appear to “provide an unwarranted and unintended subsidy to high-income individuals.”⁴⁰

38. Deadweight loss results whenever nonneutral tax rules induce taxpayers to change their behavior. See RICHARD A. MUSGRAVE & PEGGY B. MUSGRAVE, *PUBLIC FINANCE IN THEORY AND PRACTICE* 291–312 (4th ed. 1984). Thus if the Rabbi had a preference for deferred compensation and current compensation was sufficiently tax preferred to induce the Rabbi to accept current compensation, deadweight loss would result.

This extremely simple exposition of deadweight loss from nonneutral taxation overlooks the (ever-present) inefficiency that results from a tax on labor income, which causes taxpayers to substitute leisure (which cannot practically be taxed) for work. The labor-leisure tradeoff can be factored out of discussions of the inefficiency caused by nonneutral taxation of labor income if one assumes (as we have) that labor income will bear tax in some form. Ignoring the inefficiency that results from the choice to tax labor income allows us to focus on the margins that are relevant when formulating rules for the taxation of labor income—(a) the margin between current and deferred compensation, and (b) the margin between equity-based compensation and non-equity-based compensation. For a more rigorous treatment of deadweight loss, see HARVY S. ROSEN, *PUBLIC FINANCE* 282–305 (6th ed. 2002). For an argument that efficiency can and should be used in formulating tax rules to draw lines between formally distinct transactions that are close substitutes for one another—such as current and deferred compensation—see David A. Weisbach, *Line Drawing, Doctrine, and Efficiency in the Tax Law*, 84 CORNELL L. REV. 1627, 1679 (1999).

39. Employers, rather than employees, might capture some or all of the tax benefit by paying employees accepting deferred compensation a lower pretax amount. See Gregg D. Polsky & Brant J. Hellwig, *Taxing the Promise To Pay*, 89 MINN. L. REV. 1092, 1146–47 (2005). If so, this would blunt the inequity. How the tax benefit resulting from deferred compensation is shared between the parties is a function of their bargain. For a provocative argument that when setting executive pay, boards of directors and executives do not bargain at arm’s length, see generally BEBCHUK & FRIED, *supra* note 4.

40. Halperin, *supra* note 22, at 541. There is a congressional policy, embodied in the qualified plan nondiscrimination rules, that tax favored retirement plans be made available to a broad group of individuals in different income cohorts, I.R.C. §§ 401(a)(4), (5), 410(b) (2000), and that such tax favored retirement benefits be limited in amount, *id.* § 415. The nondiscrimination rules and maximum benefit limit do not restrict nonqualified deferred compensation plans; accordingly, nonqualified deferred compensation plans appear to “undermine[]” congressional policy. Halperin, *supra* note 22, at 539–41.

It is possible that Congress’s policy preferences have shifted over time and that it was more politically expedient to permit nonqualified deferred compensation to flourish as a backdoor rate cut for the highly compensated than to repeal the nondiscrimination rules and maximum benefit limit (or, more generally, to alter the rate structure). In other words, the rules governing both qualified and nonqualified deferred compensation, taken

Goals other than efficiency and equity are often promoted through tax policy. There may be legitimate arguments that deferred compensation should be tax preferred relative to current compensation. For example, one could argue that a tax preference for deferred compensation helps startup companies attract and retain employees, which is good for society as it promotes economic growth and innovation. Deferred compensation may also help solve agency problems, for instance, by bonding employees to their employers—as where the deferred compensation is subject to forfeiture—or by aligning managers' financial fortunes with those of the shareholders—as where the deferred compensation is in the form of employer stock. We do not pass on the validity of these arguments.⁴¹ Instead, like the other commentators who have written on this subject, our goal is to explore how current and deferred compensation can be taxed neutrally, to minimize the inefficiency and inequity that results from tax-driven compensation arrangements.

C. *Deferred Compensation Alternatives—Restricted Stock and Stock Options*

All of the deferred compensation arrangements we have described thus far are unfunded, unsecured promises to pay future compensation. Such unfunded, unsecured promises are not considered property for purposes of § 83,⁴² the rule that requires service providers to pay tax on the receipt of in-kind property transfers in exchange for services rendered.⁴³ Were there only two

together, might embody a deliberate (though nontransparent) congressional policy rather than an “unintended subsidy,” Halperin, *supra* note 22, at 541, although it is impossible to say for sure.

41. We note, though, that empirical research casts a pall on claims that corporate governance goals can effectively be achieved through tax rules. See, e.g., Nancy L. Rose & Catherine Wolfram, *Regulating Executive Pay: Using the Tax Code To Influence CEO Compensation* 23 (Nat'l Bureau of Econ. Research, Working Paper No. 7842, 2000) (concluding that the \$1 million cap on deductions for executive compensation has had “relatively little real impact on overall compensation”).

Furthermore, if Congress wants to use tax rules to implement nontax policies, it could do so in a more targeted fashion. For instance, if the desire is to subsidize start-up companies, current law treatment of deferred compensation is a poor policy choice since the subsidy it affords is not restricted to start-ups. In addition, many nontax business goals associated with deferred compensation can be achieved outside of the deferred compensation context. For instance, if the employer's goal is to facilitate employee ownership of company stock, employers could pay cash and impose contractual obligations on employees to procure such stock. Fostering employee stock ownership via deferred compensation tax rules is not the only alternative.

42. See Treas. Reg. § 1.83-3(e) (2006).

43. See I.R.C. § 83(a).

relevant forms of compensation—current compensation and nonqualified deferred compensation excepted from § 83—the neutrality argument for equalizing their tax treatment would be unassailable.⁴⁴

Unfunded, unsecured promises are not, however, the only form of compensation received in exchange for services that is eligible for preferential tax treatment. Property interests (including an employer's funded or secured promise) that are both unvested and nontransferable are not currently taxed.⁴⁵ We will refer to this alternative category of deferred compensation as "§ 83 deferred compensation." As noted, this Article is primarily about the taxation of nonqualified deferred compensation—i.e., unfunded, unsecured promises—but the presence of § 83 deferred compensation complicates the question whether reforming the taxation of nonqualified deferred compensation is worthwhile. A reform that eliminates an inconsistency between the tax treatment of current compensation and nonqualified deferred compensation may create a new (or exacerbate an existing) inconsistency between nonqualified deferred compensation and § 83 deferred compensation. It is not clear whether the tax system would be improved by trading one inconsistency for another. We consider this issue below, after illustrating the tax advantage gained by remunerating employees with § 83 deferred compensation.⁴⁶

1. The Tax Advantage of § 83 Deferred Compensation

Suppose an employer transfers employer stock to its employee, subject to the condition that if the employee leaves the company at

44. As we discuss above, qualified deferred compensation is tax-advantaged, as are fringe benefits excluded from income under § 132, but since taxpayers' ability to exploit these forms of tax advantaged compensation is quite limited, they are not reasonable alternatives to the forms of tax-favored compensation we do discuss, and are thus irrelevant at the margin. *See supra* Part I.

45. *See* I.R.C. § 83(a).

46. Although § 83 technically applies to compensatory transfers of any property interest (other than an unfunded, unsecured promise to pay), we limit our discussion below to transfers of the employer's stock and stock options. We do this because, as a practical matter, deferred compensation subject to § 83 is nearly always stock-based. If the employer were to take the unusual step of transferring unvested property other than its own stock or stock options, the analysis below would change substantially. Under current law, when the non-stock-based property vests, the employer must recognize gain or loss to the extent the fair market value of the property (determined at the time of vesting) differs from the employer's basis. *See* Treas. Reg. § 1.83-6(b). This gain or loss recognition does not occur in stock-based § 83 deferred compensation because of § 1032, which provides for nonrecognition when a corporation transfers its own stock or stock options.

any time within the next three years the stock will be forfeited—an arrangement commonly referred to as restricted stock. This is not merely an unfunded promise given that the employer has actually transferred property to the employee. Under current law, the employee owes no tax until the condition lapses—that is, until the shares vest.⁴⁷ On vesting, the employee will owe tax on the “bargain element”—the excess of the fair market value of the shares when they vest over the amount paid for the shares (which is zero in this example, as the employee paid nothing for the shares).⁴⁸ Critically, the employee’s basis in the shares will equal her taxable income when the shares vest, as if the employer paid her the cash value of the shares when they vested, and the employee used the cash to purchase vested shares, establishing a cost basis. Consider the following example.

Example 2. An employer transfers 100 shares of restricted stock worth \$100 to an employee at the beginning of Year 1. The shares appreciate to \$150 by the time they vest at the end of Year 3. The employee owes tax on \$150 of income when the shares vest in Year 3—the excess of the shares’ value on vesting (\$150) over the price paid (\$0)—and takes a \$150 basis in the shares. If the employee sells the shares on the day they vest, then assuming a marginal tax rate of 35%, the employee will net \$97.50 ($\$150 - (\$150 \times 35\%)$).

Had the employer in Example 2 paid cash at the outset, rather than issuing restricted stock, the employee would have been worse off considering the tax consequences. She would have netted \$65 when the cash salary was paid ($\$100 - (100 \times 35\%)$). If she invested this \$65 in employer stock it would have grown to \$97.50 over the same three year period (the stock appreciated by 50% between Years 1 and 3, so sixty-five shares would be worth \$97.50 at the end of Year 3). If the employee sold the shares for \$97.50 she would net \$92.63 ($\$97.50 - (\$97.50 - \$65) \times 15\%$). The employee’s aftertax wealth on the sale of her shares in this non-§ 83 alternative is \$4.87 lower because she has a lower stock basis when she purchases the shares with her cash compensation (that is, the difference is attributable to the inferior basis results that occur when the share purchase occurs outside of § 83). Arguably the superior results for unvested compensation for which § 83 defers taxation is justified on the ground that the employee has not “earned” the compensation until vesting. In this

47. I.R.C. § 83(a).

48. *Id.*

view, the two transactions just compared are not comparable. It is easy to make too much of this point, however. In practice, vesting conditions "may really be little more than legal 'boilerplate' to meet the letter of" § 83, while the actual agreement, shorn of the vesting conditions, is governed by implicit contracts or informal understandings.⁴⁹ On the other hand, in circumstances where vesting conditions are bona fide, deferred taxation under § 83 is justifiable, even if not unambiguously correct, as a policy matter.

Nonqualified stock options ("NQSOs") are another common form of § 83 deferred compensation.⁵⁰ Although a compensatory transfer by an employer to its employee of a stock option is within the terms of § 83(a), suggesting the bargain element is subject to tax when NQSOs vest, NQSOs are excepted from § 83(a), unless they have a readily ascertainable fair market value, which is extraordinarily rare.⁵¹ NQSOs lacking a readily ascertainable value are excluded from § 83(a) because, if they were included, it would be necessary to value the options to compute the bargain element subject to tax, and a judgment was made that valuing NQSOs is prohibitively difficult in most cases.⁵² Thus, under current law, an employee in receipt of an NQSO has no taxable income until exercise of the NQSO, and at that time has taxable income equal to the value of the stock received on exercise less the price paid for the stock; the employer is entitled to a deduction equal to the employee's taxable income. Upon disposition of the stock purchased on exercise of the option the employee's gain (or loss) is determined by reference to the stock's value on the date the option is exercised, since the employee's basis will equal fair market value on that date. This regime confers a benefit on the employee when compared with an analogous transaction not excluded from § 83. The benefit is roughly analogous to the benefit obtained from a restricted stock plan versus cash compensation, as described above.⁵³ That is, inside a NQSO plan, on the employee's disposition of the optioned shares, no tax would be due on the

49. See Miller and Scholes, *supra* note 28, at 191 & n.16.

50. The moniker "nonqualified stock options" is used to distinguish such options from incentive stock options (sometimes called statutory or qualified stock options) that are taxed under §§ 421-422. Incentive stock options are usually tax inefficient; accordingly we do not focus on this form of compensation.

51. I.R.C. § 83(e)(3); Treas. Reg. § 1.83-7(b).

52. This judgment is reflected in the regulations. Treas. Reg. § 1.83-7(b); see BITTKER & LOKKEN, *supra* note 10, ¶ 60.5.2.

53. See Miller & Scholes, *supra* note 28, at 193-94; Knoll, *supra* note 27, at 213.

appreciation in the value of the company's stock between the date the option is granted and the date it is exercised.⁵⁴

2. Is Reform Worth the Trouble?

Is reforming the tax treatment of nonqualified deferred compensation to eliminate the inconsistency between current compensation and nonqualified deferred compensation worth the trouble if § 83 deferred compensation is still taxed preferentially? We begin to answer this question by asking another: Is § 83 deferred compensation an immutable feature of our tax system? (This might be the case, for instance, if the current tax treatment of § 83 deferred compensation is the best way to handle difficult problems of valuation, the resulting nonneutrality notwithstanding.) If the answer to this second question is no, then the optimal solution may be to reform *both* nonqualified deferred compensation *and* § 83 deferred compensation to bring the tax treatment of both in line with current compensation (and with each other). If the answer to this second question is yes, on the other hand, then the argument in favor of reforming the taxation of nonqualified deferred compensation is weakened, at least to the extent that the reform is justified by the resulting gains in efficiency and fairness, though the case for reforming the taxation of nonqualified deferred compensation may still be supportable on other grounds.⁵⁵

The second question—whether § 83 is an immutable feature of our tax system—is not amenable to a simple yes or no answer. It is likely that the taxation of restricted stock, to take one prominent form of § 83 deferred compensation, could be reformed to eliminate the tax preference identified above.⁵⁶ An extreme approach to reforming the taxation of restricted stock would be to require the employee to include the unvested stock in income (and to permit the employer a deduction) when the stock is transferred, rather than when it vests. Under such an approach, if the employee ultimately forfeits the unvested property because a vesting condition is not

54. See *infra* note 59 for a more complete explanation of the tax benefits derived from NQSOs that lack a readily ascertainable fair market value.

55. Other arguments for reforming the taxation of nonqualified deferred compensation may not depend on fairness or efficiency. For instance, it could be argued that accrual taxation of nonqualified deferred compensation is desirable because it is more consistent with the Haig-Simons definition of income. For a rebuttal of this and similar arguments in another context, see David A. Weisbach, *Reconsidering the Accrual of Interest Income*, TAXES, Mar. 2000, at 36, 40–43.

56. As noted, different tax treatment of unvested § 83 deferred compensation may be justified at least in certain cases. See *supra* note 49 and accompanying text.

satisfied, the employee should be allowed a deduction (and the employer should have to include in income the amount of its prior compensation deduction), to correct the inclusion and deduction that proved, in hindsight, to have been unwarranted.⁵⁷ A less extreme approach to reforming the taxation of restricted stock would be to allow the employee to defer her compensation income (and to require the employer to defer its deduction) until the property vests—as under current law—but to require the employee to pay tax on any price appreciation in the property that occurs between the date of the (unvested) property transfer and the date the employee's rights in the property vest.⁵⁸

On the other hand, it is unlikely that an administrable set of rules could be formulated to tax all forms of § 83 deferred compensation on par with current compensation. NQSOs are the most important example. To design rules to negate the tax benefit afforded NQSOs under current law, policymakers would first be required to quantify that benefit. Unfortunately, the benefit depends in part on the grant-date value of the option. The perceived difficulty in ascertaining this information is the very reason that NQSOs are excepted from § 83(a) in the first place.⁵⁹ Recent changes to the accounting rules governing the treatment of stock-based compensation, including stock options, require firms to estimate and expense the fair value of stock-based compensation, suggesting the possibility that accounting valuations could be used for tax purposes. The malleability of the accounting

57. Because of the time value of money, reversing the employee's income with a later deduction (and the employer's deduction with later income) would be an imperfect solution, though the resulting benefit to the employer should offset the detriment to the employee, at least in part, depending on the parties' marginal tax rates and the rate of inflation.

58. This could be accomplished by setting the employee's basis according to the value of the restricted stock on the date it is transferred, rather than the date it vests.

59. As described above, inside a NQSO plan, on the employee's disposition of the optioned shares, no tax would be due on the appreciation in the value of the company's stock between the date the option is granted and the date it is exercised. *See supra* text accompanying note 54. For comparison, suppose that outside a NQSO plan, an employee were paid in cash and invested in an option with the same characteristics as the NQSO. On the employee's disposition of the optioned shares, tax would be due on the excess of the sale proceeds over the sum of (a) the amount paid for the option and (b) the amount paid for the stock on option exercise.

Thus, if the shares have appreciated between the time the option was granted and the time it was exercised, the taxpayer does better inside the NQSO plan than outside the plan. The difficulty is that it is not possible to determine how much better, unless one knows how much the option would be worth had the employee purchased it rather than received it in exchange for services. Establishing a reliable value for an analogous option outside of the NQSO plan is a formidable task absent a market for comparable options, which seldom exists in practice.

valuation rules, however, make them a poor guide for assessing taxes.⁶⁰

In sum, we think the answer to the question whether § 83 is an immutable feature of our tax system is a qualified yes.⁶¹ The class of transactions eligible for the benefit of afforded § 83 deferred compensation could be constricted without undue administrative hardships to exclude, for example, restricted stock. It is questionable, however, whether an administrable alternative to the wait-and-see approach § 83 adopts with respect to other property—principally NQSOs—could be reasonably implemented.⁶²

If we are correct that comprehensive § 83 reform is infeasible—or if there is no political appetite for such reform even if it is feasible—it takes us back to the question whether eliminating one inconsistency is worth it if it means creating another one. In the end this depends on how taxpayers would respond to such a reform, an empirical question which, in turn, depends on how readily taxpayers will substitute one form of compensation for another.

If most taxpayers would continue using nonqualified deferred compensation despite the elimination of the tax preference, or if they would switch to current compensation, then the reform would have succeeded in eliminating an important tax distortion between these

60. See *Statement of Financial Accounting Standards No. 123 (revised 2004)*, FIN. ACCT. SERIES, Dec. 2004, at 1, <http://www.fasb.org/pdf/fas123r.pdf>. Studies have demonstrated that different, yet equally acceptable, accounting valuation methodologies can produce wildly disparate fair value estimates. See, e.g., Maribeth Coller & Julia L. Higgs, *Firm Valuation and Accounting for Employee Stock Options*, FIN. ANALYSTS J., Jan.–Feb. 1997, at 26, 26–34. The basic problem is that option valuation depends on the expected volatility of the underlying security during the term of the option which must be estimated. FASB 123R “does not specify a method of estimating expected volatility; rather [it] provides a list of factors that should be considered in estimating expected volatility,” and suggests that that firms’ estimates of expected volatility “should be reasonable and supportable.” *Statement of Financial Accounting Standards No. 123 (revised 2004)*, *supra*, at 48. For a discussion of the problems that may result if the tax treatment of an item is based on its financial accounting treatment, see Linda M. Beale, *Book-Tax Conformity and the Corporate Tax Shelter Debate: Assessing the Proposed Section 475 Mark-to-Market Safe Harbor*, 24 VA. TAX REV. 301, 355–59 (2004).

61. For further discussion of this issue, see Trier, *supra* note 7, at 178 (discussing the possibility of reforming the tax treatment of stock-based nonqualified deferred compensation and concluding that the issue merits further study).

62. One alternative to the current rule that provides, in essence, that absent a public market in employee stock options, they cannot be valued, see Treas. Reg. § 1.83-7(b) (2006), would be a rule that assigns to such options a value skewed to the high side, unless taxpayers can justify a different valuation based on an active market. Rather than structuring employee stock options to avoid the possibility of ready valuation, which is the common strategy under current law, taxpayers would have an incentive to issue NQSOs with terms similar or identical to exchange-traded options, which would resolve the difficult valuation issue.

two forms of compensation and the apparent unfairness to taxpayers choosing the tax-inefficient alternative (cash compensation). But if many taxpayers using nonqualified deferred compensation would respond to tax reform by switching to § 83 deferred compensation, then the benefit of eliminating an inconsistency at the margin between current and deferred compensation would be muted (and might even be negated).

Although the presence of § 83 deferred compensation as an alternative to nonqualified deferred compensation casts some doubt on whether reforming nonqualified deferred compensation is worthwhile, leading members of the academy, and government officials, nevertheless support reform.⁶³ For the balance of this Article we too will accept the common wisdom that reform is worthwhile and will explore how such reform should be implemented.

II. PROPOSALS FOR REFORM

In this Part we discuss the leading proposals for reforming the taxation of nonqualified deferred compensation. Very generally, a deferred compensation tax regime must specify three things: (1) the timing and rate of the tax on the investment yield generated by the deferred compensation; (2) the timing of the employee's inclusion of the compensatory element of the deferred payment; and (3) the timing of the employer's deduction of this compensatory element. For instance, as illustrated above, current law (1) taxes the investment yield generated by deferred compensation to the employer at the employer's applicable rate when the income is reportable by the employer under its method of accounting,⁶⁴ (2) requires the employee to report the compensatory element when (actually or constructively) received, and (3) permits the employer a compensation deduction when the employee reports compensation income (this third element was not developed in Example 1 because the Temple was tax exempt so the deduction has no value, which will not generally be the case).⁶⁵

The two primary reform proposals that have been floated are quite similar—perhaps more similar than observers appreciate—in

63. See *supra* note 25.

64. For example, the investment income generated by a deferred compensation arrangement (like the trust in Example 1) is taxed exactly the same as such income would be taxed to the employer in the absence of a deferred compensation arrangement. Cf. I.R.C. § 501(a) (2000) (exempting from taxation the investment income generated by a qualified deferred compensation arrangement).

65. BITTKER & LOKKEN, *supra* note 10, ¶ 60.2, at 831–49, (describing taxation of deferred compensation under current law).

that they both rectify the shortcoming of current law by imposing tax on the investment yield generated by deferred compensation at a rate closer to the rate that would have applied had the employee invested directly for her own account throughout the period of deferral. (Some of the particulars of the tax on the investment yield differ between the two proposals, as detailed below.) The primary difference between the two proposals is that one would perpetuate current law by allowing the employee to defer inclusion (and require the employer to defer deduction) of the compensatory element of the payment, whereas the other would accelerate both the employee's inclusion and the employer's deduction. As we demonstrate, both proposals have the potential to substantially improve neutrality, given that the timing of the inclusion and deduction of the compensatory element (as well as the timing of the tax on investment yield) is not important *provided amounts are properly adjusted to account for the time value of money*. Timing is, however, important for reasons of tax administration. Our central claim is that the ideal reform proposal is the one that deals with the three elements in a way that best promotes neutrality in a reasonably administrable manner.

A. *Special Tax on Investment Income*

In his 1986 article *Interest in Disguise: Taxing the "Time Value of Money,"* Professor Daniel Halperin argued that a special tax should be imposed on investment income generated by nonqualified deferred compensation.⁶⁶ The amount of the special tax would be computed as if the investment income had been earned by the employee directly, although the employer would be responsible for remitting the tax.⁶⁷ Halperin's proposal effectively taxes the employer on the investment income generated by deferred compensation as if it were earned by an individual.⁶⁸

The base for the special tax would equal the product of (a) the amount of deferred compensation and (b) the (actual or imputed) investment yield earned thereon.⁶⁹ Halperin proposed that the amount of deferred compensation be established by requiring the employer to set aside funds in trust or in another segregated fund or, alternatively, by requiring the employer to keep a notional account without formally segregating funds (i.e., an account that exists as an

66. Halperin, *supra* note 22, at 539–50.

67. *Id.* at 548–49.

68. *Id.*

69. *Id.* at 545–48.

entry in an accounting journal).⁷⁰ Halperin did not make a specific proposal as to how the fund's investment yield is to be determined.⁷¹ The investment yield *must* be ascertained or estimated, otherwise the base for the special tax cannot be determined. Because the base of (i.e., the taxable income subject to) the special tax would be computed using the tax rules applicable to individuals,⁷² special rules applicable to corporations (e.g., the dividends received deduction and the nonrecognition rule applicable to corporations when dealing in their own stock⁷³) would not apply. In addition, the special tax base would be unaffected by an employer's net operating losses or carryovers.⁷⁴

The tax rate of the special tax would equal the top marginal rate applicable to individuals.⁷⁵ The ideal rule in theory would set the tax rate equal to the marginal tax rate of the employee whose compensation is being deferred; however, in Halperin's view, practical problems dictate the use of the top marginal rate for individuals.⁷⁶ Although this rate will be too high in some cases, Halperin dismissed the significance of this problem, noting that "employees may always avoid the special tax by opting out of the plan."⁷⁷

Halperin proposed retaining the current law treatment of the compensatory element of deferred compensation (as distinct from the investment return thereon).⁷⁸ Current law generally allows the employer to deduct (and requires the employee to include) the entire amount paid to the employee upon payment.⁷⁹ This treatment is

70. *Id.* at 549–50 ("To implement the special tax, nonqualified deferred compensation should be funded through a special trust or other segregated fund to facilitate identification of the employee's share. . . . Identification of assets does not necessarily require a trust and can perhaps be achieved by bookkeeping without formal segregation.").

71. Halperin did, however, analyze the issue in the context of defined benefit arrangements and suggested possible solutions. *See id.* at 546–48.

72. *Id.* at 549.

73. I.R.C. §§ 243, 1032 (2000).

74. Halperin, *supra* note 22, at 544.

75. *Id.* at 549.

76. *Id.* at 544–45.

77. *Id.* at 545. The top marginal rate may be higher than the employee's effective marginal tax rate (i.e., economic burden of the tax that would have applied had the employee made the investment directly) for myriad reasons. For example, (1) the investment income may be eligible for the capital gains rate preference, I.R.C. § 1(h), (2) the employee may have capital losses (that would otherwise not be currently used) to absorb these capital gains, I.R.C. § 1211, or (3) the employee's marginal tax rate may be lower than the maximum rate.

78. Halperin, *supra* note 22, at 549.

79. *See supra* note 65 and accompanying text.

economically similar to (in certain cases, identical to) accrual taxation because the present value of the future payment is at least approximately equal to the amount of compensation currently earned.⁸⁰ In light of this equivalency, Halperin concludes that administrative considerations make deferral of the employee's inclusion and the employer's deduction preferable.⁸¹

Thus, returning to Example 1, the Temple would be subject to a 40% tax⁸² on the 10% investment yield earned on the amount held in trust. Assuming that the investment yield is taxed year-by-year (and not deferred under the realization rule, for example), the tax will reduce the annual yield on the deferred compensation from 7.2% to 4.3%.⁸³ In Year 10, therefore, the Rabbi would be paid \$15,244,⁸⁴ which would leave him \$9,147 after tax.⁸⁵ This is identical to the result achieved under option (a), where the Rabbi is paid \$10,000 currently and invests the \$6,000 net-of-tax proceeds for his own account at a 6% annual return.⁸⁶ Thus, Halperin's special tax on investment income is one way to achieve greater neutrality between current and deferred compensation.⁸⁷

B. Accrual Taxation of Deferred Compensation

Another approach is the direct taxation of the employee on both the compensatory element and its yield when earned, on an accrual basis. For instance, Michael Doran, stimulated by Congress's recent

80. See *supra* note 22 and accompanying text (demonstrating the present value equivalency in Example 1). The equivalency is only approximate, rather than perfect, in cases where the employer's aftertax rate of return differs from the aftertax rate earned on the deferred compensation. See Halperin, *supra* note 22, at 532 & n.95; *infra* Part IV.A.3.

81. Halperin, *supra* note 22, at 541-42.

82. In Example 1, the Rabbi is in the 40% bracket; this illustration assumes that rate to be the highest marginal tax rate applicable to individuals.

83. The realization rule might not be implicated, for instance, if the trust assets are invested in a bond that pays interest at least annually and all of the investment yield is attributable to interest, not price appreciation. We address below whether the special tax should incorporate the realization rule or, instead, should be applied on a mark-to-market basis. See *infra* Part III.A.3.

84. $\$10,000 \times (1 + 4.3\%)^{10} = \$15,244.38$. This assumes that the contractual arrangement between Rabbi and Temple provides that the amount of the special tax paid by the Temple reduces dollar-for-dollar the amount owed to Rabbi upon the payment event. In other words, it assumes that the Temple's tax liability will be funded out of the trust.

85. $\$15,244 \times (1 - 0.4) = \$9,147$.

86. $\$10,000 \times (1 - 0.4) \times (1 + 4.3\%)^{10} = \$9,147$.

87. On the facts of Example 1, Halperin's proposal would result in perfect neutrality, but this would not always be true. For example, if the employee's effective tax on investment income were lower than the top marginal rate, Halperin's proposal would create a bias in favor of current compensation.

enactment of § 409A, which imposes accrual taxation on certain “bad” nonqualified deferred compensation plans,⁸⁸ has proposed extending accrual taxation to all nonqualified deferred compensation plans.⁸⁹

The accrual taxation approach treats the parties as though the employer paid the employee currently and the employee lent the funds back to her employer for the period of deferral.⁹⁰ If this were to occur, then under existing law the employee would be taxed currently on the compensation, and the employer would get a corresponding deduction. Neither the disbursement of the loan proceeds by the lender-employee to the borrower-employer nor the repayment would give rise to tax consequences, but interest accruing on the loan would be accounted for by both the lender-employee and the borrower-employer as it accrues economically.⁹¹

This approach differs from Professor Halperin’s special tax in three fundamental ways. First, the accrual approach encompassed in § 409A imposes the nominal burden of the tax on investment income on the employee rather than on the employer.⁹² Second, because the accrual approach taxes the investment yield through to the employee, it uses the employee’s marginal tax rate instead of using the highest individual marginal tax rate as a proxy. Third, instead of taxing the employee on (and permitting the employer a deduction for) the compensatory element of deferred compensation—as distinct from the investment yield thereon—when paid, the § 409A approach would

88. In general, I.R.C. § 409A imposes accrual taxation when the deferred compensation arrangement provides the employee with certain rights—for example, the ability to accelerate payment—that Congress determined ought to be proscribed if the employee is to receive the benefit of tax deferral. See STAFF OF JOINT COMM. ON TAXATION, 108TH CONG., REPORT OF INVESTIGATION OF ENRON CORPORATION AND RELATED ENTITIES REGARDING FEDERAL TAX AND COMPENSATION ISSUES, AND POLICY RECOMMENDATIONS 632–37 (Comm. Print 2003) (recommending reforms ultimately codified at § 409A).

89. DORAN, *supra* note 25, at 1–2.

90. See Treas. Reg. § 1.451-1(a) (2006) (requiring that, under the accrual method, income is generally realized when earned, and deductions are generally allowed when the liability for payment is incurred).

91. See I.R.C. § 1272(a) (2000) (requiring holder of debt instrument with original issue discount to include in gross income the interest on such debt as it economically accrues); *id.* § 163(e) (allowing corresponding deduction to issuer of debt instrument with original issue discount).

92. As discussed above, the placement of the nominal burden is usually not significant. Which party bears the economic burden of the tax, which is significant, will depend on the parties’ bargain. See *supra* note 27 and accompanying text.

result in the immediate deduction and inclusion of the compensation when earned.⁹³

On the facts of Example 1, the Rabbi would be taxed on \$10,000 in Year 0, when the compensation is earned. Then the Rabbi would be taxed, year-by-year, on the investment yield to the deferred compensation "loan." During the first year, for example, the Rabbi would be taxed on \$718, the excess of the amount held in the trust at the end of the year—\$10,718—over the amount held at the beginning of Year 1—\$10,000. During the second year, the Rabbi would be taxed on \$769, the excess of the amount held at the end of the year—\$11,487—over the amount held at the beginning of the year—\$10,718. And so on. The year-by-year tax on the investment yield is effectively the same as Halperin's special tax.

The results under the accrual tax approach are economically equivalent to the results under option (a), where the Rabbi is paid \$10,000 currently and invests the \$6,000 net proceeds for his own account at a 4.3% annual return.⁹⁴ Thus, accrual taxation is another way to achieve neutrality between current and deferred compensation.

C. *Deconstructing the Proposals*

Although the two systems outlined above appear quite different, they are economically equivalent.⁹⁵ One way to see this equivalency is to observe that both systems leave the employee who receives deferred compensation in the same aftertax position in Year 10 as the

93. See I.R.C. § 409A(a)(1)(A) (requiring accrual accounting for deferred compensation income when the deferred compensation plan fails to meet certain statutory requirements); *id.* § 404(a)(5) (keying the timing of the employer's deduction to the timing of the employee's inclusion). Our discussion of I.R.C. § 409A disregards the interest and penalties applicable to "bad" nonqualified deferred compensation. See *id.* § 409A(a)(1)(B).

94. The timing of the cash flows is different for options (a) and (b) under an accrual taxation regime, but the present values of the flows are identical. Under option (b), the Rabbi must pay the tax liability attributable to the deferred compensation in Years 0 through 10 with separate funds because the tax liability does not reduce the amount invested in the trust for the employee's benefit. *Cf. supra* note 84. In Year 10, the Rabbi would receive a distribution of \$20,000, the future value of \$10,000 earning 7.2% per year. In the interim, however, the Rabbi would have paid taxes annually on accrued income (\$4,000 of tax in Year 0, \$420 in Year 1, \$431 in Year 2, \$443 in Year 3, etc.). The future value of these payments in Year 18, computed using the 4.3% aftertax yield available to the Rabbi, is \$10,853. The net benefit to the Rabbi from the arrangement is \$9,147 (\$20,000 – \$10,853) in Year 10, which equals the net benefit in Year 10 under option (a).

95. They are economically equivalent putting aside certain ancillary tax provisions that might come into play, such as the dividends received deduction under I.R.C. § 243. These complicating factors are addressed below in Part III.

employee would have occupied had she taken current compensation and invested for her own account; that is, both systems are neutral. The differences between them relate to their administration.

There are three obvious differences between the proposals. The first two relate to the taxation of the investment component. Halperin's special tax on investment income imposes the tax on the employer and sets the tax rate at the top marginal tax rate for individuals;⁹⁶ the accrual taxation model, on the other hand, imposes the tax directly on the employee and uses the appropriate marginal rate for that employee.⁹⁷ The third difference relates to the taxation of the compensatory element. Halperin's proposal would leave in place current law, which allows the employee to defer inclusion of (and requires the employer to defer deduction of) the compensatory portion of the payment until payment;⁹⁸ in contrast, the accrual taxation model would tax (and permit a deduction for) the compensatory element when earned.⁹⁹

These two proposals do not exhaust the universe of options. Each of the three key elements of a deferred compensation tax regime—the taxation of investment income, the inclusion of the compensatory element by the employee, and the deduction of the compensatory element by the employer—could be reckoned for tax purposes (1) at the beginning—i.e., when the compensation is earned; (2) at the end—i.e., when the period of deferral ends; or (3) periodically—i.e., throughout the period of deferral. So long as the base for taxation is properly adjusted in each instance to account for the time value of money, each element could be accounted for at any of the three stages, without undermining neutrality.

Furthermore, consistency is not required. For example, a neutral system might tax the employee on the compensatory element at the end of the deferral period, while at the same time allowing the employer to take its compensation deduction at the outset.

Finally, responsibility for remitting tax (and eligibility for deductions) can be assigned to either party to the compensation arrangement without changing the economics, *provided that the parties face equivalent tax rates*. Consider, for instance, that on the facts of Example 1, Halperin's special tax would impose the burden

96. Halperin, *supra* note 22, at 549.

97. See *supra* notes 90–91 and accompanying text.

98. Halperin, *supra* note 22, at 549.

99. See Treas. Reg. § 1.451-1(a) (2006) (requiring that, under the accrual method, income is generally realized when earned and deductions are generally allowed when the liability for payment is incurred).

on the employer (using the top marginal tax rate for individuals as a proxy for the Rabbi's marginal tax rate), which would cause a reduction in the aftertax yield from 7.2% to 4.3%. The accrual tax model, on the other hand, would impose the burden directly on the Rabbi, who would continue to earn 7.2% on the deferred compensation throughout the period of deferral. But the Rabbi would have to remit a tax representing 40% of the investment yield, which would effectively drive down his aftertax yield from 7.2% to 4.3%.¹⁰⁰ The parties would also be indifferent as to the identity of the payor of the tax on, and the recipient of the deduction for, the compensatory element of the arrangement, provided that the employer's and employee's tax rates are the same, since they could shift the incidence of the tax by adjusting the nominal pretax compensation.¹⁰¹ If rates are different then there is an incentive to allocate income (deductions) to the party with the lower (higher) marginal tax rate.

In the two Parts that follow, we address how neutral taxation of deferred compensation can be achieved with the lowest administrative burden and potential for abuse. Part III addresses how the special tax on investment income should be formulated. Part IV addresses when the employee's compensatory income should be taxed and the employer's compensatory deduction allowed.

III. FORMULATING THE SPECIAL TAX

Following Professor Halperin, we will refer to the tax burden imposed on the investment return earned on deferred compensation during the period of deferral as a "special tax." As illustrated in Example 1, without a special tax, there will often be a tax bias in favor of deferred compensation. To say that neutrality depends on a special tax, however, does not end the matter. There are several features of the special tax that must be specified, many of which present tradeoffs between neutrality and ease of administration.

100. See *supra* note 94.

101. In other words, assuming the parties faced equivalent tax rates, if responsibility for remitting the tax were placed on the employer, the Temple would agree to provide the Rabbi with a 4.3% yield on his deferred compensation. But if responsibility for remitting the tax were placed on the Rabbi, the Temple would agree to provide the Rabbi with a 7.2% yield. The two transactions would have the same economic (i.e., aftertax) results for each party. The assumption as to equivalent tax rates is critical and, of course, quite artificial. In fact, assuming equivalent tax rates for the parties, current law works perfectly well as the correct tax on the investment yield, while payable by the employer, is charged. Polsky & Hellwig, *supra* note 39, at 1143–44.

There are at least two ways of integrating the special tax with the preexisting tax rules—either the special tax could be imposed *in addition to* the preexisting rules, or *instead of* those rules. To illustrate the *instead of* approach, consider an employer that parks assets (of the employee's choosing) in a trust¹⁰² (as in Example 1), rather than paying the employee cash currently, which would permit the employee to make the investment directly. A neutral solution would be to impose the special tax on the income earned by the funds in the trust, to exclude that income from the employer's tax base, and to deny the employer an interest deduction for funds constructively borrowed from the employee. No employer interest deduction is warranted since in substance the employer is not borrowing from the employee so much as investing on the employee's behalf.

A serious drawback of this approach is that a rule needs to be devised to deal with the situation where the employer *does not* park assets in a trust or other segregated fund, but instead uses the funds for capital investment in its business, to fund working capital, to reduce borrowing, or the like. Such a rule might deem that the employer had set up a hypothetical trust and then borrowed funds from that trust for business purposes.¹⁰³ Under this approach, it would be necessary to account for the investment performance of funds in the hypothetical trust, since the yield earned on these funds is the special tax base, and to permit the employer an interest deduction for the money it has constructively borrowed from the employee.¹⁰⁴ It would also be necessary to distinguish cases where the employer sets up a trust (or other segregated fund) from cases where it does not, since the tax ramifications would differ. Suppose, for example, that an employer is obligated to pay deferred compensation

102. Whenever we use the term "trust" or "segregated fund" we refer to the typical deferred compensation arrangements that qualify as "rabbi trusts," which are, under current law, effectively ignored for tax purposes. See *supra* note 16.

103. Professor Halperin's proposal uses this approach. Halperin, *supra* note 22, at 546–47 (suggesting that in the absence of a segregated fund the employer should be permitted an interest deduction).

104. Essentially, the hypothetical trust which invests for the employee's benefit and lends money to the employer is a disaggregated version of the actual deferred compensation transaction. In form, the employer makes a promise to pay the employee some amount in the future. One way to view the substance of this transaction is to recast it as though (1) the employer pays the employee currently, (2) the employee loans the current payment to the employer, (3) the employer invests for the employee's benefit the sum borrowed from the employee, and (4) the employer pledges the investment it has made for the employee's benefit as collateral for a second loan that it uses to fund its business. The yield on the investment in step (3) of the recast transaction is the special tax base. The interest accruing on the loan in step (4) of the recast transaction should generate an interest deduction for the employer.

and the investment performance on the deferred compensation is tied to the performance of General Motors stock. Suppose further that the employer has a portfolio investment in General Motors stock (but such stock is not formally earmarked as an investment made on behalf of the employee). Does the employer get an interest deduction in this circumstance?¹⁰⁵

The complications are somewhat less severe if the special tax is imposed *in addition to* the normal tax rules. Under this alternative (1) the investment yield (either actual or imputed) on the deferred compensation is subject to the special tax, (2) the employer is taxed as it normally would be on any income it earns when it invests the funds that it did not pay the employee currently, irrespective of whether it segregates funds for the employee's benefit or instead uses the funds in its business, and (3) the employer gets an interest deduction for the funds it has constructively borrowed from its employee.¹⁰⁶ The advantage of the *in addition to* approach is that it obviates the need to distinguish between cases where the employer sets aside funds and where it does not.

In general terms, if the employer sets aside funds in a trust or segregated fund, then the income actually earned by the funds in the trust will be offset by the interest deduction on the constructive employee-to-employer loan under an *in addition to* approach. Because the income and deduction offset, this is the same economic result reached under the *instead of* approach. On the other hand, if the employer does not set aside funds but instead uses the funds in its business, the employer will enjoy a benefit from its interest deduction, which is appropriate since the employer would have gotten an interest deduction had it borrowed a like sum from a lender that was not its employee. For the balance of this Part we assume that the *in addition to* model is selected. We think it is the better selection both because of the administrative advantages described above and because we

105. Professor Halperin suggests that employers be required to set up a "trust or other segregated fund," which would obviously eliminate the need to make this determination. Halperin, *supra* note 22, at 549. As he notes, however, "a trust could not be mandated without a change in current law," which precludes deferral in the case of funded trusts, I.R.C. § 402(a) (2000), and this requirement could impair some firms' access to credit. Halperin, *supra* note 22, at 550. He also concedes that offering employees greater security might be unwise given the effect it would have on incentives to offer qualified deferred compensation. *Id.* at 550 n.164.

106. The constructive loan can be seen by disaggregating the deferred compensation payment into a current salary payment by the employer to the employee followed by a loan from the employee to the employer. The amount of the salary payment and the loan net to zero, so we do not observe this transfer, but in substance this is what is transpiring. See *supra* note 104; *infra* Part III.A.4.

think it is politically unlikely that a proposal would succeed that forced employers to fund a trust or trust-like arrangement and thereby denied firms ready access to the credit extended by employees who agree to be paid deferred rather than current compensation.

We address the issues raised in formulating the special tax below, first addressing the issues raised by defined contribution plans,¹⁰⁷ and then turning to defined benefit plans.¹⁰⁸

A. *Defined Contribution Plans*

1. Special Tax Base

For defined contribution plans, the special tax base is simply the product of (a) defined contribution and (b) the rate of return specified in the agreement between employer and employee.¹⁰⁹ The special tax base should be determined without consideration of any tax preferences to which the employee would not ordinarily be entitled, such as the dividends received deduction under § 243.¹¹⁰

Assuming (as will likely be the case) that the special tax is imposed periodically, the investment growth already subject to the special tax in prior periods must be subtracted from the special tax base to avoid double counting. This will occur automatically in certain circumstances. For example, suppose that the employer establishes a segregated account to hold the deferred compensation and that the special tax is imposed on the employer. If the employer pays the special tax by withdrawing funds from this account, then the special tax base is the difference between the account balance at the end of the tax period and the account balance at the beginning of the tax period.

107. Defined contribution plans specify the amount the employer will invest on the employee's behalf. Employees participating in defined contribution plans bear the investment performance risk for the deferred compensation; the employer makes no guarantee regarding how much will be paid when the period of deferral ends. (For this reason, the employee typically selects the investments, or at least the investment strategy, to be used in a defined contribution plan).

108. Defined benefit plans specify the amount the employer is required to pay the employee in the future. The amount is sometimes a fixed sum, but more typically is specified formulaically, for example as a percentage of the employee's average wages during the final few years of employment.

109. *But see infra* Part IV.A.4 (discussing one instance where the rate specified in the parties' agreement should not be respected).

110. Section 243 would ordinarily shield from tax between 70% and 100% of the dividends received by a corporation, but it does not apply to dividends received by an individual. I.R.C. § 243(a), (c).

However, determining the special tax base is more complicated if the employee pays the special tax or if the employer pays the special tax without subtracting the special tax payments from its future obligation to the employee. Where the employee pays the special tax, the employee's special tax payment is, in effect, an employee-to-employer loan. The employee is forced to pay taxes attributable to the investment yield; meanwhile, the employer enjoys use of the investment in its business without an obligation to pay current interest. As a result, part of the deferred compensation's investment growth is accrued interest on this loan and is not technically part of the special tax base, but treating it as such does not create any additional distortion¹¹¹ and keeps the accounting simple.

Where the employer pays the special tax with separate funds (i.e., funds not committed to the deferred compensation account), similar complexities arise. There are two ways to look at this case. Under one view, the arrangement's nominal defined contribution is less than the defined contribution that exists as an economic matter, because the employer is conferring a benefit on the employee equal to the present value of the future special tax payments.¹¹² Alternatively, the employer could be viewed as paying additional deferred compensation equal in timing and amount to its periodic special tax payments.

2. Identity of the Payor; Special Tax Rate

It is theoretically unimportant whether the employer or the employee remits the special tax. The employer's concern will be its total aftertax cost of remunerating a given employee. The employee's concern will be her total aftertax income. The special tax drives a wedge between the two: It raises the cost to the employer of providing the employee with the same aftertax income. The tax wedge is the same size regardless of whether the duty to remit the tax is imposed on the employer or the employee. The parties can shift the economic incidence of the special tax from employer to employee (or vice versa) simply by adjusting the nominal return deemed to be earned on the defined contribution.

Three factors, however, make the identity of the payor an issue of practical significance: (1) if the burden for remitting the special tax

111. As discussed below in Part III.A.3, we propose that the special tax be imposed on a mark-to-market basis, which would impugn neutrality to some extent in certain situations. See *infra* notes 129–40 and accompanying text.

112. The problem of artificially low (or high) defined contributions is discussed in more detail below in Part IV.A.4.

is placed on the employee, it is easier to take into account the employee's particular circumstances when setting the special tax rate and determining if preferences apply (such as a lower rate of tax on capital gains); (2) if the burden is placed on the employee, the obligation to remit the special tax would precede the receipt of funds with which to pay the tax, raising liquidity concerns; and (3) if the burden is placed on the employee, it limits policymakers' flexibility in determining when the employee will be required to include in income, and the employer will be allowed to deduct, the compensatory element of deferred compensation.¹¹³ We address the first and second factors in turn below, and the third factor in the next Section.¹¹⁴

Tax rate.—If the obligation to remit the special tax is imposed on the employee, it is easy to set the rate equal to the employee's marginal tax rate given that the employee must compile all of the information necessary to determine her marginal tax rate as part of her preexisting tax return filing obligation.¹¹⁵ This is the ideal rate in theory, because the goal of the special tax is to match the results that would follow if the employee had invested for her own account.¹¹⁶

If compensation is paid currently, the employee could invest the aftertax income in capital assets giving rise to income eligible for the preferential capital gains tax rate.¹¹⁷ Corporate dividends are currently taxed at the same preferential rate.¹¹⁸ So long as the special tax is imposed on the employee, it would be feasible to calculate the special tax rate to take into account whatever preferences are available to the employee. If the employee's W-2 reflects both the amount and character of the income generated by the actual or constructive investment funded by the defined contribution, the

113. Specifically, placing the tax burden on the employee effectively precludes deferral of inclusion and deduction of the compensatory element of the deferred compensation plan by the employee and the employer, respectively, for reasons discussed below. See *infra* Part IV.A.2.

114. *Id.* (explaining that if the employee remits the special tax, deferring the employee's inclusion and employer's deduction of the compensatory element until payment becomes unwieldy).

115. In other words, if the obligation to remit were imposed on the employee, the employee could simply include the investment income earned on the deferred compensation in her gross income as if the investment income were earned directly by her.

116. Cf. Christopher H. Hanna, *The Virtual Reality of Eliminating Tax Deferral*, 12 AM. J. TAX POL'Y 449, 508 (1995) (criticizing the interest charge method in § 453A(c) for using the highest marginal tax rate in computing the interest charge instead of using the taxpayer's actual marginal rate).

117. See I.R.C. § 1(h)(1) (2000).

118. See *id.* § 1(h)(11).

employee could incorporate this information into her individual tax return.¹¹⁹ This would permit application not only of the capital gains and dividend income tax preferences, but also enable the employee to make myriad other adjustments on her individual return that depend on the character of items of income, gain, deduction, or loss.¹²⁰

If, on the other hand, the obligation to remit the special tax is placed on the employer, it becomes far more difficult to set the special tax rate equal to the rate the employee would have borne had she made the investment for her own account. The employer generally will not know the employee's marginal rate. Forcing employees to divulge the necessary details raises privacy concerns.¹²¹ Furthermore, the incremental compliance burden might be substantial given that the employer would, in effect, be required to prepare a duplicate of the employee's tax return to determine its special tax liability. We agree with Professor Halperin that if the employer remits the special tax, the only practical alternative is to use a proxy rate, such as the top marginal rate for individuals.¹²² Yet, for the reasons outlined above relating to the characterization of income, in a substantial number of cases this rate would be too high, creating a tax bias against deferred compensation.

Liquidity.—If the obligation to remit the special tax is imposed on the employee, the employee's tax burden will not be accompanied by the receipt of cash. On the other hand, if the obligation to remit the special tax is imposed on the employer, the liquidity issue is resolved, at least for the most part.

One possible solution would be to place the ultimate burden for the special tax on the employee but to place the duty to withhold tax and remit payment on the employer.¹²³ In this system, the income

119. As explained above, the employer can be viewed as investing the deferred compensation for the employee's benefit regardless of whether such an investment occurs in fact. See *supra* note 104.

120. For instance, the employee could (1) set off capital losses outside the deferred compensation plan with gains inside the plan, see I.R.C. § 1222, (2) compute net investment income for purposes of computing the limitation on investment interest by reference to investment income earned by the deferred compensation plan, see *id.* § 163(d), and (3) compute any alternative minimum tax liability, see *id.* § 55.

121. For example, employees might be loath to tell their employer of the details of their securities market transactions, or how much money their spouse earns. Both pieces of information would be required in routine cases for the employer to determine the employee's marginal tax rate on the income in question.

122. Halperin, *supra* note 22, at 544.

123. Halperin discusses the possibility of enforcing accrual taxation of all compensation through withholding. He concludes that accrual taxation of all compensation (even with withholding) would encounter "serious obstacles" (including liquidity), which is a problem

subject to the special tax and the amount withheld by the employer would appear on the employee's W-2. If the employer overwithholds because of some peculiarity of the employee's tax position unbeknownst to the employer, the employee will be entitled to a refund, as typically occurs under current administrative practice. On the other hand, if the employer underwithholds the employee will have to make up the difference, but the liquidity problem will have been mitigated to a significant extent.¹²⁴

We are persuaded that liquidity is not a significant concern for the class of taxpayers who are remunerated through deferred compensation arrangements,¹²⁵ and we take seriously the notion that the policy goal in setting the rule for the taxation of nonqualified deferred compensation should be to preserve neutrality.¹²⁶ Calibrating the special tax rate correctly is more important than alleviating the liquidity issue that is more apparent than real, particularly since the liquidity problem can be ameliorated through withholding. Consequently, there is a compelling argument that the employee should be required to remit the special tax.¹²⁷

he attributes more to perception than reality. As Halperin notes and as we discuss below, accrual taxation coupled with withholding would not ordinarily be burdensome. *See id.*, at 541-42 & n.136; *infra* Part IV.C.

124. In a rare case, an employee's current compensation in a given year could be outstripped by the tax liability attributable to investment returns on balances in their deferred compensation account, so withholding zeroes out current compensation. Affected taxpayers are likely to be extremely wealthy and thus able to pay the additional tax without difficulty.

125. Liquidity is discussed in greater detail below. *See infra* Part IV.C.

126. Halperin acknowledges that his proposed solution of using the top rate for individuals would result in erring to the high side "in some cases," but he argues that "this rate preserves the maximum incentive for deferral through qualified plans." Halperin, *supra* note 22, at 544-45. Setting the rate at the top marginal rate for individuals would likely result in overtaxation in a significant number of cases (perhaps most cases) given that deferred compensation is often invested in assets that would be eligible for the capital gains and qualified dividend income tax rate preferences if the employee made the investment directly. As for "preserv[ing] the maximum incentive for deferral through qualified plans," *id.*, the ability to avoid tax on the inside build-up on qualified plan accounts is a strong incentive for companies to maintain such plans—together with whatever protections their nondiscrimination rules provide—but the existence of qualified deferred compensation does not, in our view, justify creating tax distortion at the margin between current and nonqualified deferred compensation.

127. At this juncture we are considering in isolation the policy choice regarding the identity of the payor. This choice has important implications for the choice of the timing of the employee's inclusion, and the employer's deduction of the compensatory element of the deferred compensation, as discussed below, and deferring the inclusion and deduction might be impossible as a practical matter if the special tax burden is not placed on the employer. *See infra* Part IV.A.2 & CONCLUSIONS (3 & 4).

3. Realization Versus Mark-to-Market Accounting

The special tax on the investment yield could in principle be imposed on either a realization or mark-to-market basis,¹²⁸ regardless of which party remits the tax. Imposing the special tax on a realization basis appears to be the most neutral rule when viewed from the employee's perspective. 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. In this circumstance the employee would get the benefit of the realization rule. At first blush it seems that she should get the same benefit when she invests through a deferred compensation plan.

From a joint contracting perspective, however, it is more neutral to impose the special tax on a mark-to-market basis.¹²⁹ If the employer makes a portfolio investment to backstop its obligation under the deferred compensation plan, the employer will get the benefit of the realization rule.¹³⁰ At the same time, the employer should be allowed to deduct periodically the interest accruing on the constructive loan outstanding from the employee.¹³¹ Taken together, these two rules will provide the employer with a timing benefit resulting from a combination of a current deduction for interest and deferred income from the portfolio investment. The consequence is to shift the benefit of the realization rule from the employee to the employer. There is no reason to expect that the economic benefit of the realization rule will coincide with the nominal benefit. Just as the parties can be expected to shift the economic incidence of the special tax between themselves, they can be expected to shift the economic benefit of the realization rule. Thus, allocating the nominal benefit of the realization rule to the "wrong" party (employer rather than employee) is of no theoretical significance.

There are two important qualifications to the foregoing analysis. First, the benefit of exploiting the realization rule will be worth more to the employer than the employee if the tax rate on the employer's

128. Under mark-to-market accounting, gains and losses are taken into account for tax purposes annually as they accrue, regardless of whether there has been a realization event.

129. In this regard, our assumption that an *in addition to* approach will be used is critical. If an *instead of* approach is used, then in the segregated fund context it would better promote neutrality to impose the special tax on a realization basis, even when viewed from a joint contracting perspective.

130. Thus, for example, if the employer purchases Microsoft stock to backstop its obligations under a deferred compensation arrangement based on the value of such stock, the employer will realize income only upon the disposition of the stock.

131. We discuss the rationale behind the employers interest deduction below. See *infra* Part III.A.4.

investment income is higher than the employee's.¹³² In certain instances, the employer may face a higher tax rate on investment income than its employee, even if ordinary income rates for employers and employees are the same (as is true currently), because the employee but not the employer is eligible for the capital gains rate preference and a reduced rate of tax on qualified dividend income.¹³³ In this case, shifting the benefit of realization from the employee to the employer is not a zero sum proposition; it would result in tax savings to the parties in the aggregate.¹³⁴

Second, the employer might use the funds it would have paid the employee had the parties bargained for current rather than deferred compensation—in other words, the borrowing implicit in the deferred compensation arrangement—to finance its normal business operations, rather than investing in whatever portfolio securities are necessary to backstop its deferred compensation obligation.¹³⁵ If so, whether the employer will enjoy the benefits of the realization rule depends on which asset the borrowed funds are deemed to finance. If it is an asset that is held by the employer for more than one year, deferral would generally result.¹³⁶ Otherwise, no deferral would result.¹³⁷ Given the fungibility of money, it is impossible to

132. The opposite is true if the employee has a higher tax rate on investment income than the employer. Whichever party has a higher rate derives a greater advantage from the deferral benefit that follows from the realization rule.

133. On the other hand, the employer—assuming it is a corporation—will be eligible for the dividends received deduction, unlike the employee. See I.R.C. § 243 (2000). We address the dividends received deduction below, and suggest that the employer should be denied the benefit of the deduction when it makes portfolio investments to backstop its deferred compensation obligation. See *infra* notes 149–55 and accompanying text.

134. This tax minimization technique is in no way unique to the deferred compensation context. Whenever a high-bracket taxpayer borrows from a low-bracket taxpayer and uses the funds to finance a project, the gains from which are tax deferred, the parties will in the aggregate derive a tax benefit because interest on the loan will be deductible by the high-bracket borrower as it accrues economically while the tax on the project gains will be deferred.

135. An employer backstops its deferred compensation obligation by purchasing the benchmark security for the deferred compensation arrangement, thereby hedging the risk of appreciation in that security. Thus, for example, if the employer's deferred compensation obligation is tied to the future value of 100 shares of Microsoft stock, the employer could backstop that obligation by purchasing that amount of Microsoft stock.

136. For example, if the borrowed funds are deemed to finance a stock purchase, then the employer obtains a deferral benefit resulting from the realization rule.

137. For example, if the borrowed funds are deemed to finance the purchase of inventory that turns over within the taxable year, the employer would obtain no deferral benefit because the employer would realize gain within the current year.

definitively establish what asset is financed with these funds.¹³⁸ (Note, however, that this is true even when the employer invests in portfolio assets to backstop its deferred compensation obligation—although when there is a portfolio investment to backstop the deferred compensation plan, the connection between the employer's implicit borrowing and its investment seems less attenuated than when the funds are used by the employer for general purposes.)

Finally, consider the complications that would result from imposing the special tax on a realization basis. Suppose the employer makes a portfolio investment to backstop its deferred compensation obligation (so that the constructive employee-to-employer loan is easily traceable to an asset that would entitle the employer to the benefit of the realization rule). Both the special tax and the employer's income tax would be imposed on a realization basis, while the employer would be allowed to deduct periodically the interest expense accruing on the loan implicit in the deferred compensation arrangement.¹³⁹ Hence, rather than simply shifting the realization rule timing benefit from the employee to the employer—as occurs when the special tax is imposed on a mark-to-market basis—the timing benefit would have been duplicated.

It could be argued that duplicating the benefit of the realization rule is appropriate. Suppose, for instance, the employer paid the employee cash currently and borrowed a like sum of money from a third party. If both the employee and the employer invested their respective funds (i.e., the employee's pay and the employer's loan proceeds) in growth stock, both would be eligible for the benefit of the realization rule. Viewed from this perspective, duplicating the benefits of the realization rule produces the correct result. This analogy is inapt, however. In the deferred compensation context the employer should be seen as borrowing funds from the employee rather than from a third party; consequently, the employer and the employee could not make simultaneous growth stock investments since only the employer would have cash to invest, the employee having implicitly loaned the cash to the employer. Thus, either the employee or the employer should get the benefit of the realization rule, but not both.¹⁴⁰ To prevent both from enjoying the benefit, an

138. Because money is fungible, it is impossible to determine exactly what was purchased by the employer with the extra cash the employer has as a result of the borrowing implicit in the deferred compensation arrangement.

139. See *infra* Part III.A.4.

140. Likewise, either the employer or the employee should get the benefit of any available tax preference, such as having investment income classified as capital gains. If

offsetting adjustment would be necessary. Either the employer's investment income, to the extent it is deemed to have been purchased to backstop its deferred compensation obligation, would have to be taxed on a mark-to-market basis; alternatively, the employer's interest deduction on the loan implicit in the deferred compensation arrangement would have to be deferred until the employer's investment income is included in income.¹⁴¹

In the end, imposing the special tax on a mark-to-market basis is superior to imposing the special tax on a realization basis given the administrative difficulties of implementing a neutral realization-based special tax, even though a mark-to-market special tax will impugn neutrality when employer and employee tax rates differ. This conclusion in this Section is in tension with our conclusion, explained above, that neutrality is better served by imposing the special tax on the employee.¹⁴² The advantage of imposing the special tax on the employee is that it facilitates the use of the employee's actual marginal tax rate, taking into account the capital gain preference. The tension is caused by the requirement that to enjoy the capital gains preference, the asset in question must be held for over one year, and mark-to-market accounting posits a constructive sale of the assets on the last day of the taxable year.¹⁴³ A rule could be devised to disregard the constructive year-end sale when determining the employee's holding period, or to determine the holding period by reference to the length of the deferral period called for by the underlying deferred compensation arrangement. Alternatively, a rule akin to § 1256(a)(3) could be applied to arbitrarily classify a given percentage of the year-end mark-to-market gain or loss as long term,

our suggestion regarding which party should pay the special tax, *see supra* Part III.A.2, were adopted, however, the capital gains classification and other tax preferences could be duplicated for the same reason. This is unfortunate, but not of great significance at least for corporate employers who enjoy no capital gains tax preference (although the limit on deducting capital losses under § 1211 makes corporations sensitive to this issue nonetheless).

141. Either strategy would be considerably more difficult if the funds the employer has borrowed from the employee are not easily traceable to a portfolio investment made to backstop the employer's obligation. In such cases it would be necessary to employ an arbitrary rule to determine which of the employer's investments were financed with the borrowed funds, and quite possibly, to appraise hard-to-value investments annually to implement mark-to-market taxation.

142. *See supra* Part III.A.2.

143. More precisely, individual taxpayers enjoy a capital gains tax preference on their "net capital gain" for a given year, I.R.C. § 1(h) (2000), defined as "the excess of the net long term capital gain for the taxable year over the net short term capital loss for such year." *Id.* § 1222(11).

and the balance as short term.¹⁴⁴ Either way, the proliferation of special rules in pursuit of neutrality at some point raises the question whether the incremental neutrality improvement can justify the added complexity.

4. Employer's Interest Deduction

The employer should be given an interest deduction for money it has effectively borrowed from the employee. Although the employer is not formally issuing a security to the employee or engaging in a transaction denominated as a loan, it is functionally issuing debt to its employee.¹⁴⁵ If the security issuance and the compensation transaction are disaggregated—for instance, if an employer issues a note to the employee in lieu of the cash it would otherwise pay its employee currently—it becomes apparent that the employer should get a deduction for interest accruing on the implicit loan.

To make the same point another way, suppose an employer pays its employee currently. The funds paid are not available to the employer for use in its business. To put itself in the same position it would have occupied had it paid deferred rather than current compensation, the employer must raise funds through (tax-deductible) borrowing (from a third party lender or perhaps from the employee). If the tax law does not take cognizance of the constructive employee-to-employer loan and permit an interest deduction, current compensation followed by an explicit loan from the employee to the employer would be treated differently, a result incompatible with the goal of neutralizing the taxation of current and deferred compensation.

The interest rate used to calculate the employer's deduction should be the same rate used to compute the investment yield on the deferred compensation—in other words, computing the employer's deduction should be the same exercise as computing the special tax base.¹⁴⁶ This is the correct rate because an employer that chooses not to fund its deferred compensation plan, and instead uses the funds in its business, is in the same position as if it had borrowed an amount equal to the defined contribution where the interest rate on the

144. Section 1256(a)(3) designates 60% of any gain or loss as long term and the 40% balance as short term. *Id.* § 1256(a)(3).

145. We deal with the special case of employer stock-based deferred compensation—where the measuring rod for the deferred future payment is the employer's stock price—below. See *infra* Part III.A.5. Here, we deal only with deferred compensation where investment performance is measured by some other standard.

146. See *supra* text accompanying notes 109–10.

borrowing is set equal to the investment yield earned under the plan.¹⁴⁷ An employer that funds its deferred compensation plan by purchasing assets to backstop its future obligation will often have investment income equal in amount (though perhaps different in timing¹⁴⁸) to the interest deduction, so the offsetting income and deduction will net to zero. (The employer might, however, make an investment generating income eligible for a tax preference, as discussed below, in which case the tax liability and deduction benefit will *not* net to zero.)

A complicating factor is that the employee-to-employer loan might finance an investment eligible for a special tax preference, giving rise to a potential tax arbitrage benefit. For example, suppose an employer (other than X Corporation) promises to pay its employee the pretax total return (including price appreciation (depreciation) plus dividend yield) on 100 shares of X stock five years hence and, further, that the employer purchases 100 shares of X stock to backstop its future obligation. Say X trades at \$35 per share and pays dividends of \$2 per year (a dividend yield of 5.7%). Each year during the deferral period, the employer, assuming it is a corporation, will be entitled to a dividends received deduction of \$140 (70% of \$200), reducing the effective tax rate on the \$200 dividend yield from 35% to 10.5%,¹⁴⁹ and leaving the employer with net dividend income of \$179 (\$200 - \$21). Meanwhile, the \$3,500 implicit loan from the employee that the employer used to purchase the 100 shares will accrue interest of \$200 (equal to the 5.7% pretax dividend yield), generating a deduction that would save the employer \$70 in taxes (\$200 x 35%). Hence, the employer would net \$249 (\$179 + \$70) aftertax, giving it \$49 more than necessary to fund the \$200 increase in its obligation to the employee. This creates a bias in favor of deferred compensation.¹⁵⁰

There are two ways to correct this problem. Either (a) the tax preference could be denied or (b) the interest deduction could be reduced or eliminated. Denying the tax preference would be easier, at least when the tax arbitrage exploits the dividends received deduction. There are already rules outside the deferred

147. Halperin, *supra* note 22, at 547 & n.56.

148. See *supra* Part III.A.3 (explaining that with a mark-to-market special tax the deferral benefit that would have been enjoyed by the employee had she invested for her own account will nominally be shifted to the employer).

149. After allowing for the dividends received deduction, the taxable dividend will be \$0.60 (\$2 - \$1.40), resulting in a dividend tax of \$0.21 (\$0.60 x 35%). \$0.21/\$2.00 = 10.5%.

150. See *supra* note 110 and accompanying text.

compensation context that are designed to thwart the purchase of debt-financed portfolio stock by corporations; these could easily be extended to deferred compensation arrangements. These rules operate by limiting eligibility for the dividends received deduction.

Specifically, § 246A reduces the dividends received deduction to the extent that the stock on which dividends are paid is debt financed.¹⁵¹ If, as in the foregoing example, 100% of the stock is debt financed, the dividends received deduction would be disallowed in full.¹⁵² A thorny issue arises when implementing rules that limit tax preference income generated through tax deductible borrowing, namely, how to determine whether the borrowing financed the investment that generated the tax preference income, as opposed to some other project. Tracing, pro-rata allocation, and stacking rules are used in different circumstances to link borrowings with investments.¹⁵³ Under § 246A, a tracing rule is used—the dividends received deduction is reduced to the extent of any “indebtedness directly attributable to investment in portfolio stock.”¹⁵⁴ The same rule should be used for tying the implicit employee-to-employer loan in a deferred compensation arrangement to investments in portfolio stock. Although the tracing rule is economically incoherent and easy to manipulate, it is just as easy to manipulate when the borrowing is made outside of the deferred compensation context.¹⁵⁵

5. Employer Stock-Based Plans

Deferred compensation plans in which the investment return is tied to the employer’s stock price raise issues similar to other deferred compensation plans, but the analysis is more complicated. As detailed below, we conclude (1) that it is preferable to impose the special tax on a realization basis for employer stock-based deferred compensation plans (for nonemployer stock-based plans, in contrast, a mark-to-market special tax is preferable¹⁵⁶), and (2) whether the

151. See I.R.C. § 246A(a), (c) (2000).

152. See *id.*

153. See generally Martin J. McMahon, Jr., *Simplifying the Interest Deduction for Individual Taxpayers*, 91 TAX NOTES 1371, 1392–97 (2001) (describing these three allocation methods).

154. I.R.C. § 246A(d)(3)(A); *OBH Inc. v. United States*, 397 F. Supp. 2d 1148, 1158 (D. Neb. 2005).

155. The same rationale suggests that when the employer uses the implicit loan from its employee to finance property eligible for a business related (as opposed to investment related) tax preference—such as accelerated depreciation—the tax arbitrage that results should be allowed to stand, given that the employer would have been able to exploit the tax arbitrage if it borrowed funds from a third party instead of from its employee.

156. See *supra* Part III.A.3.

employer should be allowed an interest deduction on the funds constructively borrowed from the employee (as was appropriate for nonemployer stock-based deferred compensation plans¹⁵⁷) depends on the nondeferred compensation analogue one accepts as the proper standard for neutrality.¹⁵⁸

We emphasize at the outset, however, that reforming the tax treatment of equity-based nonqualified deferred compensation would be misguided unless policymakers were simultaneously to reform the taxation of certain forms of § 83 deferred compensation.¹⁵⁹ Phantom stock—an unfunded, unsecured employer promise to pay an amount tied to the employer's future stock price¹⁶⁰—is economically indistinguishable from restricted stock.¹⁶¹ The tax benefit from paying employees with restricted stock, however, flows from the application of § 83, and would not be corrected by a reform extending only to nonqualified deferred compensation (that is, to unfunded, unsecured promises), but not to § 83 deferred compensation. Economic identity and tax inconsistency also describe the relationship between stock appreciation rights (commonly, "SARs"), a form of nonqualified deferred compensation, and NQSOs, a form of § 83 deferred compensation.¹⁶² Reforming the tax treatment of phantom stock or SARs but not restricted stock or NQSOs would elevate form over substance, creating a trap for ill-advised taxpayers, and would inconvenience taxpayers accustomed to using one form by making them switch to another, with no offsetting benefit.

Realization versus mark-to-market.—We argued above that it was more neutral to apply the special tax on a mark-to-market basis because the employer would get the benefit of the realization rule on the investment funded by the loan implicit in the deferred compensation.¹⁶³ The parties would allocate the deferral benefit from the realization rule between themselves by adjusting the nominal pretax compensation. Implementing a special tax that incorporated a realization rule would potentially duplicate the timing benefit of the realization rule, rather than merely shifting it (nominally) from the

157. See *supra* Part III.A.4.

158. In other words, the ambiguity inherent in the definition of neutrality has practical significance in this instance. See *supra* Part I.B.1.

159. See *supra* Part I.C.

160. See *supra* text accompanying note 31 (describing phantom stock).

161. See *supra* notes 47–49 and accompanying text (describing restricted stock).

162. See *supra* notes 50–54 and accompanying text (describing NQSOs).

163. See *supra* Part III.A.3.

employee to the employer, and duplicating the timing benefit would create a tax bias in favor of deferred compensation.

In the context of employer stock-based plans, this analysis breaks down. To avoid conflating the employer's compensation decision (to issue stock-based deferred compensation, rather than paying cash) with capital structure and investment decisions, the employer in an employer stock-based deferred compensation plan can be seen as repurchasing shares with the cash it would have paid its employee had they bargained for current cash compensation.¹⁶⁴ If the firm paying employer stock-based deferred compensation does not repurchase shares, it will have different cash flows and a different capital structure than a firm paying cash, preventing an apples-to-apples comparison.¹⁶⁵ If, on the other hand, the firm paying employer stock-based deferred compensation *does* repurchase shares, it will have no more cash than it would have if it had paid current cash, so it cannot make an incremental capital investment. Given that a meaningful comparison requires the assumption that the firm paying deferred compensation repurchases shares, it would be incorrect to conclude that taxing the employee on a mark-to-market basis simply shifts the benefit of the realization rule from employee to employer, since neither of them would get the deferral benefit of the realization rule. It follows that the argument for imposing the special tax on a realization basis is stronger for employer-stock-based deferred compensation than for other forms of deferred compensation. If mark-to-market taxation is generally applied to deferred compensation arrangements as we suggest above, however, simplicity militates against a special rule for this circumstance, even if it is desirable in principle.¹⁶⁶

Employer's interest deduction.—A second complication that arises for employer stock-based deferred compensation relates to the employer's interest deduction. Under one view, there is no employee-to-employer loan implicit in a typical employer stock-based deferred compensation arrangement. To see this, consider the first nondeferred compensation analogue to the phantom stock plan

164. Miller & Scholes, *supra* note 28, at 185 (explaining that hypothesizing corresponding transactions in this way "avoids the confounding of tax, cash flow, and risk effects encountered so often in the standard legal and accounting discussions of compensation plans."); see Knoll, *supra* note 27, at 208–09.

165. See *infra* text accompanying note 167.

166. A consistent rule is also desirable to deal with situations, not uncommon in practice, where the return to deferred compensation is dependant in part on the employer's stock price and in part on other metrics.

described above,¹⁶⁷ where (1) the employer pays current compensation, (2) the employee takes the net-of-tax cash and uses it to purchase newly issued employer stock, and (3) the employer uses the stock sale proceeds to repurchase shares in the open market. Because this nondeferred compensation analogue is devoid of an *explicit* borrowing, arguably the deferred compensation transaction is devoid of an *implicit* borrowing. If so, granting the employer an interest deduction would create a tax bias in favor of deferred compensation.

But this is not the only way to view the transaction. A different nondeferred compensation analogue, also discussed above, would have (1) the employer pay the employee \$100 and (2) the employee then loan her net-of-tax salary to the employer for three years at a market rate of interest. To account for the employer stock-based aspect of the deferred compensation arrangement, (3) the employer would be seen as selling a forward contract on its own stock to the employee.¹⁶⁸ Under this scenario, the employer would get a \$100 deduction for the salary payment and, in addition, might get an interest deduction for the three-year employee-to-employer loan, depending on the application of § 163(l), which disallows interest deductions on loans whose interest rate is determined by reference to the issuer's stock value.¹⁶⁹ Allowing an interest deduction in this circumstance would not impair neutrality to the extent that the deduction would have been available outside of the deferred compensation context.¹⁷⁰

B. *Defined Benefit Plans*

The principal difficulty in formulating the special tax for defined benefit deferred compensation plans is determining the special tax base. The special tax base is the difference between (a) the present value of the employer's defined benefit obligation at the end of the year and (b) the present value of that promise at the beginning of the year. The special tax base thus depends principally on the defined benefit established by the deferred compensation arrangement, and the discount rate used in the present value computation. Values for both variables will require estimates.

167. See *supra* text accompanying note 32.

168. See *supra* text accompanying note 33.

169. See *supra* text accompanying note 33; IRC § 163(l) (2000); Rev. Rul. 2003-97, 2003-2 C.B. 380; GARLOCK, *supra* note 34, at § 9.09[B].

170. See *supra* text accompanying notes 33–36.

If the defined benefit established by the arrangement is a fixed sum, then no estimate is required for the first variable; however, it is typical for defined benefit plans to be formulaic. For instance, one common form of defined benefit plan—so called supplemental executive retirement plans, or SERPs—often provides for a payout that depends on final pay, entitlements under qualified plans and Social Security benefits, and the employee's length of service.¹⁷¹ In such cases, a prediction is necessary regarding the myriad factors that plug into the payout formula. Even in simpler cases when the defined benefit is fixed in advance, if the timing is contingent (e.g., a fixed sum payable at retirement), then an estimate is required regarding the appropriate number of periods to use when discounting the defined benefit to present value.

The second variable, the discount rate used to reduce the defined benefit to present value, is the interest rate the employee is charging the employer for the loan implicit in the defined benefit arrangement. Because there is never an explicit loan, this interest rate must be estimated. One option is to use a market rate as a proxy for what the employee would charge had she bargained with the employer over a rate at arms' length, such as interest rates issued by the Pension Benefit Guarantee Corporation ("PBGC") for valuing deferred annuities.¹⁷² These rates are based on the premiums insurance companies charge in the marketplace for paid-up annuities and thus reflect investment yield assumptions made by professional actuaries advising insurance companies.¹⁷³ Other options are to use a historic market return, for example a return gauged by reference to U.S. Treasury securities, or the employer's actual borrowing rate based on bank loans, or for companies with publicly traded debt, yields in the bond market.¹⁷⁴

171. SERPs are discussed in more detail below. *See infra* Part IV.B.

172. These rates are posted on the PBGC web site. *See* PENSION BENEFIT GUAR. CORP., VALUING IMMEDIATE AND DEFERRAL ANNUITIES, http://www.pbtc.gov/services/interest/VAL_ANNU.HTM (last visited Nov. 6, 2006). For a description of the procedure used to compile these rates, see EDWARD E. BURROWS, SOC. OF ACTUARIES, FIXING THE PENSION PLAN FUNDING RULES (June 2003), http://library.soa.org/library-pdf/m-rs04-1_23.pdf.

173. *See* BURROWS, *supra* note 172.

174. If the return earned by the employer on the cash it saved by not paying current compensation is higher or lower than the rate of return assumed in making the present value comparison, it raises no additional complications. If the employer invests the funds constructively borrowed from its employee and earns a rate higher (or lower) than the employee's interest charge, the employer stands in no better (or worse) position than it would if it had taken out an explicit loan from a third party on the same terms. Halperin, *supra* note 22, at 546 & n.153.

Taxing defined benefit plans based on estimates raises critical issues regarding whether it is necessary to correct erroneous estimates ex post, and if it is, how to do so. This issue has implications for the special tax and also for the proper treatment of defined benefit deferred compensation plans if the compensatory element of such plans is included or deducted (or both) at the beginning of the deferral period when the right to payment is created, but before the amount of the payout is known.¹⁷⁵

As an initial matter, whether it is even necessary or desirable to correct the mistaxation that results from erroneous estimates is debatable. One argument in favor of correcting errors is that it is necessary to achieve fair results. Although errors would result in winners and losers, ex ante the parties will be taxed appropriately on an expected value basis (leaving aside for the moment the likelihood that a taxpayer would, if given the chance, pervert estimates to save taxes). This suggests that any inequity may be more apparent than real.¹⁷⁶ Thus, if we could be confident that errors resulted only from good faith misestimation, perhaps error correction would be unnecessary.

Nonetheless, correcting erroneous estimates is probably necessary to keep taxpayers honest: Without error correction, there would be a (perhaps significant) payoff from gaming the assumptions used to compute the special tax base.¹⁷⁷ Generally speaking, an error correction mechanism should reverse the under taxation that results from erroneous estimates. This could be done by taxing the difference between the special tax base per the ex ante estimate and the special tax base implied by the actual defined benefit when it becomes known. The error-correcting tax would have to negate the time value of money advantage of not making periodic special tax payments throughout the deferral period.¹⁷⁸

175. See *infra* Part IV.B.1.

176. Halperin, *supra* note 22, at 546 & n.153 (suggesting this argument). But see Michael J. Graetz, *Implementing a Progressive Consumption Tax*, 92 HARV. L. REV. 1575, 1601 (1979) (arguing that "horizontal equity must be an ex post concept. Circumstances should be considered as similar only after results are known; lucky gamblers are not the same as unlucky gamblers").

177. In other words, without error correction, the parties to a deferred compensation would have the incentive to use assumptions that would always result in the lowest amount of taxation, when viewed from a joint contracting perspective. By properly correcting errors, this incentive is removed.

178. Conceivably, the error might run against the taxpayer. If so, the tax base should be negative, implying the party responsible for remitting the special tax should get a deduction and perhaps even a refund.

Although not impossible, implementing an error correction mechanism of this sort would be complex. The current payroll tax treatment of SERPs is proof of this complexity given that the rules are designed to avoid the issue altogether. Section 3121(v) imposes payroll taxes on the present value of deferred compensation when it vests.¹⁷⁹ Recognizing the difficulty in ascertaining present value in the context of SERPs, however, Treasury regulations provide that employers can delay withholding payroll taxes on deferred compensation plans providing for an amount that is not “reasonably ascertainable.”¹⁸⁰ An amount is not reasonably ascertainable until the “amount, form, and commencement date of the benefit payments attributable to the amount deferred are known, and the only actuarial or other assumptions regarding future events or circumstances needed to determine the amount deferred are interest and mortality.”¹⁸¹

If the complexity associated with error correction is simply too great, one option would be to apply the special tax to contingent defined benefit plans on the same basis as payroll taxes are applied. This would not substantially impugn neutrality in most instances. To see why, consider that if taxpayers were forced to apply the special tax to a base dependant on estimates, the yield would never be eligible for capital gains or other preferences, such as those provided by §§ 243 and 1032. This is because the nondeferred compensation analogue to a defined benefit plan is an original issue discount debt instrument issued by the employer, which would generate a yield taxed as ordinary income.¹⁸² Under a wait-and-see approach like the one used for payroll taxes,¹⁸³ during the period between when the employer promises to pay deferred compensation and the time when the amount of the defined benefit becomes reasonably ascertainable, the special tax would not apply—but neither would the employer enjoy an interest deduction for funds constructively borrowed from the employee.¹⁸⁴ Denying the employer the interest deduction effectively imposes a substitute tax on the employer in lieu of the special tax (denying the employer an interest deduction increases its

179. I.R.C. § 3121(v) (2000).

180. Treas. Reg. § 31.3121(v)(2)-1(e)(4) (2006).

181. *Id.* § 31.3121(v)(2)-1(c)(4)(B).

182. An original issue discount (“OID”) debt is one in which at least some portion of the interest component is unstated. *See* IRC § 1274(a). In the defined benefit context, because the employer’s obligation is to pay an identified sum in the future, it lacks any stated interest component and, therefore, is akin to an OID instrument.

183. *See supra* notes 179–81 and accompanying text.

184. *See supra* Part III.A.4.

income). Thus neutrality would only be impaired to the extent that the employer's marginal tax rate differs from the special tax rate.

There is another reason why taking a wait-and-see approach to contingent defined benefit plans makes sense. Contingent defined benefit plans like SERPs are not nearly as tax-motivated as other forms of deferred compensation. Given that the payout is uncertain at the outset, the parties themselves cannot reasonably quantify the foregone compensation. This implies that what is transpiring is not merely a deferral of current salary; rather, there are likely significant nontax motivations behind such arrangement (i.e., bonding the employee to the employer, encouraging the employee to retire upon reaching an appropriate age, etc.). Because these arrangements are likely genuine business transactions rather than tax plays, policymakers should care less about the distortions that may result if these plans are taxed imperfectly.¹⁸⁵

IV. ACCOUNTING FOR THE COMPENSATORY ELEMENT

In this Part we address the timing of the employee's inclusion of, and the employer's deduction for, the compensatory element of deferred compensation. We first discuss defined contribution plans, then turn to defined benefit plans, and finally address two additional implications of the timing of inclusion and deduction that are common to both defined contribution and defined benefit plans: The liquidity issue raised if taxes are imposed prior to the receipt of cash; and the neutrality implications if tax rates change over time.

As noted above, the employee's inclusion and the employer's deduction can be set to occur at any time without impugning neutrality *provided* that the amounts included and deducted are properly adjusted to account for the time value of money.¹⁸⁶ Timing of inclusion and deduction will, however, have important administrative implications because in certain cases it will be difficult to ascertain the information necessary to make proper time value of

185. Compare these SERPs to voluntary salary reduction plans where employees simply defer a portion of their current salary, which is then set aside for the employee's ultimate benefit and invested in specified assets. In these arrangements, the employee is simply "parking" specific assets temporarily with the employer, generally for tax reasons.

186. See *supra* Part II.C. To be clear, current inclusion and deferred inclusion are mutually exclusive events. In a current inclusion regime, the compensatory amount is taxed once and only once, at the beginning of the deferral period. In a deferred inclusion regime, the compensatory amount is similarly taxed once, only at the end of the deferral period. The same is true on the deduction side.

money adjustments; in other cases, this information will be readily available.

The two most natural times to require inclusion and allow deduction of the compensatory element are alternatively at the outset of the deferral period when the right to payment is created (“current” inclusion or deduction), or at the end of the period when payment is actually made (“deferred” inclusion or deduction). In the analysis that follows, we focus on these two options.

A. Defined Contribution Plans

1. Determining Current Inclusion and Deduction Amounts

In defined contribution arrangements, both the proper current inclusion and deduction amounts are simply the amount of the defined contribution. Thus, for defined contribution plans, in most cases requiring current inclusion, current deduction, or both will be extremely easy.¹⁸⁷ This will not be true if the employer pays the special tax without deducting the payments from its future obligation to the employee¹⁸⁸ or if the rate of return on the deferred compensation specified by the parties is artificially too high or low.¹⁸⁹

2. Determining Deferred Inclusion Amounts

The proper deferred inclusion amount is the defined contribution inflated at the aftertax return rate earned during the period of deferral.¹⁹⁰ Inflating the defined contribution in this manner will properly compensate the government for the employee’s tax deferral. To see why an aftertax rate is appropriate, consider the following example:

Example 3. On December 31, Year 0, Employee agrees to defer compensation of \$100,000 until December 31, Year 2, at which time Employer will pay Employee the amount deferred plus the investment return thereon. Employer invests the deferred compensation in a taxable bond yielding 10%. Employee is subject to a 40% marginal tax rate.

187. See DORAN *supra*, note 25, at 15.

188. See *supra* text accompanying notes 111–12 (discussing instances where the employer pays the special tax with separate funds).

189. See *infra* Part IV.A.4. (discussing instances of artificially high or low rates of return).

190. See Stephen J. Willis, *Albertson’s: Less Emotion and More Reason Would Be Helpful*, 64 TAX NOTES 961, 963 (1994).

If the compensation had not been deferred, Employee would have owed tax of \$40,000 for Year 0. The ability to defer this liability is like a \$40,000 loan by the government to Employee. If there were an actual loan, interest of \$4,000 would accrue in Year 1.¹⁹¹ The Year 1 interest accrual would, in turn, generate an interest deduction that would reduce Employee's Year 1 tax liability by \$1,600 (40% x \$4,000). Therefore, the net amount owed to the government at the end of Year 1 would be \$42,400, as follows:

Year 0 deferred tax on compensation due gov't	\$40,000
Year 1 deferred interest due gov't	\$4,000
Year 1 deferred tax benefit due Employee	<u>(\$1,600)</u>
Net amount owed gov't on 12/31/Year 1	\$42,400

For Year 2, Employee would owe interest of \$4,240 (10% x \$42,400), giving rise to an interest deduction worth \$1,696 (40% x \$4,240). Thus, the net amount owed to the government at the end of two years would be \$44,944, as follows:

Amount owed gov't on 12/31/Year 1	\$42,400
Year 2 deferred interest due gov't	\$4,240
Year 2 deferred tax benefit due Employee	<u>(\$1,696)</u>
Net amount owed gov't on 12/31/Year 2	\$44,944

The amount included by the employee when she receives the deferred compensation must yield a tax of \$44,944 if the government is to be fully compensated for the deferral. This implies a deferred inclusion amount of \$112,360.¹⁹² If the defined contribution (\$100,000) is inflated by the aftertax rate of return earned on the deferred compensation (6%), the value at the end of the deferral period is \$112,360.¹⁹³ This demonstrates that if the deferred inclusion amount is calculated by adjusting (usually increasing) the defined contribution by an aftertax rate of return, the adjustment properly compensates the government for Employee's tax deferral.

Making this adjustment is simple in some cases and complex in others, depending on which party is responsible for remitting the special tax. If the employer remits the special tax, things are simple because the deferred compensation ultimately paid will equal the deferred inclusion amount.¹⁹⁴

191. This assumes Employee pays the government a market rate of interest, i.e., 10%.

192. $\$112,360 \times 40\% = \$44,944$.

193. The deferred compensation earns an aftertax amount of 6% regardless of which party pays the special tax, assuming that the special tax rate matches the employee's marginal tax rate ($10\% \times (1 - 40\%) = 6\%$).

194. For an illustration, see *supra* notes 82-86 and accompanying text.

If, on the other hand, the employee remits the special tax, things are significantly more complicated. To see why, consider that each special tax payment is, in effect, an employee-to-employer loan, as previously discussed.¹⁹⁵ The employee is forced to pay taxes attributable to the investment yield on the deferred compensation; meanwhile, the employer enjoys use of that investment yield in its business without an obligation to pay current interest. When the employer ultimately pays the employee, a substantial portion of the payment represents the defined contribution increased by enough to remunerate the government for the deferral of the compensatory element. But some of the payment is repayment of the de facto employee-to-employer loan (and implicit interest thereon) extended by the employee to the employer each time the employee made a special tax payment. This additional portion of the deferred compensation payment is not part of the compensatory element. Including it as such would overtax the employee.¹⁹⁶

The correct deferred inclusion amount in these circumstances is (a) the defined contribution (b) increased by the yield earned thereon during the deferral period and (c) decreased by the employee's special tax payments (with interest). Parts (a) and (b) are easy to compute, part (c) is the difficult part. To figure out (c), one must figure out both the employee's special tax liability each year during the deferral period and what interest rate should be used to compute the future value of these liabilities.

The employee's year-by-year special tax liability would be the difference between the employee's actual tax liability (taking into account the special tax) and a hypothetical tax liability computed without considering the special tax. Recall that one important benefit

195. See *supra* text accompanying note 111 (using this implicit loan analysis when discussing the computation of the special tax base when the employee pays the special tax).

196. Another way to explain why using the actual payment amount as the deferred inclusion amount in cases where the employee pays the special tax is as follows. Where the employee pays the special tax, the deferred compensation grows by a pretax rate of return because the employee is paying the special tax out of her own pocket. By contrast, where the employer pays the special tax, the deferred compensation grows by an aftertax rate of return because the deferred compensation obligation is reduced by the employer's special tax payments. Cf. *supra* note 111 and accompanying text (recharacterizing deferred compensation arrangements that provide for a pretax rate of return despite the employer's special tax liability). We have already explained that to compute the deferred inclusion amount, the current inclusion amount must be inflated by the *aftertax* rate of return. See *supra* note 190-92 and accompanying text. Therefore, where the employee remits the special tax, the actual payment amount (which represents the current inclusion amount inflated by the *pretax* rate of return) will be greater than the deferred inclusion amount whenever the special tax rate is greater than 0%.

of placing the obligation to remit the special tax on the employee is that it allows the employee to apply capital gains and other preferences to the investment yield on deferred compensation, and to consider other peculiarities of her individual situation, as appropriate. Taking a shortcut in computing part (c)—for instance, by simply multiplying the special tax base by the highest marginal tax rate for individuals—would undermine this benefit. Once the employee's special tax liabilities for all relevant years have been determined, they must be adjusted for the time value of money before they are subtracted from the deferred compensation payment. A proper discount rate would be the after-special-tax rate of return earned on the deferred compensation.

To illustrate, recall the facts of Example 3. Suppose that Employee will pay the special tax and has negotiated for a pretax return on the deferred compensation. The deferred compensation would have grown to \$121,000 at the end of Year 2.¹⁹⁷ The deferred inclusion amount should be \$121,000 less the periodic special tax payments by the employee, each inflated to its value on the date the deferred compensation is paid. In Year 1, Employee would owe a special tax of \$4,000 ($\$100,000 \times 10\% \times 40\%$). In Year 2 she would owe a special tax of \$4,400 ($\$110,000 \times 10\% \times 40\%$). The sum of these payments, when inflated to their value on the date of the payment, is \$8,640.¹⁹⁸ Thus, the proper deferred inclusion amount is \$112,360 ($\$121,000 - \$8,640$). The computation was easy here because the special tax was computed applying a stipulated tax rate; however, as a practical matter, this will not be the case. As a result, deferred inclusion will involve significant administrative complexity if the special tax is remitted by the employee.¹⁹⁹

3. Determining Deferred Deduction Amounts

Ascertaining the deferred deduction amount is conceptually easy. The starting point in figuring the proper amount to deduct is the amount of the defined contribution. This amount should be inflated using the aftertax return that the employer would have

197. $\$100,000 \times (1 + 0.1)^2 = \$121,000$.

198. The Year 1 special tax payment would be \$4,000 ($\$100,000 \times 10\% \times 40\%$); when increased by the aftertax market yield (6%) it is \$4,240 ($\$4,000 \times 1.06$). Adding \$4,240 to the Year 2 special tax payment of \$4,400 ($\$110,000 \times 10\% \times 40\%$) yields \$8,640.

199. Mechanically, the easiest way to achieve the correct inclusion amount would be for the employer to report on the employee's W-2 the entire deferred compensation payment and allow the employee to deduct the time value adjusted amount of special tax paid. This two-step method would be necessary because employers would ordinarily not know the amount of special tax paid by the employee.

earned if it had instead received a current deduction and invested the resulting tax benefit in an investment with a term equal to the deferral period.

What is the appropriate interest rate that the employer should earn on this hypothetical loan? In a deferred compensation arrangement, the employer bears market risk, since its future obligation to its employee vacillates with the benchmark security.²⁰⁰ The interest rate on the hypothetical government-to-employer loan must reflect this risk. Accordingly, the starting point for figuring the interest rate on the hypothetical government-to-employer loan is the pretax rate of return on the benchmark to which the deferred compensation is pegged. This rate of return must be adjusted to account for the fact that the interest on the hypothetical government-to-employer loan would have been taxable to the employer if it were an actual loan. As a result, to calculate the deferred deduction amount, the current deduction amount must be inflated by the pretax return on the deferred compensation after adjustments for the government's foregone taxes on that return.

To illustrate, recall the facts of Example 3. Assuming that the Employer is subject to a 30% marginal tax rate, if the \$100,000 of compensation had been paid currently, Employer would have received a deduction worth \$30,000 ($\$100,000 \times 30\%$). If this deduction is deferred, it is analogous to a loan by Employer to the government in exchange for the government's promise to repay the \$30,000 plus interest through a future reduction in tax. The term of this hypothetical loan equals the term of the deferral period. On these numbers, the deferred deduction amount equals \$114,490, which is the defined contribution (\$100,000) inflated by the aftertax return (7%) that would have been earned by Employer had it made an investment in the benchmark security. This deduction is worth \$34,347,²⁰¹ which is the same amount that Employer would have accumulated had it invested the value of the foregone current deduction in the benchmark security during the deferral period.²⁰²

Calculating deferred deduction amounts with precision would appear to be infeasible as a practical matter. To do so, for the first year of deferral, the defined contribution amount would need to be

200. Of course, the employer could hedge this risk by taking a long position in the benchmark security. The decision to hedge, however, can be seen as a financing decision that is independent of the choice regarding when to pay compensation. Accordingly, we ignore this possibility in evaluating the proper treatment of deferred compensation.

201. $\$114,490 \times 30\% = \$34,347$.

202. $\$100,000 \times 30\% \times (1 + .07)^2 = \$34,347$.

increased by the aftertax return the employer would have earned had it invested the deferred compensation in the security or index to which the deferred compensation is pegged. For Year 2, the resulting amount would then be increased in the same manner. And so on until the deferred compensation is paid. From an administrative standpoint, these calculations would seem to create significant hardship. Although the year-by-year return on the deferred compensation benchmark might be ascertainable, figuring the hypothetical tax the employer would have paid on that return would be extremely difficult.

One "rough justice" solution would be to use the actual payment amount, provided that the obligation to remit the special tax is placed on the employer. Professor Halperin suggests this option.²⁰³ If the employer remits the special tax, the actual payment amount would only differ from the proper deferred deduction amount to the extent that the employer's marginal tax rate differed from the special tax rate.²⁰⁴ If these rates differ, using the actual payment amount would create an incentive or disincentive to pay deferred compensation, all else being equal.²⁰⁵ Nevertheless, if deferring the deduction is an important goal, the extreme administrative ease of this option makes it attractive, despite its imprecision.

To sum up, designing a rule to calculate the correct deferred deduction amount with precision will be impossible as a practical matter. The only reasonably administrable option would be to use the actual payment amount as the deduction amount, provided that the employer pays the special tax, with the understanding that this would not yield perfect results in many cases.

4. Anti-Abuse Issues

Absent some legal restriction, the parties could specify a yield for their defined contribution plan that is unrealistically high or low, to their collective benefit. For example, assume that the parties intend that the employee will be paid \$1,000,000 in 10 years. They could achieve this by contracting for a \$463,193 defined contribution and a

203. Halperin, *supra* note 22, at 550 & n.166.

204. When the employer remits the special tax, the deferred compensation grows by the after-special-tax rate of return. *See supra* note 196. If the special tax rate approximates the employer's marginal tax rate, then the actual payment amount would approximate the proper deferred deduction amount.

205. If the employer's marginal tax rate is higher, then using the actual payment amount will overstate the deferred deduction, resulting in an incentive to pay deferred compensation. If the special tax rate is higher, then using the actual payment amount will understate the deferred deduction, resulting in an incentive to pay current compensation.

fixed return of 8%, assumed to be a market rate. Alternatively, the parties could arrange for an \$820,348 defined contribution and a fixed return of 2%. Ignoring tax consequences, the parties would be indifferent between these alternatives given that the payout is the same in both.

Once taxes are considered, however, the options are no longer equivalent if the employer and the employee face different marginal rates. Under a current inclusion and current deduction regime, the 2% alternative will overtax the employer and undertax the employee by overstating the compensatory element (\$820,348 instead of \$463,193) while understating the yield (\$179,652 instead of \$536,807). This would result in the employee including too much income in Year 1 and not enough in Years 2 through 10, while the employer deducts too much in Year 1 and not enough in Years 2 through 10. Although the nominal amount of the errors in Year 1, on the one hand, and Years 2 through 10 in the aggregate, on the other, would offset,²⁰⁶ considering the time value of money, the overtaxation of the employee in Year 1 outweighs the undertaxation of the employee in Years 2 through 10, and vice versa for the employer. Although the employee will be overtaxed by the same amount the *employer* is undertaxed if their marginal tax rates are identical, if these rates are different the parties can turn the mistaxation to their advantage by minimizing their aggregate tax liability and sharing the savings by adjusting the nominal amount of deferred compensation.²⁰⁷

To address this, a reform proposal would need to prevent the parties from contracting for artificially high or low yields. For instance, the Code or regulations could provide that the parties' defined contribution arrangement should be respected only if the agreed upon rate of return is reasonable. A rate of return should automatically be deemed reasonable if it is based on a predetermined actual investment held by the employer because an actual investment

206. The employee includes \$357,155 extra in Year 1 (as compared with the market rate arrangement), but includes \$357,155 too little in Years 2 through 10. Conversely, the employer deducts \$357,155 too much in Year 1, but deducts \$357,155 too little in Years 2 through 10.

207. If deduction and inclusion are deferred until payment, the incentives will run in the opposite direction. Because the compensatory element would always equal \$1,000,000 at the time of payout (i.e., the time of the inclusion and deduction event), manipulating the yield will only affect the special tax liability of the employee and the complementary employer interest deduction. Understating this yield would result in undertaxation of the employee and overtaxation of the employer (and vice versa in the case of overstatement of the yield). As a result, the parties would have the incentive to understate the yield when the employee is subject to higher marginal tax rates than the employer (and overstate the yield when the employer is subject to higher marginal tax rates).

return is obviously realistic.²⁰⁸ In the absence of an actual investment, whether the negotiated rate of return is reasonable should be based on the facts and circumstances present at the time the rate is set.²⁰⁹ If a rate of return is determined to be unreasonable, then the present value of the defined contribution could be determined using a market rate of interest.

5. Summary

Current inclusion and deduction amounts are easy to ascertain with precision in almost all cases. The same cannot be said with respect to deferred inclusion and deduction amounts.

Deferred inclusion is straightforward if the special tax is remitted by the employer; in such a case, the proper inclusion amount would equal the amount actually paid. If the special tax were instead remitted by the employee, it would be quite onerous to calculate the deferred deduction amount.

A deferred deduction regime could not achieve perfectly neutral results, as a practical matter. The best administrable option is to allow the employer a deduction for the amount paid, but this would require that the obligation to remit the special tax be placed on the employer.

B. *Defined Benefit Plans*

Some defined benefit plans—i.e., plans where the payout is specified but the contribution is not—present greater challenges to taxing deferred compensation neutrally than defined contribution plans. The principal difficulty arises in the case of defined benefit plans with a formulaic defined benefit. For instance, certain plans—for example, SERPs—commonly tie the amount and timing of the payout to such factors as the employee's salary and bonus during her

208. For this predetermined actual investment safe harbor to apply, the parties' arrangement would have to correctly account for which of the parties bears the special tax. If the employer bears the special tax, the employee's account ought to be reduced by the special tax liability; otherwise, the employee's return is excessively high. *See supra* notes 111–12 and accompanying text (discussing this scenario and suggesting that the transaction be correctly taxed by either recasting the defined contribution as higher than stated or treating each special tax payment as additional compensation). Likewise, if the employee bears the special tax, the employee's account ought to grow by the pretax return generated by the investment; otherwise, the employee's return is too low.

209. We imagine a rule evaluating the "reasonableness" of a given rate in a manner akin to Treas. Reg. § 1.1274-3(b)(3) (2006) (defining "clearly excessive interest" as an amount "clearly greater" than the amount of interest that would have been charged between the two parties had the same transaction been consummated at arm's length).

last years with the employer, the length of her tenure, and interaction with other retirement plans such as qualified plans and Social Security. We will refer to these plans as “contingent defined benefit plans.” The problem with such plans is estimating the present value of the future benefit at the outset. As noted above in our discussions of the special tax base and the attendant difficulty of determining the proper amount to include and deduct, the present value of the future benefit is a necessary input into the policymaker’s calculus.²¹⁰

On the other hand, neutral taxation of defined benefit plans with a fixed payout date and amount is relatively straightforward. For instance, consider an arrangement that requires the employer to pay the employee (or her heirs) \$1 million in thirty years. The present value of the defined benefit will be easy to ascertain if, as we suggest above, a proxy rate is used to gauge the interest rate earned by the employee on the loan implicit in the deferred compensation.²¹¹ Calling such plans defined benefit plans as opposed to defined contribution plans is more semantic than substantive. There is no difference between the plan described above (fixed defined benefit of \$1 million payable in thirty years) and a plan that specifies that the employer will make a defined contribution of \$99,377, to grow for the employee’s benefit at an aftertax rate of 8%, since, in either case, the employee will receive \$1 million in thirty years. Given that such defined benefit plans are economically similar to (in some cases identical to) defined contribution plans, what we have said about defined contribution plans applies to these plans too, and we will not discuss them separately.

We discuss, first, how to determine current inclusion and current deduction amounts for contingent defined benefit plans, second, how to determine deferred inclusion amounts for these plans, and third, how to compute deferred deduction amounts.

1. Determining Current Inclusion and Deduction Amounts

A typical SERP might provide for a continuation of salary based on a percentage of the executive’s final pay, reduced by qualified plan and Social Security benefits.²¹² The proper current inclusion and current deduction amounts are the present value of the defined

210. See *supra* Part III.B.

211. See *supra* notes 172–74 and accompanying text.

212. See Brisendine et al., *supra* note 31, at A-6.

benefit. To determine present value, all of the inputs into the payout formula must be estimated.²¹³

Making reliable estimates would be exceedingly difficult. It is unclear whether the *ex ante* predictions would result in an estimate within a tolerable range, even if we ignore the advantages taxpayers might gain by perverting estimates to minimize their taxes.²¹⁴ Once taxpayer self-interest is factored into the analysis, the outlook for reliable estimates grows dim. One possibility—discussed above—is to use an error correction or “true up” mechanism to correct past errors, although this would add complexity.²¹⁵

2. Determining Deferred Inclusion Amounts

As with defined contribution plans, the deferred inclusion amount is easy to calculate if the employer pays the special tax. In this case, it is simply the benefit paid.²¹⁶ If the employee pays the special tax, however, computing the deferred inclusion amount is more complex. As described above, each special tax payment by the employee is, in effect, an employee-to-employer loan. When the employer ultimately pays the employee, a portion of the payment represents repayment of this *de facto* employee-to-employer loan, plus interest. This portion of the defined benefit is not part of the compensatory element. It must be subtracted when computing the deferred inclusion amount. The difficulties this would entail are the same for defined contribution and defined benefit plans.²¹⁷

213. Furthermore, if the percentage of final pay target varies with length of service, this too must be estimated. For example, assume that the executive is to receive 50% of final pay (after reductions for qualified plan and Social Security benefits) upon retirement, but this percentage is increased two percentage points (but not above 100%) for every year of service beyond twenty years. To estimate present value, the expected retirement date must be determined. *See supra* Part III.B.

214. Given a regime that provides for *both* current inclusion *and* deduction, the parties would have competing incentives. Understating the present value of the defined benefit would reduce the employee's inclusion, but it would also diminish the employer's deduction. If the parties face equivalent marginal tax rates, any overtaxation of the employer would perfectly offset undertaxation of the employee, keeping tax planning in check. If their marginal tax rates differ, however, this analysis breaks down; the parties could plan to either over or understate the amount included and deducted to their mutual advantage, sharing the tax savings between themselves by adjusting the nominal pretax amount.

215. *See supra* Part III.B.

216. *See supra* note 194 and accompanying text (noting that, where the employer remits the special tax, the amount ultimately paid equals the deferred inclusion amount).

217. *See supra* notes 194–99 and accompanying text.

3. Determining Deferred Deduction Amounts

Recall that for defined contribution plans, the appropriate deferred deduction is the defined contribution inflated at a rate comparable to the aftertax rate that the employer would have earned had it received a current deduction and then loaned the value of the deduction to the government for a term equal to the deferral period for the plan.²¹⁸ The pretax yield on this loan would be tied to the return earned on the deferred compensation.

In the defined contribution context, we concluded that, if deferring the deduction were an important goal, the only feasible option would be to place the obligation to remit the special tax on the employer and to use the actual payment amount.²¹⁹ Although this option will often be imprecise, the cost of additional precision would appear to outweigh its benefit. Our conclusion is the same for defined benefit plans.

It is important to emphasize that the inability to estimate reliably the present value of the employer's promise, which renders current inclusion and deduction administratively impractical for contingent defined benefit plans, does not arise if the employee's inclusion and the employer's deduction is deferred. This is because the amount of the inclusion and deduction need not be figured until payment, at which time all contingencies have been resolved.²²⁰

4. Summary

Computing the current inclusion and deduction amounts for contingent defined benefit plans is likely to be fraught with error. The computation will frequently depend on estimates of such factors as future salary, time until retirement, and interaction with other retirement plans. None of these things can reliably be estimated. The likelihood that taxpayers would exploit this uncertainty by perverting estimates militates in favor of an ex post "true up" to correct past errors to deter opportunistic planning, which in turn would magnify complexity.

Computing the deferred inclusion and deduction amounts for contingent defined benefit plans is comparatively easy, provided that

218. See *supra* notes 200–01 and accompanying text.

219. See *supra* notes 203–05 and accompanying text.

220. While deferring inclusion and deduction in the contingent defined benefit context will solve the estimation problem with regard to the compensatory element, the problem nevertheless persists with regard to the calculation of the special tax. See *supra* notes 175–78.

the employer remits the special tax. The calculations follow the same pattern as for defined contribution plans.

C. Liquidity

In a current inclusion regime, tax would be imposed on the employee prior to her receipt of cash. This raises liquidity concerns, which some have considered significant enough to preclude a current inclusion regime.²²¹ We believe the importance of the liquidity issue has been exaggerated.

The inclusion of the compensatory element by the employee will trigger a wage-withholding obligation for the employer.²²² The employer would satisfy its obligation by withholding a greater amount of the employee's cash compensation; alternatively, the employer could require, as a condition of the deferred compensation arrangement, that the employee remit the required withholding amount to the employer.²²³ Each of these scenarios could theoretically create a liquidity problem for the employee as they would impair her current cash position. However, given the wherewithal of executives remunerated through deferred compensation arrangements and the fact that the executives who choose to participate are willing to defer the receipt of large amounts of cash for long periods, employee liquidity concerns rarely will be implicated.²²⁴

In these rare cases, an employer could solve the problem. If the employer has cash on hand—for instance, cash from tax savings attributable to its current compensation deduction²²⁵—or access to credit, it would be able to satisfy its withholding obligation.²²⁶ Thus a

221. See, e.g., Halperin, *supra* note 22, at 542 (identifying liquidity concerns as a “serious obstacle[] to immediate accrual taxation of all compensation”).

222. We assume the employer will have the same reporting obligations it has with respect to wages as under current law.

223. Such a condition is common in cases where an employee receives a significant amount of noncash compensation, particularly stock and nonqualified stock options. John L. Utz, *Restricted Property—Section 83*, Tax Mgmt. Portfolio (BNA) No. 384, at A-62 (2001) (noting prevalence of this withholding arrangement in the context of restricted stock grants).

224. Also, in defined contribution arrangements where parties agree that the employer will “fund” the plan by setting aside certain assets, the parties could restructure for a reduced set-aside amount, thus freeing up assets to satisfy the withholding tax.

225. This of course assumes that a current inclusion regime is paired with a current deduction regime, as we have concluded is preferable with respect to defined contribution arrangements. See *supra* Part IV.A.5.

226. Under current law, the employer does not receive a current deduction; therefore, the employer's current tax liability will (all else being equal) be lower after reform. This

current inclusion regime would impose a hardship on taxpayers in a very small number of cases.

Even if, as a realistic matter, liquidity is almost never a concern for the typical deferred compensation beneficiary, it still may be difficult politically to pass reform that would impose large tax burdens on employees (even high-ranking corporate executives) before they receive cash. For this reason, some have predicted that reform of the tax rules governing deferring compensation will inevitably perpetuate current law by allowing the employee to defer inclusion of the compensatory element,²²⁷ although recent legislation may belie this prediction.²²⁸

D. Changing Tax Rates

If a deferred inclusion regime is implemented, unstable tax rates will impugn neutrality. Under such a regime, if the employee's marginal tax rate decreases between the beginning and end of the deferral period, the parties will be better off (all else being equal) structuring for deferred rather than current compensation. Alternatively, if the employee's marginal tax rate increases, the parties will be better off structuring for current rather than deferred compensation. This occurs because, even though the base of the tax (i.e., the compensatory element) is appropriately adjusted for the time value of money, the tax rate that applies when figuring the tax liability would

reduced tax liability would free up cash to pay the withholding tax, assuming that the employer is in a taxable position.

Where the employer satisfies the withholding obligation out of its own funds (as compared with funds that would otherwise be payable to the employee as compensation), two issues arise. First, this would result in additional tax liability (and, as a result, another withholding obligation) in that the employer is paying the employee's tax liability. See *Old Colony Trust Co. v. Comm'r*, 279 U.S. 716, 729–30 (1929) (holding that when employer satisfies employee's federal tax liability, it results in additional income for employee). Second, this would result in more compensation paid to the employee than originally contemplated; accordingly, the parties would need to reduce the employee's future compensation to achieve the intended level of compensation.

227. See Halperin, *supra* note 22, at 542 (concluding that a “lack of employee understanding of the accrual method . . . may be the most serious obstacle to implementing [an accrual method system]”); cf. Terrence R. Chorvat, *Perception and Income: The Behavioral Economics of the Realization Doctrine*, 36 CONN. L. REV. 75, 101–11 (2003) (discussing behavioral economics research suggesting that people do not conceive of themselves as wealthier until property appreciation is reduced to cash).

228. See I.R.C. § 409A (West Supp. 2006) (originally enacted as American Jobs Creation Act of 2004, Pub. L. No. 109-357, § 885(a), 118 Stat. 1418, 1634 (2004)) (imposing accrual taxation on certain deferred compensation arrangements). However, § 409A is viewed as a penalty on nonconforming deferred compensation arrangements, not as imposing accrual taxation generally.

differ. This issue pushes in favor of current inclusion but, as we explain below, we do not think it is very significant.

Employees who structure significant amounts of deferred compensation will almost always be permanently subject to the highest statutory marginal rates.²²⁹ As a result, the only factor causing rate fluctuation will in most cases be legislative change. All else being equal, deciding between current and deferred compensation (under a deferred inclusion regime) would essentially involve a bet on how statutory tax rates will move during the often lengthy deferral period. Given the speculative nature of this bet, we believe that the impact of employee tax rate fluctuation is best ignored.²³⁰

CONCLUSIONS

Our principal conclusions are as follows.

1. Imposing a special tax on deferred compensation investment yield is necessary to a neutral deferred compensation tax regime.

2. Determining which party should remit the special tax on deferred compensation investment yield is complex. Viewing the issue in isolation, we conclude that there is a strong case for imposing the tax on the employee, so the rate of tax and available tax preferences can be gauged by the employee's individual circumstance.²³¹ However, imposing the tax on the employee has significant drawbacks, as discussed in conclusions 3 and 4.

3. If the employee remits the special tax then, for reasons described in Parts IV.A.2 and IV.A.3, it is difficult to account for the compensatory element of the deferred compensation program at the time of payment—that is, it is difficult to determine how much income should be included, and how much the employee should be permitted to deduct, when the deferred compensation is paid. Therefore, if the employee remits the special tax, administrative

229. See DORAN, *supra* note 25, at 16 (noting the wealth of typical deferred compensation recipients).

230. Some might argue that, because of nonlegislative marginal tax rate fluctuations (because, e.g., of a taxpayer's fluctuating levels of income), a deferred inclusion regime, while resulting in nonneutrality, might be normatively preferred. This argument would be based on the notion that self-help income averaging ought to be permitted. Halperin, *supra* note 22, at 549. We believe that this argument is not persuasive because affected employees will almost always be subject to the highest marginal rates for the duration of their lives. See *id.* (noting "the marginal rate of very high earners will not be reduced significantly, if at all, upon retirement"). Furthermore, it is difficult to justify allowing certain select ultra-rich taxpayers to engage in this self-help while other taxpayers suffer from the inability to income average.

231. See Part III.A.2.

considerations counsel for inclusion and deduction of the compensatory element of deferred compensation—as distinct from the yield thereon—at the time of the employer’s promise. Taxing the employee in this fashion raises liquidity concerns that have been emphasized in previous academic work. We conclude that concern over the employee’s liquidity has been overblown, but may have political salience.

4. If the employer remits the special tax, on the other hand, then the policymaker has substantial additional flexibility regarding when to account for the compensatory element of the deferred compensation. Administrable rules are feasible to include the deferred compensation at the outset (i.e., at the time of the employer’s promise) or upon payment. Thus, if concern over liquidity or other factors leads policymakers to defer taxing compensation until payment, administrative factors militate strongly towards placing the obligation to remit the special tax on the employer.

5. Finally, neutral taxation of contingent defined benefit plans raises one seemingly insuperable administrative challenge—how to determine the present value of the employer’s contingent future promise. We suggest that policymakers design rules that take a wait-and-see approach, allowing taxpayers to defer taking account of both the special tax and the compensatory element until the amount of the defined benefit is reasonably ascertainable. Although not ideal in theory, no neutral regime is possible until this information is known.