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An End to the Unintentional Subsidy for Executive Savings

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In this report, Trimm discusses the tax treatment of nonqualified deferred compensation and proposes a legislative reform to address neutrality and vertical equity concerns.

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I. Introduction

With wealth disparity on the rise,[1] the extravagant salaries of executives have been the subject of increased attention from academics, the media, and Congress.[2] Executive employees are not only more highly compensated than rank-and-file employees, they are also compensated differently. Much executive pay comes in the form of deferred compensation, specifically nonqualified deferred compensation (NQDC). When compensation is deferred, generally, tax liability is as well. Despite the recent increased scrutiny and ire toward executive salaries, NQDC has received relatively little attention.

The tax rules governing that compensation are inequitable and inefficient because they create a strong preference for deferred, rather than current, compensation among executive employees and their employers, and they effectively subsidize excess remuneration in the form of executive pensions. Moreover, because this subsidy almost exclusively benefits high-income taxpayers, it disrupts the generally progressive scheme of the American tax system and undermines the integrity of the qualified plan system. The Tax Cuts and Jobs Act (P.L. 115-97) increased the tax preference for NQDC by widening the disparity between the corporate and individual income tax rates and eliminating the corporate alternative minimum tax.

This report discusses the preferential tax treatment of NQDC compared with current compensation, the tax policy objectives that suggest reforming those rules, and possible statutory solutions that balance those objectives with the need for rules that are reasonably administrable.

II. Overview of Deferred Compensation

A. The Tax Treatment of Current Compensation

To establish a baseline for comparison, it is necessary to understand how current compensation is taxed. As a general rule, an individual is taxed on income when he actually or constructively receives it.[3] That is, an individual must include compensation in his income tax return either when it has been reduced to actual possession or when it has been credited to his account, set apart for him, or otherwise made available so that he could have drawn on it during the tax year if notice of intent to withdraw had been given.[4] An employer can deduct the compensation paid in the tax year when the employee's services were rendered.[5] Typically, this means that the employee's inclusion of the compensation is matched with the year the employer deducts it.

[1] *See* Congressional Budget Office, "Trends in Family Wealth, 1989 to 2013" (Aug. 2016).

[2] *Cf.* the Emergency Economic Stabilization Act of 2008, P.L. 110-343, sections 802 and 301(a); the American Recovery and Reinvestment Act of 2009, P.L. 111-5, section 7001; and the Pension Fairness and Full Disclosure Act, H.R. 2233, 109th Cong., sections 201 and 202 (2005).

[3] Reg. section 1.446-1(c)(i).

[4] Reg. section 1.451-2(a).

[5] Sections 162(a) and 461(h).

B. Qualified Deferred Compensation

Deferred compensation comes in two basic varieties: tax-qualified plans and nonqualified plans. A qualified deferred compensation arrangement is one that earns favorable tax treatment by satisfying numerous conditions enacted to protect the pension benefits of participating employees and encourage adequate retirement savings. One condition is that the deferred compensation must be set aside in a trust for the exclusive benefit of the participating employees or their beneficiaries.[6] Further, qualified plans must comply with minimum coverage requirements,[7] minimum age and service conditions,[8] minimum funding requirements,[9] and vesting standards.[10] One particularly important restriction on qualified plans is that they cannot discriminate in favor of highly compensated employees[11] in coverage, amount, or benefit.[12] To that nondiscriminatory end, qualified plans are subject to a ceiling on the amount or benefit they can provide.[13] These qualifying conditions in the tax code substantively track the pension plan content controls found in ERISA.[14]

[6]Section 401.

[7]Section 410(b)(1) (providing that a trust won't constitute a qualified trust unless the plan benefits at least 70 percent of non-highly compensated employees, or benefits a percentage of non-highly compensated employees that is at least 70 percent of the percentage of highly compensated employees who benefit under the plan).

[8]Section 410(a)(1)(A) (providing that an employee who has either completed one year of service or attained the age of 21, whichever occurs later, cannot be excluded from participating in a qualified plan).

[9]Section 412(a).

[10]Section 411(a) (providing that depending on the type of plan, a participant's interest must become non-forfeitable either by vesting gradually from three to seven or two to six years of service, or by vesting fully upon the completion of three or five years of service).

[11]A highly compensated employee is defined as one who either owns more than 5 percent of the company sponsoring the plan or whose compensation in the preceding year exceeded an indexed dollar threshold. For tax year 2018, that dollar limit is $120,000. Section 414(q)(1)(B).

[12]Sections 410(b) and 401(a)(4) and (5). There are special nondiscrimination rules for cash or deferred arrangements. Section 401(k)(3) and (m).

[13]Sections 410(a)(17), 415, 402(g), and 401(a)(17) (limiting the allowance of benefit or contribution rates that are facially neutral but discriminatory in effect). The code and Treasury regulations provide several methods for nondiscrimination testing, as well as a few statutory safe harbors. *See, e.g.*, section 401(a)(5)(B).

[14]29 U.S.C. section 1001, et seq.

C. Tax Treatment of Qualified Plans

In exchange for their compliance with the extensive rules governing them, qualified plans receive favorable tax treatment.[15] Ordinarily, under the economic benefit doctrine, an individual would be immediately taxable on income that has been irrevocably set aside for him in a trust beyond the reach of the payer's creditors, even if he has no current right to demand payment.[16] However, when the trust is part of a qualified plan, the employee-participant defers taxation until he actually receives the income in the form of distributions.[17] However, the plan sponsor need not wait for the employee to receive distributions to deduct the contributions it has made for him; it may deduct payments made to a qualified plan in the year the money is set aside.[18] Also, while the money is in the trust during the deferral period, it earns interest tax free.[19] These provisions give the participant a tax advantage by delaying the taxation of compensation until he actually receives it. At the same time, they grant an asymmetrical tax benefit to the plan sponsor by allowing it to deduct the compensation before the employee is required to include it in his gross income.

The exclusion of contributions to and earnings of pension funds make these plans one of the United States' largest tax expenditures.[20] Congress granted this subsidy to qualified plans because of a desire to improve the welfare of employees and encourage the establishment of pension trusts for their benefit.[21]

[15]Sections 401(a)(1) and 501; and 29 U.S.C. section 1001(a) (1974) (stating Congress's finding that employee benefit plans "substantially affect the revenue of the United States because they are afforded preferential tax treatment").

[16]Section 404(a). *See, e.g.*, *United States v. Drescher*, 179 F.2d 863 (2d Cir. 1950); and *Minor v. United States*, 772 F.2d 1472 (9th Cir. 1985).

[17]Section 402(a).

[18]Sections 401(a) and 501.

[19]*Id.*

[20]The estimated tax expenditure for the 2018 tax year, excluding plans covering partners and sole proprietors (Keogh plans), is $198.7 billion. Joint Committee on Taxation, "Estimates of Federal Tax Expenditures for Fiscal Years 2016-2020," JCX-3-17, at 40 (2017).

[21]"Revenue Revision of 1942: Hearings Before the House Ways and Means Committee," 77th Cong. 2405-2406 (1942) (statement of Randolph Paul, special tax adviser to the Treasury secretary).

D. Nonqualified Plans

NQDC arrangements are plans that are not entitled to favorable tax treatment because they fail to meet the qualification criteria. ERISA's provisions, however, apply to any employee pension plan, whether tax-qualified or not, unless the plan is specifically exempted by ERISA.[22] Nonqualified executive pension plans, commonly referred to as "top hat" plans,[23] evade the burden of complying with most of ERISA's rules because they are "unfunded and . . . maintained by an employer primarily for the purpose of providing deferred compensation for a select group of management or highly compensated employees."[24] Generally, that means that the plans may cover only high-level employees.[25]

E. Tax Treatment of Nonqualified Plans

Because top hat plans don't qualify for the express tax subsidy granted to qualified pension plans, they must be carefully designed to avoid current taxation of the employee on the deferred compensation. An ill-crafted nonqualified plan may subject the employee to current taxation under section 83 or 409A, or under common law tax principles.[26]

To successfully delay taxation, the employee's compensation must be deferred before it is earned.[27] The employer cannot set aside any assets for the exclusive benefit of the employee during the deferral period; the nonqualified plan assets must remain subject to the claims of the employer's general creditors.[28] A plan cannot restrict the plan assets to the provision of benefits upon a change in the employer's financial health, and it cannot directly or indirectly set aside plan assets in a foreign trust.[29] The deferred compensation must be distributed according to a schedule established before the election to defer is made.[30] The distribution can never be accelerated before the specified time except upon disability, death, or unforeseeable emergency, and it may be further deferred only under narrow conditions.[31] Failure to comply with those rules renders all of the employee's vested NQDC subject to immediate taxation. For some violations, the employee also faces a 20 percent punitive tax and an interest charge calculated from the time of the initial deferral.[32]

For nonqualified plans, the tax law matches the timing of the employee's inclusion of the income to the timing of the employer's deduction. As long as the employee defers tax on her nonqualified pension, the employer cannot deduct the compensation.[33] Also, because the employer is the owner of the nonqualified plan assets during the deferral period, the interest earned by those assets is currently taxable to the employer.[34] Compared with current compensation, which also matches the timing of inclusion and deduction, the matching principle as applied here places the tax burden on the employer rather than the employee.

F. The Tax Incentives for NQDC

Both the executive employee and the corporate employer derive significant tax benefits from the use of NQDC arrangements. The employee can both defer and reduce her tax burden, while the employer can enjoy many of the tax benefits afforded to qualified plans and deduct compensation it would otherwise not be able to. Thus, the code creates a strong incentive

[22] 29 U.S.C. section 1003(a).

[23] *See, e.g.*, 29 C.F.R. section 2520.104-23(c).

[24] 29 U.S.C. sections 1051(2) (exempting top hat plans from ERISA's minimum participation requirements); 1081(a)(3) (exempting top hat plans from ERISA's minimum vesting standards); and 1101(a)(1) (exempting top hat plans from ERISA's fiduciary responsibility provisions).

[25] *In re New Valley Corp.*, 89 F.3d 143, 148 (3d Cir. 1996). *See also* Brief for Bond et al. as Amici Curiae Supporting Plaintiffs-Appellants, *Bond v. Marriott International Inc.*, No. 15-1160 (4th Cir. 2016).

[26] Section 409A was enacted in 2004 to fill the regulatory void surrounding NQDC plans. Before its enactment, the tax treatment of those plans was primarily regulated by common law tax doctrines. Section 409A didn't replace those doctrines for NQDC but merely added to them. *See* Notice 2005-1, 2005-1 C.B. 274.

[27] Section 409A(a)(4)(B).

[28] Section 409A(b); reg. section 1.83-3(3); and Rev. Rul. 60-31, 1960-1 C.B. 17.

[29] If either of these terms is violated, there is a transfer of property under section 83, rendering the compensation immediately taxable. Section 409A(b)(1) and (2).

[30] Section 409A(a)(2)(A).

[31] Section 409A(a)(2), (3), and (4)(C).

[32] Section 409A(b)(5).

[33] Section 404(a)(5). *See also Alberton's Inc. v. Commissioner*, 95 T.C. 415, 431-432 (1990) (Halpern, J., concurring) ("It can be said that the effect of the matching principle is that the employer is being taxed in substitution for not currently taxing the employee.").

[34] Section 404(a)(5).

for both parties to prefer deferral over current compensation.

1. The tax benefits of NQDC to executive employees.

On its face, the matching principle applied in the context of NQDC may seem to merely shift the tax burden from the employee to the employer when compared with current compensation. However, this is true only if the corporate and individual tax rates align for all types of income. When the corporate and individual rates diverge, it is not just the tax incidence that changes but also the amount of the tax liability incurred. A corporation is subject to lower tax rates on ordinary income and most types of investment income than its highly compensated employees. Thus, the primary advantage an executive or managerial employee derives from participating in a nonqualified pension plan is that she may effectively substitute her employer's lower tax rate for her own during the deferral period. The executive employee thereby increases her after-tax rate of return when she elects to defer through a nonqualified plan rather than receive the compensation in the year she earns it. The tax liability is not only deferred; it is also reduced.

While individual and corporate income tax rates have changed over time, the highest marginal rate for individuals[35] has generally been higher than that for corporations (see Appendix). For tax years beginning in 2018, however, the TCJA reduces the corporate rate from 35 percent to 21 percent, a historic low, and the corporate AMT has been eliminated.[36] The highest marginal individual rate under the TCJA is 37 percent.[37] The 16 percentage-point difference between the highest marginal individual and corporate ordinary income rate is the greatest since the early 1980s.

Of course, the ordinary income tax rate is not the only relevant rate to consider. The compensation, whether deferred or current, is unlikely to be left sitting idly, and different types of investments are taxed at different rates. A corporation's effective tax rate on dividends will generally be 10.5 percent,[38] while an individual's will be 15 percent. Corporate capital gains are taxed at the same 21 percent rate as ordinary income, while individual capital gains are taxed at 15 percent.[39] Although the preferential individual capital gains rate may seem to counter some of the tax advantage for the deferring employee, it is important to note that corporations are not taxed on dividends or capital gains derived from the corporation's own stock when the stock is held by the corporation.[40] Further, executive employees, as high-income taxpayers, are generally subject to a 3.8 percent surtax on investment income, whereas corporations are not.[41]

Merely looking at the statutory rates, however, doesn't paint a complete picture and may understate the true tax advantage provided by nonqualified plans. Many corporations pay an effective tax rate of zero because they carry net operating losses that offset their income, including a significant number of corporations simultaneously reporting book profits.[42] The TCJA's elimination of the corporate AMT may increase the prevalence of corporations reporting no tax liability, since they may now be able to deduct their way to zero. Regardless of how the corporation arrives there, when the corporate employer has an effective tax rate of zero, it is functionally turned into a tax-exempt investment vehicle for its executive employees. The deferred compensation earns interest at a pretax rate of return, exactly as it would under a qualified deferred compensation plan.

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[35] The highest marginal individual rate bracket is the most relevant bracket for comparison because NQDC plans are typically offered only to executives and other highly compensated employees.

[36] TCJA section 12001(b) (codified at section 11(b)).

[37] TCJA section 11001 (codified at section 1).

[38] Although the corporate rate that applies to dividends is the same 21 percent as for ordinary income, the corporate dividends received deduction allows a deduction of at least 50 percent. Section 243.

[39] Section 1(h).

[40] Section 1032.

[41] Section 1411.

[42] *See* Government Accountability Office, "Corporate Tax Rates: Most Large Corporations Paid Tax but Effective Tax Rates Differed Significantly From the Statutory Rate," GAO-16-363 (Mar. 2016).

Table 1.

	Year 25 After-Tax Cost of Compensation To Employer	Year 25 After-Tax Value of Income to Employee
Current Compensation	($83,234)	$54,718
Qualified Deferred Compensation	($83,234)	$85,336
Nonqualified Deferred Compensation, Subject To 21 Percent Statutory Corporate Tax Rate	($83,234)	$66,376
Nonqualified Deferred Compensation, Effective Corporate Tax Rate of Zero	($83,234)	$85,336

As shown in Table 1, in most cases, NQDC is significantly more valuable to the employee than current compensation because of the tax advantage she derives from substituting the corporation's tax rates for her own. For this example, the amount of compensation either paid or invested in year 1 in each scenario is $40,000, and the deferral period is 25 years. For the sake of simplicity, the only tax imposed is ordinary income tax.[43] If the pretax rate of return on investment is 5 percent, compounded annually, a corporation paying the statutory tax rate has a 3.95 percent after-tax rate of return, and an individual in the highest-rate bracket has a 3.15 percent after-tax rate of return. The left-hand column displays the cost of the compensation to the employer at the end of year 25, while the right-hand column shows the after-tax income to the employee in year 25.

In all cases — whether the compensation is given currently, contributed to a qualified plan, or contributed to a nonqualified plan — the cost to the employer is the same, but the value to the employee changes, with current compensation being the least valuable option.

[43]The rate applied for the employee is 37 percent, but using the highest marginal rate ignores income averaging. By deferring, the employee may reduce her current compensation enough to move into a lower-rate bracket. Later, when she begins receiving distributions in retirement, she will often pay a lower tax rate than she would have had she taken the compensation during her working years because her income in retirement is reduced.

This substituted lower rate is not the only possible tax advantage for an employee; the deferral may also help her reduce her tax liability in other ways. First, by electing to defer, an employee may be able to move into a lower-rate bracket, thereby reducing her current income tax liability in addition to postponing a portion of it. Second, her federal income tax liability may be further reduced if her state and local taxes would exceed the $10,000 deduction limit but for the deferral.[44] Finally, participating in a nonqualified pension plan may help the employee reduce her state and local income tax liability in retirement. If the employee lives and works in a high-tax state while employed but establishes residency in a lower-tax state before receiving distributions in retirement, she will be subject to only the second state's income taxes.[45]

2. The tax benefits of NQDC to corporate employers.

As demonstrated in Table 1, the after-tax cost of the compensation to the employer is unchanged by the employee's election to defer;[46] however, the corporation may gain tax advantages elsewhere when a manager opts for deferred compensation. First, the corporation may be able to capture some of the tax benefit by paying executives who opt for deferred compensation a lower pretax amount than they would demand as current compensation.[47] Another significant tax incentive for providing deferred compensation to highly compensated executives is avoidance of the code's limit on executive salary deductions. Corporations have historically been entitled to deduct all employee compensation as a section 162 ordinary and necessary business expense. But in 1993 Congress

[44]TCJA section 11042 (codified at section 164).

[45]A state cannot impose income tax on the retirement income of any individual who is not a resident or domiciliary of that state. 4 U.S.C. section 114(a).

[46]The tax savings the employer gets in year 25, when it deducts the deferred compensation, offsets the tax paid on the deferred amount in year 1. In the example from Table 1, the corporation's year 1 tax liability on the $40,000 deferral is $8,400, which has a year 25 value of $22,125. The $40,000 earns after-tax interest at a rate of 3.95 percent (the 5 percent market rate less the corporation's 21 percent statutory tax rate) to a year 25 value of $105,359. When the employer distributes that money to the employee, it deducts the full amount for a tax savings of $22,125.

[47]Gregg D. Polsky and Brant J. Hellwig, "Taxing the Promise to Pay," 89 *Minn. L. Rev.* 1092, 1146-1147 (2005).

enacted section 162(m), limiting the amount a corporation could deduct in any given year for compensation paid to one of its most senior officers to $1 million. However, this limitation applies only for the period of the officer's employment. Once the manager is separated from service, the corporation may deduct all compensation paid to her, including compensation earned in prior years.[48]

Section 162(m) was enacted to curb overly aggressive pay practices.[49] Congress didn't want to subsidize excessive compensation for the key officers of public corporations. Until recently, section 162(m) had a few important exceptions. Most crucial among them, performance-based pay was not subject to the $1 million limit.[50] Congress eliminated the performance-based pay exception, along with most other section 162(m) exceptions, through the TCJA. The TCJA, however, did not change section 162(m)'s treatment of deferred compensation, so corporate employers may still avoid the $1 million limit by paying compensation exceeding the deduction ceiling after the employee has separated from service. With other avenues for avoiding the section 162(m) limit closed off, NQDC plans will become an even more valuable mechanism for corporate employers to reduce their tax liability. Although an executive earns the nonqualified pension pay while she is an employee of the corporation, she receives the compensation only after separation from service, when she is no longer a "covered employee" within the meaning of section 162(m). If a corporation paid one of its most highly compensated managers a current salary of $5 million, it would incur a tax liability of $840,000 on the $4 million exceeding section 162(m)'s limit, assuming it pays the 21 percent statutory tax rate. But if the employer arranges to provide $1 million as current compensation while crediting the remaining $4 million to a nonqualified pension plan, the corporation preserves the ability to deduct the full amount of compensation in a later year when the employee draws on those funds in retirement. The corporation's deduction is deferred, but a delayed deduction is better than no deduction at all.

Further, although nonqualified plans don't provide the same tax incentives for employers that qualified plans do (chiefly, immediate deduction and tax-free interest), there are ways an employer can replicate many of those tax benefits for its nonqualified plans. For instance, if the corporation purchases a company-owned life insurance policy with the deferred compensation, it can immediately deduct the cost.[51] If the employer uses the deferred compensation to invest in its own stock, the deferred compensation will earn interest tax free.[52]

III. Economic Neutrality

A. Defining Neutrality

The basic concept of economic neutrality is not difficult: The tax system should strive to be neutral so that actors make decisions based on their economic merits rather than on their tax consequences.[53] The decision to offer or participate in a nonqualified plan should be made because it is economically rational or represents good contracting, not because it provides a tax advantage.

[48] Section 162 disallows excessive deductions only for covered employees, defined as the company's chief officer and the three other highest-paid executives whose compensation must be reported to shareholders under the Securities Exchange Act of 1934. Only current employees are included in the SEC compensation reports.

[49] Testimony of Treasury Assistant Secretary for Tax Policy Pamela F. Olson at Senate Finance Committee hearing on Enron compensation-related issues, JS-168 (Apr. 8, 2003).

[50] It has been argued that Congress was merely responding to populist concerns when it enacted section 162(m) and that it included the performance-based pay exception to render the measure toothless. David M. Schizer, "Tax Constraints on Indexed Options," 149 *U. Pa. L. Rev.* 1941, 1942 (2001).

[51] COLI is a popular form of informal funding for nonqualified pensions for this reason. *See, e.g.*, Newport Group, "Executive Benefits: A Survey of Current Trends," 53 (2014) (more than 73 percent of survey respondents said they purchase COLI as part of their funding for nonqualified plans).

[52] Section 1032.

[53] *See, e.g.*, Olson testimony, *supra* note 49 ("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.").

Table 2

	Year 25 Pretax Income to Employee	Year 25 After-Tax Value of Income to Employee	Year 25 Tax Liability Of Employee	Year 25 Tax Liability of Compensation To Employer	Year 25 Aggregate (Total) Tax Liability
Current Compensation, $40,000 Pretax	$135,454	$54,718	$80,736	($22,125)	$58,611
Qualified Deferred Compensation	$135,454	$85,336	$50,118	($22,125)	$27,993
NQDC, Subject to 21 Percent Corporate Tax Rate	$105,359	$66,376	$38,893	$0	$38,893
NQDC, Effective Corporate Rate of Zero[a]	$135,454	$85,336	$50,118	($22,125)	$27,993

[a]This may be achieved through either deductions or NOLs reducing the taxable income to zero.

For NQDC, the reference point for neutrality is current compensation. Under present rules, the tax treatment of nonqualified plans is economically neutral only if the corporate and individual rates align. To the extent those rates diverge, the code is, in effect, either subsidizing or penalizing nonqualified executive pensions. When an employer is subject to a higher tax rate than its employee, current compensation is preferable to the employee because her after-tax rate of return on investment will be higher than her employer's. When the employer is subject to a lower tax rate than the employee, as is now the case, the opposite is true, and the federal fisc is forgoing revenue and subsidizing the savings of executive employees. The current tax rules create an unintentional subsidy for nonqualified executive pension plans and result in significant forgone revenue (see Table 2).

Government officials and tax scholars generally agree that if the tax treatment of NQDC is to be reformed, the principle goal should be economic neutrality.[54] The key challenge in establishing what neutrality is for deferred compensation arrangements is that there are various types of transactions an employee could enter into, and they are subject to different tax treatments. For that reason, the baseline against which the neutrality of deferred compensation is measured — the aggregate tax liability under current compensation — is not always easily determinable. However, it isn't necessary to settle on a precise standard to enact legislative reforms that promote neutrality.

B. The Virtues of Neutrality

Non-neutral tax treatment presents two problems: It is both inefficient and inequitable. An executive employee presented the choice between current and deferred compensation in a tax-free world should prefer current compensation. Returning to the illustration in Table 1, how highly would that executive have to value her preference to elect to take the current compensation under the present tax rules? As shown in Table 2, which uses the same basic premises as Table 1, when the employer is subject to a 21 percent statutory tax rate, deferral increases the year 25 value of the executive's compensation by more than $14,000. Moreover, and more plainly, the executive is significantly undertaxed when she opts to defer. Her election to defer betters her position by the excess of her tax savings over the value of her forgone preference.

Accordingly, society's position is worsened by the same amount. This deadweight loss, or allocative inefficiency, occurs whenever the equilibrium of a neutral market is disturbed.[55]

[54]*See, e.g., id.*; Daniel I. Halperin, "Interest in Disguise: Taxing the 'Time Value of Money,'" 95 *Yale L.J.* 506, 541 (1986); and Michael Doran, "Executive Compensation Reform and the Limits of Tax Policy," Urban-Brookings Tax Policy Center, at 1 (Nov. 2004).

[55]Deadweight loss occurs whenever the code induces taxpayers to alter their behavior. *See* Jonathan Gruber, *Public Finance and Public Policy* (2013).

That is, by encouraging behavior that a neutral tax policy would not, the code disrupts economically rational behavior to the benefit of highly compensated executives and to the detriment of society.

Table 2 demonstrates the degree of the economic distortion created by the tax rules. It expands on the information offered in Table 1 to illustrate the tax consequences of each of the transactions to the employer, the employee, and the fisc.

IV. Vertical Equity

Table 2 also demonstrates another major problem with the tax treatment of nonqualified executive pensions: The employer will often, through either clever tax accounting or plan design, be able to manufacture the same tax benefits provided to qualified plans. The ability to capture the tax benefit of a qualified plan through a nonqualified plan presents a threat to the qualified plan system and the rank-and-file workers whose retirement income it seeks to secure. The code expressly provides substantial tax incentives for companies to establish and maintain qualified plans to ensure the retirement security of millions of American workers.[56] Like many subsidies, these tax advantages are most valuable to highly compensated individuals, but the nondiscrimination rules in ERISA and the code provide that those tax benefits are available only if the qualified plan gives proportionate benefits to a substantial group of rank-and-file workers. By permitting a nonqualified plan to provide identical tax advantages, the integrity of the qualified plan system, and its express goal of ensuring American workers have adequate retirement savings, is undermined.

The tax treatment of NQDC is also inequitable by virtue of its distributional effects. NQDC is provided almost exclusively to highly compensated employees. Rank-and-file workers are not given the same opportunity to take advantage of tax-favored deferred compensation. This functions as a subsidy to high-income managerial and executive employees because their employers can achieve the same benefits of a qualified plan while excluding the rank-and-file workers who qualified plan rules were enacted to protect. Thus, to the extent the tax rules favor NQDC over current compensation, they "provide an unwarranted and unintended subsidy to high-income individuals."[57]

V. The Need for Reform

Tax policy often serves goals other than vertical equity and economic neutrality. The code is rife with provisions in which Congress deliberately eschews economic neutrality to induce specific behaviors. What if the subsidy for nonqualified executive pensions is not accidental? Perhaps Congress intended to encourage more savings, even if by taxpayers with ample incomes who may not need special incentives to save. Perhaps it intended to help solve corporate agency problems by aligning the managers' and executives' financial interests with the shareholders' interests in cases in which the deferred compensation is in the form of company stock, or by creating a bond between employee and employer when the deferred compensation is subject to a risk of forfeiture based on future performance. Any or all of those possible objectives could explain why Congress enacted section 409A without addressing the economic neutrality issue. If Congress didn't intend the subsidy, why did it not address economic neutrality concerns when it undertook that major reform of nonqualified executive pension plans in 2004?

First, when section 409A was enacted, Congress had little need to consider neutrality as a policy goal. Between 2003 and 2012, the highest marginal corporate and highest marginal individual income tax rates were identical, each 35 percent (see Appendix). Under the tax rules in place at the time, there was no obvious tax advantage granted by deferring compensation. The concerns at the forefront of legislators' minds were preventing a repeat of the Enron scandal — in which the company's executives accelerated distributions from their nonqualified plans, while the company's rank-and-file workers saw their qualified retirement savings disappear as the

[56] Olson testimony, *supra* note 49.

[57] Halperin, *supra* note 54, at 541.

company plunged toward bankruptcy — and foreclosing the ability of executives to evade the risk of loss.[58]

The economic neutrality problem reared its head years later, when the rate schedules were altered. In 2013 the highest individual rate rose by 4.6 percent to 39.6 percent, while the corporate rate remained unchanged, slightly skewing the market in favor of deferral. For tax years beginning in 2018, the slight skew will become a drastic tilt. The TCJA's reduction of the corporate income tax rate to 21 percent and its elimination of the corporate AMT turns corporations into much more heavily tax-preferred vehicles for executive saving. The 16 percentage-point gap between the highest marginal individual rate and the statutory corporate tax rate is the greatest disparity between the two rates since 1981 (see Appendix). In 2004 Congress had no reason to anticipate that such significant rate changes would occur 14 years in the future. Economic neutrality was not an issue the last time Congress deliberated over the tax treatment of NQDC. Considering the changes made by the TCJA, however, a renewed evaluation of the tax treatment of nonqualified plans is warranted.

Second, Congress has plainly tried to eliminate subsidization of excessive salaries elsewhere in the code. The history of section 162(m) is instructive here because it shares many of the same policy objectives Congress would serve by reforming the taxation of NQDC. Section 162 was enacted in 1993 to curb overly aggressive corporate pay practices.[59] Congress didn't want to spend tax dollars subsidizing excessive remuneration for the key officers of public corporations. Section 162(m) offered some exceptions to its $1 million deduction limit when it was initially enacted. Most notably, it created an exception for performance-based pay.[60] However, Congress eliminated that exception, along with most others previously provided by section 162(m), under the TCJA. By acting deliberately in its enactment and reform of section 162(m), Congress has manifested a clear intent to reduce tax subsidization of executive compensation. Considering those acts, the failure to reform the tax treatment of nonqualified executive pensions seems more like an oversight than a carefully considered decision.

Finally, Congress has granted an express subsidy to qualified pension plans, and that subsidy is awarded only to employer-sponsored retirement savings plans that include a substantial portion of the employer's rank-and-file workers. As discussed earlier, the availability of similar or identical tax benefits to plans that do not meet the stringent conditions for receiving that subsidy undermines a clearly expressed policy goal.

VI. Proposals for Reform

Academics have proposed a variety of possible answers to the question of how Congress could create neutrality between current compensation and NQDC. Some reforms propose that Congress create neutrality by altering the timing of inclusion. Others have argued for a solution that would impose a tax on the investment component of the deferred compensation.

A. Place NQDC on the Accrual Method

One approach to neutralize the treatment of NQDC compared with current compensation is to simply treat it much more like current compensation. Michael Doran argues the best approach to reform would be to impose accrual method taxation on employees for their NQDC:

> Accrual-based taxation, which follows directly from the Haig-Simons definition of income, presents the correct result as a matter of tax policy. That approach treats deferred compensation — regardless of whether it is "good" or "bad" (in the sense of satisfying or not satisfying an arbitrary set of statutory requirements)[61] — just like current compensation. In other words, accrual-based taxation eliminates the

[58] *See* JCT, "Report of Investigation of Enron Corporation and Related Entities Regarding Federal Tax and Compensation Issues, and Policy Recommendations," vol. 1 (Feb. 2003).

[59] Olson testimony, *supra* note 49.

[60] *See supra* note 50.

[61] The "arbitrary" statute to which Doran refers is section 409A.

possibility of a tax preference for deferred compensation.[62]

This would flip the timing of inclusion and deduction from its current tax position, eliminating the tax advantages of deferral by eliminating tax deferral. The employee would likely include the compensation as income either in the tax year it is earned or the tax year in which her interest in it vests.[63] The employer would still deduct when the employee includes, but the inclusion would happen sooner, as soon as the right to receive the income is fixed and the amount can be determined with reasonable accuracy.[64]

Doran argues that this shift to the accrual method for NQDC would also further other tax policy goals beyond neutrality. First, it would eliminate, or at least seriously curb, corporate avoidance of the section 162(m) $1 million deduction limit.[65] Given that Congress eliminated most exceptions to that limit when it ratified the TCJA, addressing the loophole it left open through the use of NQDC would further section 162(m)'s apparent legislative goal and make that provision more effective by reducing the amount of forgone revenue lost to executive salaries. Second, it would eliminate avoidance of state taxes by the employee, to the extent nonqualified plans are used for those purposes.[66]

This proposal, however, poses some administrative problems. The accrual method requires taxpayers to include income "when all the events have occurred which fix the right to receive such income and the amount thereof can be determined with reasonable accuracy."[67] The right to receive requirement would not be a substantial issue. And the right would be fixed when the employee earns a vested interest in the compensation — that is, the income is accrued as it is earned. However, the amount determination could be difficult. The final payout would certainly depend on investment performance and may be contingent on other conditions contractually agreed to by the employer and employee. Once an amount has been determined, the calculation each year thereafter is fairly straightforward: Each year the employee includes, and the employer deducts, the increase in the employee's vested value.

The most serious administrative problem posed by the use of the accrual method for NQDC is valuation. The amount may be difficult to determine under some plans, even after the right to receive the income has been clearly fixed. Despite that obstacle, section 457A shows that there is some congressional willingness to place deferred compensation on the accrual method. Although section 457A applies only to a narrow class of deferred compensation plans operated by foreign entities, it may provide useful guidance because it directly deals with the problem of indeterminable amounts, albeit with a blunt object.

Under section 457A, when the amount is indeterminable at the time it would otherwise be includable as income, an employee can defer inclusion and taxation until the amount becomes determinable, but this tax deferral comes at a cost. When the amount becomes determinable, the employee's tax liability on the income is increased by interest owed, calculated from the time the income would have been includable but for the indeterminability of the amount, plus an additional 20 percent of the compensation.[68] That provision may seem harsh, but the tax penalty may discourage corporations from creating plans that deliberately obfuscate the amount, thereby continuing to defer inclusion and taxation much as they do under the current tax rules.

B. Tax on the Interest Component of NQDC

In his 1986 article, Daniel I. Halperin advocated imposing a special tax on the investment income generated by NQDC.[69] His proposed tax is designed to recapture the forgone

[62] Doran, "Time to Start Over on Executive Compensation," 28 *Va. Tax Rev.* 223, 225-226 (2008).

[63] Section 83.

[64] Reg. section 1.1451-1(a).

[65] Doran, "The Puzzle of Nonqualified Retirement Pay," 70 *Tax L. Rev.* 181, 236 (2017).

[66] Employees may use NQDC to avoid state tax liability by moving from the state in which they earned the compensation to another state with lower or no income tax before they actually receive and report it. *Id.* at 194 and 236.

[67] Reg. section 1.1451-1(a).

[68] Section 457A(c).

[69] Halperin, *supra* note 54, at 539-550.

revenue associated with nonqualified compensation and would be paid annually by the employer. To achieve perfect neutrality, the rate the employer would pay would need to match the beneficiary's marginal rate. However, that level of precision would pose significant administrative problems, so the more practical implementation of this idea would require that the special tax rate equal the highest marginal individual rate.

This solution, too, has its drawbacks. First, the imposition of this special tax would require that the value of the asset pool be known. Although this wouldn't pose a significant problem for nonqualified defined benefit plans, it would create issues with other nonqualified plan types. Because nonqualified plan assets remain in the general asset pool of the employer and cannot be secured for the exclusive benefit of the employee, this is not an insignificant hurdle. Congress could work around the value issue by mandating that employers set aside nonqualified plan assets in unsecured trusts, thereby establishing a clear tax basis in every nonqualified plan, but that is not ideal because it would alter investment behavior for no reason other than to create a taxable asset. Thus, while this solution would create tax neutrality, it would not create economic neutrality.

VII. Conclusion: Alternative Tax on Interest

Imposing a surtax on the interest component of nonqualified pensions would achieve the primary policy objectives of tax reform, but there is an administratively simpler means of doing so than the method suggested by Halperin. Instead of calculating tax annually, the code could simply require that a surtax be calculated when the employee includes the deferred compensation in her income. As with other proposed solutions, this would require that the IRS be able to accurately determine the amount of compensation deferred. However, it would avoid the challenge of valuing nonqualified plan assets as separate assets commingled with the employer's general assets. Like Halperin's suggested surtax, this tax would be most administratively practical if the amount imposed makes the aggregate tax on the interest component equal to the highest marginal individual rate. Returning to the example in tables 1 and 2, this would mean applying a 16 percent surtax to the interest component when the employer is subject to a 21 percent tax on the investment income throughout the deferral period.

This solution avoids the most difficult problem in taxing NQDC: valuation. By waiting until the end of the deferral period to determine liability, the value of the distribution to the employee is certain and easily ascertainable. Moreover, this rule would not impose a significant accounting challenge for either the employer or the employee. A surtax levied upon distribution could prove difficult if the tax rates changed during the deferral period, but the IRS could get around that problem by applying the surtax pro rata based on the amount of time each rate applied during the deferral period. Although this solution doesn't address the deferred compensation loophole of section 162(m), that issue could be independently addressed by amending section 162 to apply to compensation earned in a given tax year, rather than compensation actually paid.

This solution would provide the necessary reform, while being administratively simple enough to make its imposition practical. The tax treatment of NQDC provides an upside-down subsidy to the savings of high-earning individuals, which is entirely unavailable to rank-and-file workers. This subsidy disrupts economic neutrality between current and deferred compensation and contradicts clear congressional intent to protect qualified plans and limit the extent to which the code subsidizes executive compensation. By adopting this proposed solution, Congress could correct the behavioral bias created by the non-neutral tax rules and protect the integrity of the qualified pension system.

Appendix

Year(s)	Highest Corporate Marginal Tax Rate	Highest Individual Marginal Tax Rate	Difference
1972-1978	48%	70%	(22)
1979-1981	46%	70%	(24)
1982-1986	46%	50%	(4)
1987	34%	38.5%	(4.5)
1988-1990	34%	28%	6
1991-1992	34%	31%	3
1993	34%	39.6%	(5.6)
1994-2000	35%	39.6%	(4.6)
2001	35%	39.1%	(4.1)
2002	35%	38.6%	(3.6)
2003-2012	35%	35%	0
2013-2017	35%	39.6%	(4.6)
2018	21%	37%	(16)

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