THE POLICY OF REGULATING DEFERRAL: A CRITIQUE IN LIGHT OF INTERNAL REVENUE CODE SECTION 409A

By Steven J. Arsenault and W. R. Koprowski***

I. INTRODUCTION 244
II. OVERVIEW OF NONQUALIFIED DEFERRED COMPENSATION PLANS 244
III. THE TAX LAW PRIOR TO § 409A 247
A. The Economic Benefit Doctrine 247
B. The Doctrine of Constructive Receipt 249
IV. I.R.C. § 409A 250
A. What Plans Are Affected? 250
B. What Requirements Must These Plans Meet? 251
1. Initial Deferral Election 251
2. Distribution Rules 252
3. Postponement of Distribution 252
C. Limitations Imposed by I.R.C. § 409A 252
1. Haircut Provisions 252
2. Rabbi Trust Limitations 254
D. Failure to Comply with I.R.C. § 409A 257
V. THE POLICIES BEHIND I.R.C. § 409A 257
A. In General - the Enron Motive 257
B. The Broad Policy Implications of Allowing Deferral 260
1. Employee Advantages of Deferral 260
2. The Effect of Deferral on Government Revenues 265
VI. CONCLUSION 267

---

* Associate Professor of Accounting & Legal Studies at the College of Charleston, School of Business & Economics. J.D., University of South Carolina School of Law; L.L.M., University of Florida College of Law.

** Associate Professor of Accounting & Legal Studies at the College of Charleston, School of Business & Economics. Ph.D., Temple University; J.D., University of South Carolina School of Law.

The authors would like to thank Chelsea Collins for her invaluable research assistance.

I. INTRODUCTION

Motivated by perceived abuses at Enron and other companies involving nonqualified deferred compensation plans for corporate executives,[1] the American Jobs Creation Act of 2004[2] made numerous changes to the federal tax law affecting both individuals and businesses. One of the most significant of these changes was the enactment of § 409A of the Internal Revenue Code (the "Code"),[3] which became effective at the beginning of 2005.[4] It requires that amounts deferred under a nonqualified deferred compensation plan be included in gross income to the extent they are not subject to a substantial risk of forfeiture, unless the plan meets certain detailed requirements concerning the deferral and payment of the deferred compensation.[5] This article provides a constructive critique of the policy decisions underlying the enactment of § 409A and the regulation of nonqualified deferred compensation plans generally.

II. OVERVIEW OF NONQUALIFIED DEFERRED COMPENSATION PLANS

Most employers in the United States currently provide some form of qualified retirement plan covering their employees.[6] Most common are defined contribution plans, including profit-sharing, 401(k), and money purchase pension plans, in which the employee's retirement benefit is computed based on the amount in the employee's account at retirement.[7] To a lesser degree, some employers sponsor defined benefit pension plans, in which the employee's retirement benefit is computed by reference to a formula that takes into account some combination of the

---

1. H.R. REP. NO. 108-548, pt. 1, at 343 & n.453 (2004).

2. Pub. L. No. 108-357, 118 Stat. 1418 (codified in scattered sections of 26 U.S.C.).

3. I.R.C. § 409A (West Supp. 2006). All references to code sections in this article are to the Internal Revenue Code unless otherwise indicated.

4. I.R.S. Notice 2005-1, 2005-2 I.R.B. 274, 274.

5. *Id.*

6. A recent survey shows that 60% of workers in private industry had access to retirement plans and 51% of those workers participated in those plans. News Release, U.S. Bureau of Labor Statistics, Employee Benefits in Private Industry in the United States, March 2006 (Aug. 24, 2006), http://www.bls.gov/news.release/pdf/ebs2.pdf [hereinafter Employee Benefits in Private Industry].

7. Susan J. Stabile, *Paternalism Isn't Always a Dirty Word: Can the Law Better Protect Defined Contribution Plan Participants?*, 5 EMPL. RTS. & EMP. POL'Y J. 491, 494-95 (2001) (citing Mary E. O'Connell, *On the Fringe: Rethinking the Link Between Wages and Benefits*, 67 TUL. L. REV. 1422, 1489 (1993)). In 2006, forty-three percent of all workers in private industry in the United States participated in defined contribution plans. Employee Benefits in Private Industry, *supra* note 6.

employee's earnings and years of service with the employer.[8] Both deferred compensation plans and defined benefit pension plans receive substantial tax benefits as qualified retirement plans.[9] Specifically, any funds contributed as elective deferrals by an employee may be made on a pre-tax basis.[10] Funds contributed by the employer (as funding or matching contributions) and earnings on funds held in the plan are generally not taxable until distributed to the employee.[11] Finally, the employer receives an immediate tax deduction for contributions it makes to the plan, even though the corresponding amounts are not included in the employee's income until some point in the future.[12]

In exchange for these tax benefits, qualified retirement plans are subject to substantial dollar limitations and require significant administrative efforts by the employer.[13] These dollar limitations serve the dual purposes of (1) restricting the opportunities for highly compensated employees to take advantage of the qualified plan's tax benefits to save for retirement,[14] and (2) ensuring that substantial benefits under

---

8. Stabile, *supra* note 7, at 492-93 ("The trend for many years has been away from traditional defined benefit pension plans and toward defined contribution plans as a means of providing retirement benefits to employees."); *see also* News Release, Lawrence H. Leith, U.S. Bureau of Labor Statistics, New Research on Retirement Savings Among Workers (Jan. 25, 2006), http://www.bls.gov/ opub/cwc/cm20060110yb01p1.htm (noting the same trend). In 2006, twenty percent of all workers in private industry in the United States participated in defined benefit plans. Employee Benefits in Private Industry, *supra* note 6. This trend has resulted in 401(k) plans becoming the primary source of retirement income for Americans, with forty-seven million participants with a total of $2 trillion invested in 401(k) plans. Tom Lauricella, *Up for Review: 401(k) Industry*, WALL ST. J., Dec. 28, 2006, at C1.

9. I.R.C. § 404(a) (West Supp. 2006).

10. Treas. Reg. § 1.401(k)-1(a)(4)(iii) (as amended in 2006). If the plan allows it, the employee may elect to make such contributions as Roth 401(k) contributions, in which case they are made on an after-tax basis, and the earnings on the account are exempt from federal income tax if certain conditions are met. I.R.C. § 402A. For an overview of the rules relating to Roth 401(k) plans, see William G. Gale et al., *An Analysis of the Roth 401(k)*, 110 TAX NOTES 163, 167 (2006). For a discussion of the issues for an employee to consider in making a choice between traditional and Roth 401(k) contributions, see Leonard E. Burman et al., *The Taxation of Retirement Saving: Choosing Between Front-Loaded and Back-Loaded Options*, 54 NAT. TAX J. 689 (2001).

11. I.R.C. § 402(b)(1)-(2) (2000).

12. *Id.* § 404(a) (West Supp. 2006).

13. *See, e.g., id.* § 401(a)(4) (2000) (prohibiting discrimination in favor of highly compensated employees); *id.* § 415 (West Supp. 2006) (imposing maximum dollar and percentage limitations applicable to benefits and deferrals under qualified plans); *id.* § 402(g) (West Supp. 2006) (setting an annual limit on the amount of elective deferrals an individual may make on an annual basis); *id.* § 401(a)(17) (2000) (setting an annual dollar limit on the amount of compensation that may be considered for benefit or deferral purposes).

14. S. REP. NO. 106-411, at 11 (2000).

the plan accrue to non-highly compensated employees.[15] As a result, employers often rely on nonqualified deferred compensation plans to provide additional retirement benefits to corporate executives beyond those allowed by these restrictions imposed on qualified retirement plans.[16]

Nonqualified deferred compensation plans do not receive the tax benefits enjoyed by qualified plans.[17] Specifically, the employer generally does not receive an immediate deduction for compensation deferred under a nonqualified plan.[18] Rather, the employer receives a deduction at the same time that the employee recognizes the compensation as income for tax purposes.[19] The earnings on amounts deferred under a nonqualified plan are not tax exempt.[20] If the employer sets aside funds to pay benefits due under a nonqualified plan, the employer is taxable on the income on those funds as they are earned.[21]

Despite these tax detriments, nonqualified plans allow executives to supplement their retirement savings through either employee or non-elective employer contributions.[22] In some cases, these are set up as nonqualified salary reduction plans, allowing the executive to make 401(k)-type deferrals of income into his plan.[23] In other cases, they are set up as supplemental executive retirement plans, under which the employer makes contributions to a plan to supplement the amounts the executive receives under a qualified plan or to make up for the amounts the executive cannot receive due to the qualified plan limitations.[24] Employers also often use these plans as retention techniques by providing for forfeiture of amounts deferred upon the occurrence

---

15. STAFF OF J. COMM. ON TAXATION, 105TH CONG., OVERVIEW OF PRESENT-LAW TAX RULES RELATING TO QUALIFIED PENSION PLANS 3 (Comm. Print 1998).

16. Richard Vollmar, *The Ins and Outs of Nonqualified Plans*, http://www.bna.com/payroll/ apa2003/story09.htm (last visited Apr. 25, 2007).

17. *Id.*

18. I.R.C. § 404(a)(5) (West Supp. 2006).

19. *Id.*

20. *Id.*

21. DENNIS R. LASSILA & BOB G. KILPATRICK, U.S. MASTER COMPENSATION TAX GUIDE 685 (4th ed. 2003). The most common technique for employers to set aside funds to pay these benefits is through the use of a rabbi trust. *See infra* notes 34-42 and accompanying text. Because the assets of a rabbi trust can be used to discharge the employer's legal obligations to creditors in the event of insolvency or bankruptcy, the trust is treated as a grantor trust for tax purposes. I.R.C. § 677 (2000); Treas. Reg. § 1.677(a)-1(d) (as amended in 1996); *see also infra* notes 38-39 and accompanying text.

22. *See* Kenn B. Tacchino, *Nonqualified Deferred Compensation Plans: Practical and Tax Considerations*, 10 BENEFITS Q. 30, 32-33 (1994).

23. *Id.* at 32.

24. *Id.* at 34.

of undesirable events, such as termination of the executive's employment.[25] Thus, nonqualified deferred compensation plans can be used as a form of "golden handcuffs" to retain the services of key corporate executives.[26]

III. THE TAX LAW PRIOR TO § 409A

Prior to 2005, when § 409A took effect, the taxation of nonqualified deferred compensation was governed primarily by two doctrines: economic benefit and constructive receipt.[27]

A. *The Economic Benefit Doctrine*

Under the economic benefit doctrine, codified at I.R.C. § 83, amounts become taxable to the recipient of funds when they are irrevocably set aside for the employee's benefit.[28] Under § 83, where property is transferred in connection with the performance of services, the fair market value of such property transferred is included in the employee's gross income in the first year in which the rights of the employee are transferable or not subject to a substantial risk of forfeiture.[29] Thus, the transferred property is taxed to the employee when the employee's interest in the property is vested.[30] However, Treasury Regulation § 1.83-3 defines "property" as "real and personal property other than either money or an unfunded and unsecured promise to pay money or property in the future."[31] Thus, a mere unsecured promise by the employer to pay compensation at some future date is not a taxable event under § 83.[32] In contrast, the term "property" does include a beneficial interest in funds that are set aside from the claims of the employer's creditors, in a trust or escrow account, for example.[33] This definition of property illustrates one of the underlying tensions in the economic benefit

25. *Id.* at 32.

26. *Id.* at 35.

27. *See* I.R.C. § 83(a) (2000); Sproull v. Comm'r, 16 T.C. 244 (1951), *aff'd per curiam*, 194 F.2d 541 (6th Cir. 1952).

28. *Sproull*, 16 T.C. at 247-48; Rev. Rul. 60-31, 1960-1 C.B. 174, 179-80; *see* I.R.C. § 83 (West 2000 & Supp. 2006).

29. I.R.C. § 83(a).

30. *Id.*

31. Treas. Reg. § 1.83-3(e) (as amended in 2005).

32. *Id.* One commentator has suggested that the reasoning behind this rule is because the promise to pay might be breached, the future payment is too speculative to require current taxation on the cash method of accounting. Eric D. Chason, *Deferred Compensation Reform: Taxing the Fruit of the Tree in Its Proper Season*, 67 OHIO ST. L.J. 347, 355 (2006).

33. Treas. Reg. § 1.83-3(e).

doctrine: the more secure the employee's right to future payment becomes, the more likely that payment right will be subject to taxation for the employee.

Understandably, an employee would prefer that the right to future payment be as secure as possible. The most common form of additional security employers offer is the creation of a "rabbi trust,"[34] which is an irrevocable trust established by an employer to fund benefits under a nonqualified deferred compensation plan.[35] To avoid the "property" issues discussed above,[36] the funds held in the rabbi trust remain subject to the claims of the employer's general unsecured creditors in the event of the employer's bankruptcy or insolvency.[37] For tax purposes, because the rabbi trust assets may be used to discharge the employer's legal obligation to general creditors in the event of insolvency, the rabbi trust is structured as a grantor trust[38] and thus ignored for tax purposes.[39] The assets are deemed to be owned directly by the employer, and the earnings on them are taxed to the employer.[40]

While a rabbi trust provides the employee with protection against the employer's refusal or inability to pay benefits due under the plan, it is only a partial solution to the problem of securing the employee's benefits under the nonqualified deferred compensation plan. It does not protect against bankruptcy or insolvency;[41] in those events, the employee assumes the same status as any other general, unsecured creditor. Because the employee's interest in the assets of the rabbi trust is not protected from the claims of the employer's creditors, it is not

---

34. *Nonqualified Deferred Compensation Arrangements: Hearing Before the S. Fin. Comm.*, 107th Cong. (2002) (statement of Kathryn J. Kennedy, Professor, John Marshall Law School). These trusts are called "rabbi trusts" because the first one approved by the IRS was created by a synagogue for its rabbi. *See* I.R.S. Priv. Ltr. Rul. 81-13-107 (Dec. 31, 1980). The IRS has since issued guidelines setting forth model rabbi trust provisions which provide a safe harbor for taxpayers who adopt and maintain grantor trusts in connection with unfunded deferred compensation arrangements. *See* Rev. Proc. 92-64, 1992-2 C.B. 422, 423, *modified by* I.R.S. Notice 2000-56, 2000-2 C.B. 393, 393.

35. LASSILA & KILPATRICK, *supra* note 21, at 705.

36. *See supra* notes 32-33 and accompanying text.

37. *See* Tacchino, *supra* note 22, at 38.

38. I.R.C. § 677 (2000); Treas. Reg. § 1.677(a)-1(d) (as amended in 2006).

39. *See* Tacchino, *supra* note 22, at 38.

40. I.R.C. § 677; Treas. Reg. § 1.677(a)-1(d).

41. *See* Rev. Proc. 92-64, 1992-2 C.B. 422, 425, *modified by* I.R.S. Notice 2000-56, 2000-2 C.B. 393, 394. While it is the most common technique used, a rabbi trust is not the only means for providing additional security for the employee's interest. A number of IRS rulings have approved employee purchases of surety bonds that pay the benefits due in the event of default by the employer. *See, e.g.*, I.R.S. Priv. Ltr. Rul. 93-44-038 (Aug. 2, 1993); I.R.S. Priv. Ltr. Rul. 84-06-012 (Nov. 3, 1983). However, in many cases, these techniques are difficult and expensive to obtain. *See* Chason, *supra* note 32, at 357 n.50.

subject to immediate taxation under § 83 and the economic benefit doctrine.[42]

B. *The Doctrine of Constructive Receipt*

The doctrine of constructive receipt serves as an exception to the general rule that a cash basis taxpayer does not recognize income until it is actually received.[43] Under this doctrine, a taxpayer recognizes income for tax purposes when it is credited to his account, set aside for him, or otherwise made available so that he can draw upon it at any time.[44] On the other hand, income is not considered constructively received if the taxpayer's control of the receipt of the income is subject to substantial limitations or restrictions.[45] With regard to nonqualified deferred compensation plans, the degree of control the employee can exercise over the time and manner of payment therefore becomes critical. These control issues relating to the initial election to defer compensation and to elections to either accelerate or delay payments were the subject of administrative rulings and litigation between taxpayers and the Internal Revenue Service ("IRS") for a number of years.[46] Prior to the adoption of § 409A, this body of administrative rulings and case law had established informal rules governing the design and operation of nonqualified plans that were widely accepted among benefits practitioners.[47]

Three common practices under these informal rules have been significantly affected by § 409A. First, it was commonly accepted that a provision allowing an employee to make a subsequent election to further extend the deferral of benefits would not be taxable under the doctrine of constructive receipt, as long as the subsequent election was made before the benefits were due to be paid.[48] Second, it was commonly accepted that allowing an employee to choose between a lump sum distribution

---

42. *See* Tacchino, *supra* note 22, at 38.

43. LASSILA & KILPATRICK, *supra* note 21, at 688.

44. Treas. Reg. § 1.451-2(a) (as amended in 1979).

45. *Id.*

46. *See, e.g.*, Martin v. Comm'r, 96 T.C. 814 (1991) (allowing employees to choose between a lump sum distribution and distribution in installments); Veit v. Comm'r, 8 T.C.M. 919 (1949) (allowing choice between current payment and deferral even after compensation is earned); Veit v. Comm'r, 8 T.C. 809 (1947) (attributing income to a taxpayer in years prior to the year it was received under the constructive receipt doctrine).

47. *See generally* Alden J. Bianchi, *The Impact of Internal Revenue Code § 409A on Mergers, Acquisitions and Reorganizations*, 33 TAX MGMT. COMPENSATION PLAN J. 1 (2006).

48. *Veit*, 8 T.C.M. at 921-22.

and a distribution in installment payments prior to the due date for the payments to begin would not cause constructive receipt.[49] Finally, it was common to include a so-called "haircut" provision, under which the employee agrees to forfeit a portion of his benefit in exchange for an early distribution.[50] The effect of § 409A on each of these three practices is discussed further below.

IV. I.R.C. § 409A

Section 409A specifically provides that it is not to be construed to prevent the inclusion of amounts in gross income under any other provisions of the Code or under any other rule of law.[51] Indeed, the preamble to IRS Notice 2005-1 provides that "§ 409A does not alter or affect the application of any other provision of the Code or common law doctrine."[52] However, while § 409A is not technically designed to overrule common law doctrines, the practical effect of the statute's requirements will be to overrule or limit a number of practices allowed under prior cases and rulings, including those discussed above.[53] These effects will be explored in more detail below.

A. *What Plans Are Affected?*

Section 409A applies broadly to amounts deferred under nonqualified deferred compensation plans after December 31, 2004.[54] Under § 409A, all amounts deferred under a nonqualified plan are currently includable in gross income to the extent they are not subject to a substantial risk of forfeiture[55] unless certain requirements are met.[56]

For purposes of § 409A, the term "nonqualified deferred compensation plan" includes any plan that provides for suspension of payment other than a qualified retirement plan or a "bona fide vacation leave, sick leave, compensatory time,

---

49. *Martin*, 96 T.C. at 829.

50. *See, e.g.*, I.R.S. Priv. Ltr. Rul. 80-20-145 (Feb. 26, 1980).

51. I.R.C. § 409A(c) (West Supp. 2006).

52. I.R.S. Notice 2005-1, 2005-2 I.R.B. 274, 274.

53. *See supra* notes 48-50 and accompanying text.

54. American Jobs Creation Act of 2004, Pub. L. No. 108-357, § 101, 118 Stat. 1418, 1423 (to be codified at 26 U.S.C. § 56).

55. Under § 409A, "[c]ompensation is subject to a substantial risk of forfeiture if entitlement to the amount is conditioned on the performance of substantial future services by any person or the occurrence of a condition related to a purpose of the compensation, and the possibility of forfeiture is substantial." I.R.S. Notice 2005-1, 2005-2 I.R.B. 274, 280, Q&A (10); *see* I.R.C. § 409A(d)(4).

56. I.R.C. § 409A(a)(1).

disability pay, or death benefit plan."[57] According to guidance from Internal Revenue Notice 2005-1,

> A plan provides for deferral of compensation only if, under the terms of the plan and the relevant facts and circumstances, the service provider has a legally binding right during the taxable year to compensation that has not been actually or constructively [paid to the employee] and . . . is payable to (or on behalf of) the service provider in a later year.[58]

Under these definitions, the requirements of § 409A reach many different forms of compensation, including stock option plans, phantom stock plans, and plans involving certain types of stock appreciation rights, in addition to traditional deferred compensation plans.[59]

B. *What Requirements Must These Plans Meet?*

The requirements under § 409A for deferred compensation plans fall into three broad categories: the initial deferral election, distribution rules, and postponement of distribution rules.[60] Each of these categories is discussed below.

1. Initial Deferral Election

Generally, an election to defer compensation must be made before the calendar year in which services are performed.[61] However, an exception to this general rule applies for the calendar year in which a participant first becomes eligible to participate—such participant may make an election to defer within the first thirty days of becoming eligible.[62] A second exception allows a participant to make a deferral election with regard to performance-based compensation based on services rendered during a period of at least twelve months, to be made within six months before the end of the period.[63]

---

57. *Id.* § 409A(d)(1).

58. I.R.S. Notice 2005-1, 2005-2 I.R.B. 274, 277, Q&A (4)(a).

59. *Id.* at Q&A (3).

60. *See* I.R.C. § 409A(a)(4)(B) (initial deferral); § 409A(a)(2) (distribution); § 409A(a)(4)(C) (postponement).

61. *Id.* § 409A(a)(4)(B)(i).

62. *Id.* § 409A(a)(4)(B)(ii).

63. *Id.* § 409A(a)(4)(B)(iii).

2. Distribution Rules

The initial deferral election must specify the time for payment of benefits.[64] Under § 409A, the plan must provide that distributions cannot be made earlier than the occurrence of one of six specified events: separation from service, disability, death, a specified time under the plan at the date of the deferral, change in ownership or control of the corporation, or an unforeseeable emergency.[65]

3. Postponement of Distribution

Any subsequent election to postpone payments under a plan is allowed only if it meets certain conditions.[66] First, the subsequent election "may not take effect until at least 12 months after [it] is made."[67] Second, the payment must be postponed for at least five years if the election relates to a distribution due to separation from service, a specified time for distribution, or a change in control.[68] Third, if the election relates to a payment at a scheduled time, it "may not be made less than 12 months prior to the date of the first scheduled payment."[69]

C. *Limitations Imposed by I.R.C. § 409A*

In addition to imposing very specific requirements that nonqualified deferred compensation plans must meet, § 409A also imposes limits on several techniques previously accepted as viable by the employee benefits community. Specifically, § 409A forbids the use of haircut provisions and restricts the use of rabbi trusts.[70] The limitations on each of these techniques are discussed below.

1. Haircut Provisions

The concept behind the haircut provision is, in principle, very simple. Under Treasury Regulations, "income is not constructively received if the taxpayer's control of its receipt is subject to substantial limitations or restrictions."[71] In a plan

---

64. H.R. REP. NO. 108-548(I), at 371 (2004).

65. I.R.C. § 409A(a)(2)(A)(i)-(vi).

66. *Id.* § 409A(a)(4)(C).

67. *Id.* § 409A(a)(4)(C)(i).

68. *Id.* § 409A(a)(4)(C)(ii).

69. *Id.* § 409A(a)(4)(C)(iii).

70. *See id.* § 409A(a)(3), (b)(1)-(2).

71. Treas. Reg. § 1.451-2(a) (as amended in 1979); *see also* Rev. Rul. 60-31, 1960-1 C.B. 174, 178 (stating that constructive receipt of income occurs only if the right to receive

with a haircut provision, the employee is allowed to elect to accelerate the timing of a scheduled plan distribution in exchange for forfeiture of a portion of the benefit payable under the plan.[72] The haircut provision therefore acts as a substantial limitation on the employee's ability to receive a distribution.[73]

The support for the haircut concept comes from a series of private letter rulings by the IRS dealing with qualified plans and § 403(b) annuity plans.[74] At the time of the rulings, both types of plans were subject to the doctrine of constructive receipt.[75] In one ruling, a 10% penalty in a profit sharing plan was deemed to be a sufficient restriction to avoid the application of the doctrine of constructive receipt.[76] In several other rulings, the service found a penalty of 6% to be sufficient.[77] Another ruling approved a 5% penalty combined with a prohibition on further participation in the plan for twelve months.[78] In all of these rulings, the basic concept was the same: a requirement of forfeiture of a portion of the employee's benefit in order to accelerate a distribution is a substantial limitation.

Section 409A addresses the haircut issue directly, prohibiting any plan provision that allows "acceleration of the time or schedule of any payment [of benefits] under the plan."[79] This provision appears to be a direct response to the Enron situation, in which Enron executives were able to withdraw more than $53 million from nonqualified deferred compensation plans shortly before the company filed for bankruptcy,[80] while qualified plan participants, including the rank-and-file employees, were not able to access their accounts due to blackouts.[81] Although

---

the money was not restricted).

72. *See, e.g.*, I.R.S. Priv. Ltr. Rul. 80-20-145 (Feb. 26, 1980).

73. *See id.*

74. *See id.*; I.R.S. Priv. Ltr. Rul. 80-37-056 (June 18, 1980); I.R.S. Priv. Ltr. Rul. 80-26-043 (Apr. 2, 1980).

75. Qualified retirement plans were exempted from the application of constructive receipt by the Economic Recovery Act of 1981, Pub. L. No. 97-34, § 311, 95 Stat. 172, 274 (codified as amended in scattered sections of 26 U.S.C.). Section 403(b) annuity plans were exempted by the Tax Reform Act of 1986, Pub. L. No. 99-514, § 1135(a)(3)(B), 100 Stat. 2085, 2485 (codified as amended in scattered sections of 26 U.S.C.).

76. I.R.S. Priv. Ltr. Rul. 80-20-145.

77. *See, e.g.*, I.R.S. Priv. Ltr. Rul. 80-37-056; I.R.S. Priv. Ltr. Rul. 80-26-043.

78. I.R.S. Priv. Ltr. Rul. 82-41-017 (July 9, 1982).

79. I.R.C. § 409A(a)(3) (West Supp. 2006).

80. STAFF OF J. COMM. ON TAXATION, 108TH CONG., REPORT OF INVESTIGATION OF ENRON CORPORATION AND RELATED ENTITIES REGARDING FEDERAL TAX AND COMPENSATION ISSUES, AND POLICY RECOMMENDATIONS 14 (Comm. Print 2003), *available at* http://www.gpo.gov/congress/joint/ jcs-3-03/vol1/index.html (follow "12-15" hyperlink) [hereinafter REPORT OF INVESTIGATION OF ENRON].

81. Ellen E. Schultz, *'Lockdowns' of 401(k) Plans Draw Scrutiny*, WALL ST. J., Jan. 16, 2002, at C1. For a more detailed discussion of the policy issues surrounding the

this prohibition does reduce the flexibility guaranteed to employees under deferred compensation plans, as one commentator has recognized, it can also be viewed as a statutorily authorized haircut provision.[82] As long as the employee and employer agree to accelerate distribution, a deferred compensation plan can be terminated and the benefits distributed early, causing the plan to "fail" to qualify under § 409A and triggering interest and a twenty percent penalty provision.[83] The interest and penalty, in effect, become a statutory haircut provision which the employee must forfeit in order to accelerate distribution of the benefits due.

2. Rabbi Trust Limitations

The issues involving the rabbi trust are likewise fairly simple in principle. As discussed above,[84] in order to prevent the transfer of funds to a rabbi trust from being treated as a transfer of property under § 83, funds held in a rabbi trust are held subject to the claims of the employer's general unsecured creditors in the event of bankruptcy or insolvency.[85] Two issues involving these rabbi trusts are addressed by § 409A: the use of foreign rabbi trusts and financial triggers within the rabbi trusts themselves.

Beginning in the early 1990s, some tax advisors began to suggest that just because assets are "subject to" the claims of creditors does not mean they must be easily accessible by creditors.[86] Thus, efforts to put practical impediments in the way of creditors reaching claims became a viable strategy. In particular, the use of a rabbi trust established in a foreign jurisdiction, where the ability of creditors to reach funds held in the trust is very limited, became a good strategic option.[87] A creditor trying to reach assets held in a foreign rabbi trust faces significant obstacles, including obtaining jurisdiction in the foreign country, hiring a local lawyer, enforcing a judgment or

---

Enron 401(k) plan blackout, *see infra* notes 115-19 and accompanying text.

82. Dana L. Trier, *Rethinking the Taxation of Nonqualified Deferred Compensation: Code Sec. 409A, the Hedging Regulations and Code Sec. 1032*, TAXES, Mar. 2006, at 155, 171.

83. I.R.C. § 409A(a)(1)(B)(i)(II), (a)(1)(B)(ii); *see also infra* notes 105-06 and accompanying text.

84. *See supra* notes 37-40 and accompanying text.

85. I.R.S. Priv. Ltr. Rul. 87-30-041 (Apr. 28, 1987).

86. *See* Gerald R. Nowotny, *Securing Nonqualified Deferred Compensation and Executive Benefits Using Offshore Rabbi Trusts*, 6 TAX'N OF EMPLOYEE BENEFITS 226, 228 (1999).

87. *Id.*

court order in a foreign court, and contending with bank and trust secrecy laws in the foreign jurisdiction.[88]

The imposition of these practical impediments allowed employees a great deal of security that is clearly contrary to the spirit of the rabbi trust concept, which was intended to subject the underlying assets to the claims of creditors.[89] Section 409A deals with this problem directly as well, providing that where assets are set aside in trust for purposes of paying compensation under a nonqualified deferred compensation plan, they will be treated as property transferred under § 83 if the assets or the trust are located outside the United States.[90] Logically, the provision does not apply where substantially all of the services to which the deferred compensation relates are performed in the foreign jurisdiction.[91]

The other problem involving rabbi trusts addressed by § 409A is the structuring of a rabbi trust with certain "triggering" provisions that make it practically impossible for creditors to reach the trust assets.[92] Prior to the enactment of § 409A, it was common, for example, to include a provision in the rabbi trust that would render the rabbi trust either irrevocable or fully funded if certain events related to the financial integrity of the employer occurred.[93] Such trusts are commonly known as "springing rabbi trusts" due to their potentially changing nature.[94] Similarly, some practitioners have developed plans that provide significant protection for executives through a combination of rabbi and secular trusts,[95] under which the rabbi

88. Lee A. Sheppard, *Moving Deferred Compensation Offshore*, 92 TAX NOTES 1140, 1142 (Aug. 27, 2001).

89. *See* Tacchino, *supra* note 22, at 38.

90. I.R.C. § 409A(b)(1) (West Supp. 2006).

91. *See id.*

92. *See id.* § 409A(b)(2).

93. Kathryn J. Kennedy, *Proposed Legislation to Curb Abuses*, 31 TAX MGMT. COMPENSATION PLAN. J. 95, 102 (2003) [hereinafter *Proposed Legislation to Curb Abuses*].

94. *Id.*

95. A secular trust is an irrevocable trust in which trust assets are held for the exclusive benefit of an employee and protected against the claims of the employee's unsecured creditors in the events such as bankruptcy or insolvency. Daniel I. Halperin, *Special Tax Treatment for Employer-Based Retirement Programs: Is It "Still" Viable as a Means of Increasing Retirement Income? Should It Continue?*, 49 TAX L. REV. 1, 26 n.85 (1993); *see also* Richard D. Nix & Timothy Verrall, *ERISA Article: Employee Benefit Issues in Mergers and Acquisitions*, 25 OKLA. CITY U. L. REV. 435, 465-66 (2000). Because the employee's interest is vested at the time of transfer to the secular trust, the employee's income becomes immediately taxable. I.R.C. § 83(a) (2000); I.R.S. Priv. Ltr. Rul. 88-43-021 (July 29, 1988). Thus, although the secular trust does not provide for income tax deferral, it does provide the employee with a secure source of plan benefit payments. *See* Kathryn J. Kennedy, *A Primer on the Taxation of Executive Deferred Compensation Plans*, 35 J. MARSHALL L. REV. 487, 528-30 (2002).

trust terminates upon a triggering event (such as a change in control or the occurrence of certain triggers related to the employer's financial health), and the assets therein are distributed into secular trusts for the benefit of the executives covered under the plan.[96] These and similar arrangements[97] all have the same goal: to meet the technical requirements of the "subject to the claims of creditors" language of the § 83 regulations while insulating executives from the practical risk associated with being a general unsecured creditor. Section 409A likewise deals with at least part of this issue directly, providing that when a plan provides that assets become restricted under the plan in connection with a change in the employer's financial health, there is a transfer of property under § 83.[98]

As one commentator noted in an article predating § 409A, it is common in certain industries to include in rabbi trusts triggering events tied not to a specific employer's health but to the health of the industry as a whole.[99] It does not appear that the language of § 409A, which addresses "a change in the *employer's* financial health,"[100] would reach such provisions based on industry-wide declines.

From a policy perspective, given the goals of the rabbi trust concept, the prohibition on foreign rabbi trusts seems logical. Likewise, techniques such as the springing rabbi trust[101] and the Rabbicular Trust,[102] intended to put practical limitations on the

---

96. *Proposed Legislation to Curb Abuses*, *supra* note 93, at 102. The arrangement described is known as the "Rabbicular Trust." *Id.* The term is a service mark of attorney Michael G. Goldstein. *Id.* at 102 n.56. *See also infra* note 102.

97. For a discussion of a vesting trust/rabbi trust combination and the "heavenly" trust arrangement, see *Proposed Legislation to Curb Abuses*, *supra* note 93, at 102.

98. I.R.C. § 409A(b)(2) (West Supp. 2006).

99. Kathryn J. Kennedy, *Recent Legislative Initiatives Regarding Executive Deferred Compensation Plans*, 32 TAX MGMT. COMPENSATION PLAN. J. 227, 232 (2004) [hereinafter *Recent Legislative Initiatives*].

100. I.R.C. § 409A(b)(2)(A) (emphasis added).

101. A Rabbi trust or a "springing" Rabbi trust, is designed to provide protection for the executives from everyone other than creditors of the seller corporation in the event of a change of control. These agreements provide that if there has been a change of control, assets will either have been (i) previously transferred to the Rabbi trust or (ii) contributed to the "springing" Rabbi trust immediately prior to or immediately following the change of control.

Nix & Verrall, *supra* note 95, at 465-66.

102. The Rabbicular Trust seizes upon a feature of the rabbi trust known as a "triggering event" or a "vesting trigger" in an attempt to adhere to the required form of the rabbi trust while increasing the security of the assets so held. . . .

[It] uses the required model format for a rabbi trust but, in the optional trigger section, it adds vesting triggers based upon the occurrence of a financial event involving the company.

ability of a rabbi trust to serve its intended purpose, should be prohibited. The limitations imposed by § 409A in this area accomplish this goal and seem appropriate from a policy perspective.

D. *Failure to Comply with I.R.C. § 409A*

Failure to comply with the provisions of § 409A has significant tax effects. First, all compensation deferred under the plan for the taxable year and all preceding years is includable in gross income to the extent it is not subject to a substantial risk of forfeiture.[103] A "substantial risk of forfeiture" exists if the employee's right to the deferred amount is "conditioned on the performance of substantial future services by any person or the occurrence of a condition related to the purpose of the compensation [(e.g., attainment of certain levels of earnings, equity value or a liquidity event)], and the possibility of forfeiture is substantial."[104] When a deferred amount becomes taxable under § 409A, the employee must also pay interest at the underpayment rate plus one percentage point[105] and the tax due is increased by a twenty percent penalty.[106] In effect, § 409A has imposed a significant penalty for having a "nonqualified" nonqualified deferred compensation plan.

V. THE POLICIES BEHIND I.R.C. § 409A

A. *In General - the Enron Motive*

Many of the changes implemented by § 409A were motivated by perceived abuses to executive compensation arrangements involving nonqualified deferred compensation plans.[107] Indeed, the legislative history of the provision refers to arrangements which "allow improper deferral of income" while providing executives with "security of future payment and control over

---

Karl Dickhaus, *Recent Development: The Demise of the Rabbicular Trust*, 74 WASH. U. L.Q. 1315, 1319-20 (1996) (footnotes omitted).

103. I.R.C. § 409A(a)(1)(A).

104. I.R.S. Notice 2005-1, 2005-2 I.R.B. 274, 280, Q&A (10)(a); *see also* Application of Section 409A to Nonqualified Deferred Compensation Plans, 70 Fed. Reg. 57930, 57936 (proposed Oct. 4, 2005) (to be codified at 26 C.F.R. pt. 1).

105. I.R.C. § 409A(a)(1)(B)(ii).

106. *Id.* § 409A(a)(1)(B)(i)(II).

107. Jeff Z. Brooker III, *Formula 409A: Wiping Out Nonqualified Deferred Compensation*, 17 S.C. LAWYER 16, 17 (2006); Compassinsurance.com, New Deferred Compensation Rules Under The American Jobs Creation Act (2006), http://www.compassinsurance.com/pdf/tools/exbd/409a.pdf [hereinafter New Deferred Compensation Rules].

amounts deferred."[108] As evidenced by the passage of the Sarbanes-Oxley Act,[109] the events at Enron significantly influenced Congress's reaction to these perceived abuses.[110] Thus, a brief discussion of the Enron nonqualified plans and their role in the passage of § 409A is appropriate.

Initially, it is worth noting that there was nothing particularly unusual about the terms of the Enron deferred compensation plans.[111] Indeed, the use of deferred compensation benefits as a recruiting and compensation tool for senior executives is common among Fortune 500 companies.[112] Moreover, other issues at Enron may have clouded policy-makers' views regarding the deferred compensation issues.[113] The blackout issue is a prime example.[114] Enron executives were able to sell their non-retirement plan stock (including deferred compensation plan investments)[115] and receive distributions at the same time that the vast majority of regular employees were locked into the stock due to a blackout period imposed on Enron's 401(k) plan.[116] As part of the process of changing service plan providers for its 401(k) plan, Enron determined that, in order to achieve the proper transfer of assets, it was necessary to freeze the plan's investments for a short period of time.[117] The occurrence of a blackout period in these circumstances was not unusual; indeed, it is a common procedural event necessary to achieve the transition from one administrative service provider to another.[118] The fact that the blackout period had such a

---

108. H.R. REP. NO. 108-548, at 341-43 (2004).

109. Public Company Accounting Reform and Investor Protection Act of 2002, Pub. L. No. 107-204, 116 Stat. 745 (codified in scattered sections of 11, 15, 18, 28, and 29 U.S.C.) [hereinafter "Sarbanes-Oxley Act"].

110. New Deferred Compensation Rules, *supra* note 107.

111. David E. Morse, *No Fix Needed for Deferred Comp*, 16 BENEFITS L. J. 1, 1 (2003); Richard J. Bronstein & Michael D. Levin, *A Reasonable Approach to Deferred Compensation in the Post-Enron Climate*, 103 TAX NOTES 215, 225-26 nn.68-77 (2004).

112. *See* Lucian A. Bebchuk & Robert J. Jackson, Jr., *Studies on Executive Pay: Executive Pensions*, 30 IOWA J. CORP. L. 823, 851 (2005).

113. Bronstein & Levin, *supra* note 111, at 216.

114. *The Enron Collapse and Its Implications for Worker Retirement Security: Hearings Before the H. Comm. on Education and the Workforce*, 107th Cong. 25 (2002) (statement of Mikie Rath, Benefits Manager, Enron Corporation) [hereinafter *Hearings*].

115. These distributions were in fact made under authority of a "haircut" provision in the Enron nonqualified deferred compensation plans. *See* Bronstein & Levin, *supra* note 111, at 225.

116. *Hearings*, *supra* note 114, at 4.

117. *Id.*

118. A recent survey by the Employee Benefits Research Institute found that 74% of companies surveyed had undergone a similar blackout period, with delays of one day to one month being common, and delays lasting more than one month occurring in 31% of the cases surveyed. JACK VANDERHEI, EMPLOYEE BENEFITS RES. INST., COMPANY STOCK

devastating financial effect on Enron's rank-and-file employees is tragic, but it does not suggest a policy problem with allowing nonqualified deferred compensation plans. Indeed, the blackout problem was not related to the nonqualified plans, but rather to how investments were dealt with in Enron's qualified 401(k) plan, and the Sarbanes-Oxley Act contained specific provisions designed to address those issues.[119]

The legislative history behind § 409A highlights two areas of Congressional concern: (1) executives using arrangements that allow deferral of income while providing security of future payment and control over amounts deferred,[120] and (2) the use of rabbi trusts with acceleration triggers or rabbi trusts located in foreign jurisdictions that make it very difficult for creditors to reach trust assets.[121] While these concerns over the security of payments and degree of control exercised by executives were also specifically identified as concerns by the Joint Committee on Taxation as problems in the Enron deferred compensation arrangements,[122] they are also broad in nature and apply throughout corporate America.

The logical question is whether the restrictions in § 409A are, as some commentators have suggested, an overreaction to the Enron situation,[123] or whether there are valid policy decisions to support these changes. A number of commentators have already considered the policy considerations behind the specific changes enacted by § 409A.[124] Other commentators have suggested that the changes made by § 409A were based on old tax doctrines and that full, fundamental reform is needed to achieve taxation of nonqualified deferred compensation when earned rather than when paid.[125] We believe a broader question

---

IN 401(K) PLANS: RESULTS OF A SURVEY OF ISCEBS MEMBERS 6 (2002).

119. Sarbanes-Oxley Act, § 306, 116 Stat. at 779-84 (codified as amended at 15 U.S.C. § 7244); 17 C.F.R. § 245.100-04 (2006).

120. As an example, the legislative history points to provisions that allow participants to receive distributions subject to forfeiture of a minimal amount of the funds due, commonly called a "haircut provision." H.R. REP. NO. 108-548, at 368-69 (2004).

121. *Id.* at 369-70.

122. STAFF OF J. COMM. ON TAXATION, 108TH CONG., WRITTEN TESTIMONY OF THE STAFF OF THE JOINT COMMITTEE ON TAXATION ON EXECUTIVE COMPENSATION AND COMPANY-OWNED LIFE INSURANCE ARRANGEMENTS OF ENRON CORPORATION AND RELATED ENTITIES 39 (Comm. Print 2003), *available at* http://www.house.gov/jct/x-36-03.pdf; *see also* REPORT OF INVESTIGATION OF ENRON, *supra* note 80, at 19-20, *available at* http://www.gpo.gov/congress/joint/jcs-3-03/vol1/ index.html (follow "17-20" hyperlink).

123. *See, e.g.*, Richard J. Bronstein, *Rethinking Code Sec. 409A*, TAXES, March 2006 at 179, 183.

124. *See, e.g.*, Trier, *supra* note 82, at 171; *Recent Legislative Initiatives*, *supra* note 99, at 171; Bronstein & Levin, *supra* note 111, at 179.

125. Chason, *supra* note 32, at 399.

needs to be considered: are there valid policy reasons for allowing or disallowing deferral of compensation in nonqualified deferred compensation plans in general?

B. *The Broad Policy Implications of Allowing Deferral*[126]

1. Employee Advantages of Deferral

From the employee's perspective, there are two potential tax advantages of deferral. First, deferral may result in the employee paying less tax if, as is generally assumed, he is in a lower tax bracket at the time of payment (presumably retirement) than at the time of deferral.[127] Second, deferral may also be advantageous where investment income earned during the period of deferral is taxed at the employer's rate and that rate is lower than the rate that would be applicable if the employee received the income and paid taxes on it directly.[128]

The first potential advantage described above is the classic reasoning behind deferral of tax liabilities, both for qualified plans and nonqualified deferred compensation arrangements. This type of tax planning allows an employee to engage in income averaging by shifting income into future years when he is less productive, leading to lower overall income in those future years.[129] Due to the progressive nature of the federal income tax, this type of income averaging can have significant tax saving effects for employees if their marginal tax rate in those future years is significantly lower than their marginal tax rate in the current year, creating an incentive to defer the receipt of income to a later year.[130] The concept of income averaging was once expressly permitted by the Code.[131] However, when the Tax Reform Act of 1986[132] compressed marginal tax rates, this type of

---

126. The framework for the analysis described below is based, in part, upon a methodology created by Harvard Law School Professor Daniel Halperin. Daniel I. Halperin, *Interest in Disguise: Taxing the Time Value of Money*, 95 YALE L.J. 506, 508 (1986) [hereinafter *Interest in Disguise*].

127. The deferral also results in the tax being paid with future dollars, which are worth less than present dollars due to the effects of inflation; however, from a policy perspective, this benefit is offset (although not necessarily on a dollar for dollar basis if there are differences in the employee and employer's tax rates) by the deferral of the employer's deduction. *See id.* at 519-20.

128. *See id.* at 523.

129. Chason, *supra* note 32, at 371.

130. *Id.* at 372 (citing Walter J. Blum & Harry Kalven, Jr., *The Uneasy Case for Progressive Taxation*, 19 U. CHI. L. REV. 417 (1952)) (criticizing the progressive rate structure because "it encourages this type of tax planning").

131. *See* Revenue Act of 1964, Pub. L. No. 88-272, 78 Stat. 19 (repealed 1986).

132. Tax Reform Act of 1986, Pub. L. No. 99-514, 100 Stat. 2085 (codified as amended

averaging became unnecessary and the income averaging provisions were repealed.[133] While one could argue that the repeal of those provisions indicates that Congress might support prohibiting income deferral, it should be recognized that the disparity in federal income tax rates has grown considerably since the 1986 changes, making the incentive for income tax deferral stronger and more relevant.[134]

Does this type of tax rate arbitrage justify a prohibition on nonqualified deferred compensation? While it is possible that tax rates will be lower for the employee at retirement or at some other time for payment, it is also possible that they will not be lower. In some circumstances, to be sure, the rates the employee faces at time of payment are likely to be very similar to the current rates. For example, if the deferral period is tied to a period of time rather than to retirement, the income tax rates applicable to the income may not be any different at the time of payment. Even if the deferral does continue until the employee's retirement, current tax rates are low by historical standards, with the maximum individual income tax rate at thirty-five percent.[135] Moreover, the individual rates applicable are a function both of economic policy and politics; there is certainly no guarantee that rates will not increase in the future such that amounts deferred today will be taxed at a higher rate rather than a lower rate. Given this uncertainty, it seems the employee is accepting a degree of risk in exchange for the opportunity to defer payment of income taxes, and that risk should be sufficient from a policy perspective to justify allowing deferral. Indeed, even Professor Halperin has indicated that, as a policy matter, he can accept allowing this type of deferral because of the risk tradeoff involved.[136]

It is the second possible advantage, the potential difference in tax rates on investment income during the deferral period, that Professor Halperin has suggested is the real problem from a

---

in scattered sections of 26 U.S.C.).

133. Chason, *supra* note 32, at 372-74.

134. *Id.* at 373 (citing Lily L. Batchelder, *Taxing the Poor: Income Averaging Reconsidered*, 40 HARV. J. ON LEGIS. 395, 419-20 (2003)). For an interesting analysis of the economic and policy implications of income averaging, see Neil H. Buchanan, *The Case Against Income Averaging*, 25 VA. TAX REV. 1151 (2006).

135. I.R.C. § 1 (West Supp. 2006). By comparison, the maximum federal income tax rate has been as high as ninety-four percent in 1944 and 1945. Tax Policy Center: Tax Facts, Historical Top Tax Rate, http://taxpolicycenter.org/TaxFacts/TFDB/TFTemplate.cfm?Docid=213 (last visited Apr. 25, 2007).

136. Daniel Halperin, *A Fairer and More Effective Approach to Deferred Compensation*, 103 TAX NOTES 1187, 1189 (2004) [hereinafter *Deferred Compensation*].

policy perspective.[137] Indeed, this was the focus of Professor Halperin's seminal article on the subject, in which he proposed that the central question is whether the tax system can rely on "substitute taxation" to the employer of the investment earnings.[138] To the extent the employer is taxed on the investment income on deferred amounts, in his view, the critical issue is whether the substitution of the employer for the employee is adequate from a tax policy perspective.[139]

As Professor Halperin correctly noted, the investment income component of deferred compensation is sometimes inadequate.[140] For example, where the employer is tax exempt, no tax is paid on the investment earnings which escape income tax entirely.[141] A similar result occurs where the employer has a large net-operating loss carryover which offsets the investment earnings for tax purposes,[142] or where the employer invests in dividend-paying stocks in the employer's own stock or those subject to a seventy percent exclusion from the corporate income tax.[143]

Because he concluded that substitute taxation is inadequate in these situations, Professor Halperin proposed a special tax on investment income on deferred amounts, payable by the employer at the maximum marginal tax rate for individuals.[144] He recently reiterated his proposal for the special investment tax in response to an article critical of § 409A.[145]

While Professor Halperin is correct that these circumstances involving employer net operating losses or selection of low-tax investments do sometimes occur, in many other cases there is no such effect.[146] First, in those circumstances where the employer has a net operating loss that offsets some or all of the investment income for income tax purposes, it is important to remember that when the net operating loss is used, it will be unavailable to

---

137. *Id.*

138. *Interest in Disguise*, *supra* note 126, at 515.

139. *Id.* at 523.

140. *Id.*

141. This was in large part the basis for the adoption of I.R.C. § 457, which limits the ability of tax exempt organizations and governmental employers to adopt nonqualified deferred compensation plans. *See* H.R. REP. NO. 95-1445, at 53 (1978), *as reprinted in* 1978 U.S.C.C.A.N. 7046, 7091.

142. Trier, *supra* note 82, at 163.

143. I.R.C. §243(a)(1) (2000); *see also Interest in Disguise, supra* note 126, at 540 (discussing the employer's choice of investments under the 1985 Code).

144. *Id.* at 544.

145. *Deferred Compensation*, *supra* note 136, at 1189.

146. Chason, *supra* note 32, at 377.

offset other income in the current or future years.[147] Thus, while it is true that the investment income might not be taxed due to the availability of the net operating loss, the employer will be taxed on other future income that could have been offset by the net operating loss.[148] It is therefore a trade-off of one source of taxable income for another, rather than an exemption, as Professor Halperin seems to suggest.[149]

In addition, funds held in a rabbi trust are generally invested in stocks, mutual funds, or other publicly traded securities, with the investment income of the trust taxed to the employer under a grantor trust concept.[150] In many cases, these plans are structured to allow the employees to specify a hypothetical investment choice (e.g., mutual funds, government or corporate bonds, or employer stock) for purposes of crediting their accounts under the plan; however, these employee-selected investments are merely for purposes of calculating benefits due under the plan.[151] The actual investment of rabbi trust assets is the responsibility of the trustee.[152] While the trustee is permitted to invest in accordance with the employee's selections, it is not generally required to do so.[153] In many cases, however, the employer will request that the trustee invest according to the employee's investment choices to avoid a funding deficiency when benefits become due. Thus, while it is possible that an employer might structure rabbi trust investments with a tax avoidance motive in mind, it seems unlikely; the most prudent course for the employer is to invest the rabbi trust assets such that they mirror what is actually required to be paid out under the deferred compensation plan.[154] It would be useful, in this regard, for future research to consider empirically whether Professor Halperin's concerns about the use of net operating losses and the employer's choice of investments are, in fact, a significant concern.

Professor Halperin also suggests that "a tax advantage occurs when the investment income earned during the period of deferral is taxed at a lower rate than it would be if the employee

---

147. Buchanan, *supra* note 134, at 1166.

148. *Id.*

149. *Id.* at 1165-66.

150. Christopher Rich, *Rethinking Funding Design for Nonqualified Deferred Compensation*, 13 EMPLOYEE BENEFIT NEWS, Apr. 15, 1999, at 66.

151. Tacchino, *supra* note 22, at 39.

152. *Id.* at 38.

153. *See* I.R.S. Priv. Ltr. Rul. 84-11-022 (Dec. 8, 1983).

154. *See* Nowotny, *supra* note 86, at 228.

made similar investments for her own account."[155] While it is true that such an advantage would occur where those circumstances exist, as they did in 1986 when his original article was published,[156] due to changes in marginal tax rates and how they are applied to different types of income, in many cases they currently do not. The maximum marginal tax rate applicable to an individual's income is currently 35%,[157] while the maximum marginal tax rate applicable to a corporation's income is currently 39%.[158] The tax rates applicable to $100,000 of income are currently 28% for an unmarried individual or a married couple filing a joint return[159] and 34% for a corporation.[160] These rates apply to interest income for both individual and corporate taxpayers and to capital gains received by a corporate taxpayer.[161] Capital gains received by an individual taxpayer currently receive preferential treatment, being taxed at a maximum capital gains tax rate of 15%.[162]

The only category of investment income that might be subject to a higher rate of tax for individuals is dividends.[163] Most dividends received by an individual taxpayer are currently taxed at the same rate as capital gains, with a maximum rate of 15%.[164] Dividends received by a corporation are subject to the corporation's normal rate of tax, but the corporation may be entitled to a deduction for dividends received that may exempt a portion of them from tax.[165] A corporation is generally allowed a deduction for 70% of dividends received from a domestic corporation owned less than 20% by the recipient corporation.[166]

---

155. *Deferred Compensation*, *supra* note 136, at 1188.

156. In 1986, the maximum federal tax rate applicable to earned income for an individual was 50%, while the maximum federal tax rate applicable to earned income for a corporation was 46% plus a 5% surtax on the first $405,000 in excess of $1,000,000. *See* U.S. Treasury–Fact Sheet on the History of the U.S. Tax System, http://www.treas.gov/education/fact-sheets/taxes/ustax.shtml (last visited Apr. 25, 2007); CCH-EXP 86 Fed. Par. 111C; CCH-EXP 86 Fed. Par. 117.

157. *See* I.R.C. § 1(i)(2) (West Supp. 2006).

158. *See id.* § 11(b)(1) (2000).

159. *Id.* § 1(a), (c), (i)(2).

160. *Id.* § 11(b)(1)(C).

161. *See id.* § 61(a)(4) (2000); Tax Reform Act of 1986, Pub. L. No. 99-514, § 311, 100 Stat. 2085, 2219 (codified as amended in scattered sections of 26 U.S.C.) (eliminating the preferential tax rate on capital gains for corporate taxpayers).

162. I.R.C. § 1(h)(1).

163. *See id.* § 1(h)(11).

164. *See id.* § 1(h)(1), (11). To receive the preferential tax rate, the dividends must be paid by a domestic corporation (generally including mutual funds) or certain foreign corporations, and the investor must have held the stock for at least sixty days during the 121-day period beginning sixty days before the ex-dividend date. *Id.* § 1(h)(11).

165. *Id.* § 243(a) (2000).

166. *Id.* § 243(a), (c). In order to be entitled to the deduction, the corporation must

Effectively, this would make the maximum marginal tax rate 11.7% on most dividends received by a corporation.[167] It is important to note that capital gain dividends from a mutual fund or real estate investment trust and distributions that are a return of capital do not qualify for the deduction.[168] Thus, unless 100% of the mutual fund's income is from corporate dividends, a portion of the dividends paid will not qualify for the dividends received deduction.[169]

For a corporation paying tax on interest or capital gains investment earnings of deferred compensation amounts, the tax is actually higher than it would be if the individual employees invested the same amounts in their own accounts; and for dividends, it is only slightly lower if the dividends all qualify for the corporate dividends received deduction.[170] As is the case with the first potential advantage described above, there is potential for tax rates to change in response to economic and political factors, creating risk and uncertainty for the employer and the employee that could arguably justify allowing deferral given the lack of a tax incentive to encourage abuses.

2. The Effect of Deferral on Government Revenues

The question of whether income deferral should be allowed can also be examined by considering the effect deferral has on government revenues. Some commentators have used a model developed by economics professor E. Cary Brown of the Massachusetts Institute of Technology to describe this effect as a partnership between the government and the taxpayer in the deferral situation.[171] In this model, the deferral is viewed as a partnership between the government and the employee in which the amount deferred is the property contributed to the partnership.[172] The government is treated as having contributed to the partnership the taxes due on the amount deferred and employee is treated as having contributed the remaining

---

have held the underlying stock for at least forty-six days during the ninety-one day period beginning forty-five days before the ex-dividend date. *Id.* § 246(c)(1)(A) (West Supp. 2006).

167. 39% maximum marginal tax rate x (100% total dividends – 70% total dividends) = 39% x 30% = 11.7%.

168. I.R.C. § 243(d)(1), (3).

169. *Id.* §§ 243(d)(2), 854(a)-(b) (West 2000 & Supp. 2006).

170. *See supra* notes 157-61, 165-66 and accompanying text.

171. *See* Christopher H. Hanna, *Demystifying Tax Deferral*, 52 SMU L. REV. 383, 384-86 (1999).

172. *Id.* at 402.

funds.[173] Each year, the employer's tax payments on the investment income earned are viewed as allocations of partnership income to the government, with the remaining income allocated to the employee's partnership share.[174] While we do not intend to pursue the application of this model in this article, the concept of sharing the additional revenues generated by the deferral between the employee and the government is a useful analogy for the analysis that follows. The analysis demonstrates that allowing deferral is beneficial not only to the employee but also to the government in all cases.

Consider the following simple example.[175] An employee agrees to defer $10,000 of compensation for a period of three years. The employer immediately contributes the $10,000 to a rabbi trust, which invests the funds. The employer pays the taxes due on the investment earnings, and at the end of the three years, the employee receives a distribution from the rabbi trust of the $10,000 deferred plus the investment earnings on it. Assuming a constant income tax rate of 30% for both employee and employer, and assuming a 20% rate of return for investments, as Table 1 below demonstrates, the employee would receive a distribution of $14,400, pay taxes of $4,320, and have $10,080 after taxes. The employer receives a net $3,000 tax savings from the transaction, so the after-tax cost of this compensation to it is $7,000. The total tax paid to the government on the transaction is $1,320.

How do these results compare with a non-deferral situation? If no deferral was made, as Table 2 shows, in Year 1, the employee pays $3,000 in tax and receives $7,000 after-tax to invest. The employee pays tax on an annual basis on the investment earnings, and at the end of the three years he would have $9,097.20. The employer receives an immediate deduction for the $10,000 paid in Year 1, so the net cost to the employer is still $7,000, and the total taxes paid to the government are $898.80. Thus, as Table 3 shows, and as we would expect, the employee gains a considerable benefit from deferral, receiving an additional $982.80. What is not as intuitive, however, is that the government also benefits from deferral, receiving $421.20 more than in the non-deferral situation. The partnership concept of the Cary Brown model[176] is at work here—the $3,000 taxes deferred are generating significant additional investment

---

173. *Id.*

174. *Id.*

175. Tables referred to in this example are appended to this article.

176. *See* discussion *supra* notes 171-74 and accompanying text.

income, which the employee and the government are, in effect, sharing via the employer's payment of taxes on that income.

What happens if we change the tax rate assumptions? If, for example, the employee's tax rate is higher than the employer's tax rate, does it change the results? Similarly, does a change in the employer's tax rate make any difference? Table 4 demonstrates the comparison of the net benefit of deferral based on these types of changes. As Table 4 demonstrates, changing the employee's tax rate has a significant effect on the benefit of deferral for both the employee and the government. An increase in the employee's tax rate to 40% results in an increased net benefit of $130.80 to the employee and $321.20 to the government. The increase in the employee's tax rate is beneficial to both the employee and the government because more taxes are deferred at the beginning of the transaction, allowing additional investment earnings from the additional capital invested. However, the increased tax rate significantly changes the percentage sharing arrangement in the hypothetical partnership between the employee and the government.

Interestingly, changing the employer's tax rate has no net effect on the benefit to the employer, the employee, or the government. As Table 4 shows, even when the employer's tax rate is zero (i.e., the employer is either exempt from tax or has net operating loss carryovers that offset all income the employer earns), the net benefit to the employee and the government is the same, and in all cases, the employer receives no tax benefit from the deferral.[177] This is logical, because the employer is ultimately receiving a deduction for the exact amount taken into income by the employee, which in turn is based on the amount deferred plus the earnings on that amount.

VI. CONCLUSION

Section 409A was, at least in part, an overreaction to perceived abuses at Enron and other companies involving nonqualified deferred compensation plans for corporate executives.[178] The addition of § 409A was one of the most

177. The only factor not accounted for in this analysis is the time value of money. While the simple example above illustrates the net tax effects of these transactions, it does not take into account the deferral of the employer's tax deduction for a three year period. While a deferral for a three year period might not produce significant timing results, a deferral for periods of ten or twenty years might do so. Nonetheless, the examples above do illustrate that there is no tax benefit to the employer from the deferral.

178. *See supra* notes 107-10 and accompanying text.

significant changes in the American Jobs Creation Act of 2004.[179] The changes implemented by § 409A affect deferred compensation plans of all shapes and sizes, requiring such plans to comply with detailed requirements concerning the deferral and payment of the deferred compensation.

The broader question considered by this article is whether there are valid policy reasons for allowing or disallowing deferral of compensation in nonqualified deferred compensation plans in general. Given the uncertainty of future tax rates, the risk tradeoff involved for the employee in deferring income, the likelihood of a lack of tax avoidance motive for employers in structuring rabbi trust investments, the current tax rate structure, and the net effect of deferral on government revenues, we believe there are valid policy reasons for allowing deferral under such plans. We also believe, however, that it would be useful for future research to consider empirically whether the concerns identified above about the use of net operating loss carryovers and the employer's choice of investments are, in fact, a significant concern that might significantly affect the policy choices discussed above.

179. *See* Pub. L. No. 108-357, 118 Stat. 1418 (codified in scattered sections of 26 U.S.C.).

TABLE 1
TAX CONSEQUENCES OF DEFERRED PAYMENT OF COMPENSATION

Employee:

Year	Compensation Deferred	Compensation Received	Investment Earnings	Tax Paid	Net Received After Tax
1	$10,000	$0	$0	$0	$0
2	0	0	0	0	0
3	0	14,400	0	4,320	10,080
TOTALS	$10,000	$14,400	$0	$4,320	$10,080

Employer:

Year	Compensati on Deferred to Rabbi Trust	Compensation Paid from Rabbi Trust	Investment Earnings of Rabbi Trust	Employer Taxes Paid or (Saved)	Net Cost to Employer After Tax
1	$10,000	$0	$0	$0	$10,000
2	0	0	2,000	600	600
3	0		2,400	720	720
End of 3		14,400		(4,320)	(4,320)
TOTALS	$10,000	$14,400	$4,400	$(3,000)	$7,000

Assumptions:
Income Tax Rate for Employee: 30%
Income Tax Rate for Employer: 30%
Rate of Return for Investments: 20%

TABLE 2

TAX CONSEQUENCES OF DIRECT PAYMENT OF COMPENSATION

Employee:

Year	Compensation Received	Investment Earnings	Tax Paid	Net Received After Tax
1	$10,000	$0	$3,000	$7,000
2	0	1400	420	980
3	0	1596	478.80	1,117.20
TOTALS	$10,000	$2,996	$3,898.80	$9,097.20

Employer:

Year	Compensation Paid	Investment Earnings	Taxes (Saved)	Net Cost After Tax
1	$10,000	$0	$(3,000)	$7,000
2	0	0	0	0
3	0	0	0	0
TOTALS	$10,000	$0	$(3,000)	$7,000

Assumptions:

Income Tax Rate for Employee: 30%

Income Tax Rate for Employer: 30%

Rate of Return for Investments: 20%

TABLE 3

COMPARISON OF RESULTS OF NON-DEFERRAL AND DEFERRAL

	NON-DEFERRAL	DEFERRAL	NET BENEFIT OF DEFERRAL
Net Compensation Received by Employee	$9,097.20	$10,080	$982.80
Net Cost to Employer	$7,000	$7,000	$0
Net Taxes Received by Government	$898.80	$1,320	$421.20

TABLE 4
COMPARISON OF NET BENEFIT OF DEFERRAL BASED ON CHANGES IN EMPLOYEE AND/OR EMPLOYERTAX RATES

Net Benefit of Deferral to Employee

		EMPLOYEE'S TAX RATE	
		30%	40%
EMPLOYER'S TAX RATE	30%	$982.80	$1113.60
	40%	$982.80	$1113.60
	0%	$982.80	$1113.60

Net Benefit of Deferral to Employer

		EMPLOYEE'S TAX RATE	
		30%	40%
EMPLOYER'S TAX RATE	30%	$0	$0
	40%	$0	$0
	0%	$0	$0

Net Benefit of Deferral to Government

		EMPLOYEE'S TAX RATE	
		30%	40%
EMPLOYER'S TAX RATE	30%	$421.20	$742.40
	40%	$421.20	$742.40
	0%	$421.20	$742.40