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Incidence and Accidents: Regulation of Executive Compensation Through the Tax Code

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I. INTRODUCTION

Many working Americans receive little more than a salary or hourly wage from their employers. Furthermore, although more than half of the workforce is fortunate enough to receive some employee benefits in addition to their pay, these benefits are hardly comparable to those received by corporate executives and other top management personnel.[1] The benefits packages most employees receive consist of access to a health care plan, a retirement savings plan, and a life insurance policy.[2] In contrast, executives typically receive a compensation package that not only includes a generous annual salary – at present, almost 400 times more than the pay of the average worker[3] – but also includes some combination of the following:

- short-term incentives (*e.g.*, cash or stock bonuses),
- long-term incentives (*e.g.*, stock options),
- qualified retirement plan benefits (*e.g.*, a 401(k) plan),
- nonqualified deferred compensation (*i.e.*, an additional retirement plan),
- perquisites (*e.g.*, use of the company aircraft or country club memberships),
- severance payments,
- change in control (parachute) payments,
- various types of insurance (life, medical, dental, split-dollar),
- and a vast array of other types of compensatory benefits. [4]

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[1] For purposes of this article, the term "executive" refers to an individual belonging to a distinct class of employees. This group includes not only a company's chief executive officer ("CEO") but also all its senior management personnel. Executive, here, also refers to an executive of a publicly held corporation, unless otherwise stated. The reason for the focus on publicly held corporations is in large part because the law discussed in this paper was generally designed to apply to public corporations. Accordingly, the focus here is mainly on those corporations and their executives.

[2] According to a survey conducted by the U.S. Department of Labor in 2007, among private industry workers 61 percent have access to an employer sponsored retirement plan, 71 percent have access to a medical plan, and 58 percent have access to life insurance. *See* U.S. Bureau of Labor Statistics, *National Compensation Survey: Employee Benefits in Private Industry in the United States, March 2007*, at 7 tbl.1, 12 tbl.5, and 21 tbl.13 (2007), *available at* http://www.bls.gov/ncs/ebs/sp/ebsm0006.pdf.

[3] *See Pay Gap Between CEOs and Workers Now a Chasm*, State News Service, June 8, 2007 ("[T]oday, the average CEO is paid nearly 400 times as much as the average worker."), *available at* http://www.senate.gov/~levin/newsroom/release.cfm?id=275778. For more information about pay ratios and their calculation, see *generally* Linda Levine, *A Comparison of the Pay of Top Executives and Other Workers*, Congressional Research Service**,** Apr. 13, 2004, *available at* http://digitalcommons.ilr.cornell.edu/cgi/viewcontent.cgi?article=1181&context=key_workplace.

[4] *See, e.g.*, STAFF OF THE JOINT COMM. ON TAX'N, 109th CONG., PRESENT LAW AND BACKGROUND RELATING TO EXECUTIVE COMPENSATION (2006) [hereinafter JCT COMPENSATION REPORT]. The composition of any particular executive's pay package will depend on a variety of factors, such as the type of industry in which the executive's firm is operating, the size of the firm, and the composition of competitors' compensation plans. *See id.* at 6-7 (listing several factors as examples). This is because most firms aim to offer compensation and benefits comparable to those offered to executives of other companies in the executive's peer group, and an executive's peer group is usually determined with reference to firm industry and size. *See, e.g.*, Bruce Greenblatt & Diane Doubleday, *Executive Remuneration Perspective: A Responsible Executive Pay Peer Group Selection Guide*, Apr. 5, 2007, *available at* http://www.mercer.com/referencecontent.htm?idContent=1263170 (explaining use of peer groups to determine appropriate compensation).

Over the course of the last few decades, the media has publicized both the typical and atypical benefits offered to executives that are not extended to the average worker. To highlight just a few examples, in 1996, Walt Disney Co. fired its president, Michael Ovitz, after only one year on the job, and paid him over $100 million to compensate him for the termination.[5] When Jack Welch retired as CEO of General Electric in 2001, his retirement package included use of a corporate jet, a Manhattan apartment, and country club memberships.[6] In the late 1990s and early 2000s, Tyco International, Ltd. paid for its then-CEO, Dennis Kozlowski, to use and maintain an $18 million Manhattan apartment, including $6,000 for a shower curtain in the maid's bathroom.[7]

Reports of such extravagances and compensation levels often incite public outrage, especially when contrasted with the lifestyle, salary, and benefits of most other working Americans.[8] Combine executives' extravagant lifestyles, made possible by their generous compensation packages, with a good dose of corporate scandal or a turbulent economy, and you have one potent cocktail for political action.[9] Since the 1980s, that political action has come,

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[5] *See* Corie Brown, Managing Hollywood, Newsweek, Nov. 30, 1998, at 40 (discussing Ovitz's $100 million-plus compensation for his "ill-fated year as president of the Walt Disney Co"); Bernard Weinraub, Hollywood's Next Sequel: The Return of Ovitz, N.Y. Times, Dec. 7, 1998, at C1 (noting severance Disney paid Ovitz "reached an extraordinary $100 million").

[6] *See* William A. Drennan, *The Pirates Will Party On! The Nonqualified Deferred Compensation Rules Will Not Prevent CEOs from Acting Like Plundering Pirates and Should Be Scuttled* 17 (2008), *available at* http://works.bepress.com/william_drennan/3. Other benefits included wine service, laundry service, and Boston Red Sox tickets. *See id.*

[7] *See id*. Other items included a $30,000 pair of opera glasses, a $16,000 dog-shaped umbrella stand, and a $2 million birthday party for Kozlowski's wife. *See id.*

[8] *See* Charles M. Elson, *Executive Overcompensation -- A Board-Based Solution*, 34 B.C. L. REV. 937, 937 (1993). Elson writes:

> Envy, for better or worse, is a fundamental part of the human condition. Whether we admit it or not, most of us take a keen interest in the financial status of our neighbors. Few aspects of existence in contemporary society create more anger, resentment and dissension than how much we are compensated for our daily toils in comparison to what our fellow workers earn. It is this simple fact, along with distributive justice concerns, that explain the cause of the extraordinary popular attention and fury directed at the seemingly innocuous issue of executive compensation.

Id. It is notable, however, that public resentment is not similarly directed at the compensation levels of other categories of highly paid individuals, such as entertainers or athletes. *See generally*, *CEOs Are Ridiculed for Huge Salaries: Why Aren't Athletes and Entertainers?*, Knowledge@Wharton, Nov. 19, 2003, *available at* http://knowledge.wharton.upenn.edu/article.cfm?articleid=877 (asking why athletes and entertainers who make as much as CEOs are not similarly criticized); Mark J. Loewenstein, *Reflections on Executive Compensation and a Modest Proposal for (Further) Reform*, 50 SMU L. REV. 201, 201 (1996) ("[T]he public outcry that accompanies stories on CEO pay has no parallel in sports or cinema, where lavish compensation is hardly unknown."). Several commentators have suggested that the difference lies in the extent to which the public perceives the compensation to have been bargained for at arms length or tied to performance. *See*, *e.g.*, *id.* ("People feel, instinctively, that if a movie studio pays a star $10 million for a single motion picture, the star must be worth that much, but the public is skeptical that the studio's CEO is worth $10 million for serving in that capacity for the year."); Nicholas D. Kristof, Op-Ed., *Millions for Moochers*, N.Y. TIMES, Mar. 6, 2004, at A15 ("Athletes and movie stars are paid ridiculous sums as well, of course, but at least they earn them in arm's-length negotiations.").

[9] *See* Kenneth M. Rosen, *"Who Killed Katie Couric? And Other Tales From The World Of Executive Compensation Reform*, 76 FORDHAM L. REV. 2907 (2007-2008) (discussing scandal-driven reform and noting that "[w]ith average Americans perturbed about executive pay, government officials are acting to assuage that anxiety"); Thompson, *infra* note 140.

inter alia, in the form of legislation attempting to influence corporate behavior (and thereby executive compensation levels) through the Internal Revenue Code (the "Code").[10]

The Code is often used not only as a means of raising revenue, but also as a means of implementing social policy.[11] With regard to the latter, the Code contains various provisions that are designed to reward taxpayers for engaging in certain desired activities and penalize them for engaging in certain seemingly undesirable activities.[12] To discourage taxpayer conduct, Congress enacts provisions that alter what would otherwise be the normal operating tax rules in order to penalize the targeted conduct.[13] Such penalty provisions may, for example, disallow or limit a deduction or impose an additional tax with the aim of increasing the after-tax cost of the undesirable activity.[14] The theory is this increased cost will discourage taxpayers from engaging in the conduct.[15] It is important to note, however, that the Code does not prohibit or permit

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[10] All section references, unless otherwise stated, are to the Internal Revenue Code of 1986, as amended, and the regulations promulgated thereunder. A question that might be raised at this point is whether the 1980s is an appropriate reference date inasmuch as section 162(a)(1), which imposes a reasonableness limit on compensation deductions, was enacted before the 1980s. Note 90, *infra*, explains why this article treats section 162(a)(1) differently than the other Code provisions discussed herein.

[11] *See generally* Stanley S. Surrey, *Tax Incentives as a Device for Implementing Government Policy: A Comparison with Direct Government Expenditures*, 83 HARV. L. REV. 705 (1970) (assessing logic of using tax laws to accomplish policy goals). *See also generally* Susan Stabile, *Is There a Role for Tax Law in Policing Executive Compensation?*, 72 ST. JOHN'S L. REV. 81 (1998) (discussing tax laws that were not enacted to raise revenue but to police executive compensation).

[12] *See generally* Eric M. Zolt, *Deterrence Via Taxation: A Critical Analysis of Tax Penalty Provisions*, 37 UCLA L. REV. 343 (1989) (discussing rewards and penalties in income tax system). *See also generally* Kurt Hartman, Comment, *The Market for Corporate Confusion: Federal Attempts to Regulate the Market for Corporate Control Through the Federal Tax Code*, 6 DEPAUL BUS. L.J. 159 (1994) (same).

[13] The phrase "normal operating tax rules" is used in this article to refer to the already existing rules that would apply to determine the tax consequences in the absence of a subsequently enacted rule clearly disallowing that treatment or prescribing different treatment in order to penalize the taxpayer; it is not meant to refer to a comparison of current rules to a normative income tax. *Cf.* Zolt, *supra* note 12, at 348 (avoiding identification of tax penalty provisions by reference to departures from a "normal" income tax structure and instead identifying tax penalties by their function); Edward D. Kleinbard, Chief of Staff, Joint Committee on Taxation, *Rethinking Tax Expenditures*, May 1, 2008, at 9, *available at* http://www.house.gov/jct/Rethinking_Tax_Expenditures.pdf ("[I]n many cases, it is not possible to identify in a neutral manner the terms of the 'normal' tax to which present law should be compared."). The penalizing provisions that are the focus of this article are referred to as tax penalties, even though they are not labeled as such by the statute, because they operate as penalties and are not aimed at measuring a taxpayer's net income or raising revenue. *See infra* Part III.B. As discussed in Part III.B, their function and nature are inherently penal. In other contexts, this has been sufficient for the Supreme Court to treat certain tax provisions as imposing a penalty even though they were similarly not labeled as penalties by the statute. *See* United States v. Reorganized CF&I Fabricators of Utah, Inc., 518 U.S. 213, 226 (1996) (looking "behind the label placed on the exaction and rest[ing] its answer directly on the operation of the [tax] provision").

[14] *See* Zolt, *supra* note 12, at 343-44. Other methods of discouraging taxpayer conduct include "deny[ing] favored tax statuses, . . . or, disallow[ing], limit[ing], or postpon[ing] tax credits." *Id.* at 344. In general, the Code imposes tax penalties on two types of taxpayer activities: (1) illegal activities, and (2) undesirable activities. *See id.* This article focuses on the latter type.

[15] *See id*. Conversely, to encourage taxpayer conduct, Congress enacts provisions that confer "deductions, credits, exclusions, exemptions, deferrals, and preferential rates." Surrey, *supra* note 11, at 706. *See also* Zolt, *supra* note 12, at 343 ("Congress encourages good conduct by providing special tax statuses, rates, exclusions, deductions, or credits."). These types of provisions operate to reduce the costs of engaging in certain activities, in theory making those activities more attractive to taxpayers. *See id*. In this way, the federal government foregoes taxes that it would otherwise collect and have available to spend. *See* Hartmann, *supra* note 12, at 169 ("[A] tax [benefit] serves as the functional equivalent of a direct government subsidy for the particular activity."). Forty years ago Stanley Surrey

nontax behavior; the Code can only provide how certain items are to be taxed, and thereby influence nontax taxpayer behavior.[16]

Congress has enacted several tax penalty provisions since the 1980s designed in particular to influence executive compensation practices.[17] They were enacted, in part, to respond to the furor of rank-and-file Americans[18] over executive excesses by attempting to rein

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called these types of provisions "tax expenditures" precisely because they are "special provisions of the federal income tax system which represent government expenditures through that system to achieve various social and economic objectives." Surrey, *supra*. It should be noted, however, that a number of commentators are critical of the utility of the tax expenditure label. *See, e.g.*, Edward A. Zelinsky, *The Defined Contribution Paradigm*, 114 YALE L.J. 451, 519 (2004) ("There are those who dispute in general the utility of the tax expenditure label") (citation omitted); Edward D. Kleinbard, Chief of Staff, Joint Comm. on Tax'n, Rethinking Tax Expenditures 8, Address Before the Chicago-Kent College of Law Federal Tax Institute (May 1, 2008), *available at* http://www.house.gov/jct/Rethinking_Tax_Expenditures.pdf (proposing a new approach to classifying tax provisions as tax expenditures that is aimed at responding to the criticisms of traditional tax expenditure analysis); Victor Thuronyi, *Tax Expenditures: A Reassessment*, 1988 DUKE L.J. 1155, 1187 (1988) (discussing some of the academic criticisms of the tax expenditure label).

[16] The Code does prohibit tax-related behavior, such as engaging in tax fraud.

[17] *See infra* Part III.B discussing sections 280G and 4999, section 162(m), and section 409A. Prior to the mid-1980s, tax law did not attempt to directly influence executive compensation practices. *See infra* notes 46-50 and accompanying text. With regard to some of the tax penalty provisions enacted since then (sections 280G and 162(m)), Professor Susan Stabile has identified and analyzed the following possible overarching legislative goals: (1) "a desire to affect the amount or type of compensation paid to executives;" (2) a "desire to affect the relationship between executive compensation and the pay of rank and file employees;" and (3) a desire to raise revenue. *See* Stabile, *supra* note 11, at 95-100.

[18] For purposes of this article, a rank-and-file American is any American belonging to a household with income of $250,000 or less. Even though the average American household only has an income of $50,233, proposals designed to "tax the rich" often are aimed at those making $250,000 or more. *See* Carmen DeNavas-Walt, Bernadette D. Proctor & Jessica C. Smith, *Income, Poverty, and Health Insurance Coverage in the United States: 2007*, U.S. CENSUS BUREAU, CURRENT POPULATION REPORTS, P60-235, at 6 (2008), *available at* http://www.census.gov/prod/2008pubs/p60-235.pdf (calculating real median household income in 2007); Omnibus Budget Reconciliation Act of 1993, Pub. L. No. 103-66, 13202 (adding the 36% and 39.6% tax brackets during the Clinton administration, of which the latter generally applied to taxpayers with taxable income over $250,000); Katherine Lim & Jeffrey Rohaly, *The Impact of the Presidential Candidates' Tax Proposals on Effective Marginal Tax Rates*, Tax Policy Institute, Urban Institute and Brookings Institution, Sept. 30, 2008, at 13, *available at* http://www.taxpolicycenter.org/UploadedPDF/411759_candidates_tax_proposals.pdf (noting Barrack Obama would raise payroll taxes on wages and salaries above $250,000); David Leonhart, *For Democrats, Instincts Differ On Economics*, N.Y. TIMES, May 4, 2008, at A1 (noting Hillary Clinton's campaign promise to raise taxes on those making over $250,000 a year); Leslie Wayne, *Edwards Proposes Raising Capital Gains Tax*, N.Y. TIMES, July 27, 2007, at A19 (describing John Edwards' proposal to raise capital gains tax rate for those with incomes over $250,000 a year).

It is important to note, however, that just as Americans with incomes of $250,000 or less are not all equal, Americans with incomes above $250,000 are not all equal: they are all quite well off, but some are only "merely rich" and not "super-rich." And, although there is a substantial gap between America's lowest-income working population and its highest, "the income gap between the [super-rich] households and the rest can only be described as massive." Edward N. Wolff & Ajit Zacharias, *Class Structure and Economic Inequality*, Working Paper No. 487 (Levy Economics Institute of Bard College, 2007), *available at*, http://www.levy.org/pubs/wp_487.pdf (referring to households with "nonhome wealth of at least $4 million or business equity worth at least $2 million"). *See also,* Martin J. McMahon, Jr., *The Matthew Effect and Federal Taxation*, 45 B.C. L. REV. 993 (2004).

These days, even the super-rich are being left behind by the "ultra-rich." According to a recent survey by Fidelity, "just 8 percent of millionaires think they're 'very' or 'extremely' wealthy, while 19 percent don't feel rich at all." *10 Things Millionaires Won't Tell You*, Yahoo! Finance, Aug. 26, 2008, *available at* http://finance.yahoo.com/banking-budgeting/article/105626/10-Things-Millionaires-Won't-Tell-You. Apparently, it in and shape executive compensation packages.[19] But tax legislation attempting to control executive compensation has not reduced overall compensation levels or achieved other legislative goals.[20]

This article adds to the literature assessing the use of tax penalties to regulate compensation paid to executives.[21] Although legal scholars have considered whether such legislation is effective in meeting stated legislative goals, the literature has not focused on the

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takes $23 million to feel truly rich. *See id.* In any event, most of the executives that the tax penalties discussed in this article are aimed at receive over $250,000 in total compensation annually, removing them from the rank-and-file class (and many belong to the super-rich or ultra-rich classes). *See, e.g.,* Joann S. Lublin & Scott Thurm, *Money Rules: Behind Soaring Executive Pay, Decades of Failed Restraints; Instead of Damping Rewards, Disclosure, Taxes, Options Helped Push Them Higher; Return of Golden Parachutes*, WALL ST. J. Oct. 12, 2006, at A1 ("The average [pay in 2005 for CEO's of large companies] was $10.5 million, a figure that includes salary, bonus and the value of stock and stock-option grants.").

[19] One scholar has noted that there are generally two varieties of outrage over executive compensation: (1) populist outrage over salaries that are considered too high (and thus inherently wrong), and (2) shareholder outrage over "ineffective compensation structures." Kevin J. Murphy, *Politics, Economics, and Executive Compensation*, 63 U. CIN. L. REV. 713, 725-29 (1995). But this line has been blurred, see discussion *infra* Part IV. Presently, the compensation levels of oil company executives and mortgage lending company executives are center stage in the media and the focus of congressional hearings as the public blames them, in part, for the high price of gas and for the significant increase in home mortgage foreclosures. *See Executive Compensation II: CEO Pay and the Mortgage Crisis: Hearing Before the House Comm. On Oversight and Govn't Reform*, 110th Cong. (2008), preliminary transcript *available at* http://oversight.house.gov/documents/20080422110749.pdf; *Exploring The Skyrocketing Price of Oil: Hearing Before the S. Comm. on the Judiciary*, 110th Cong. (2008), transcript available at http://frwebgate.access.gpo.gov/cgi-bin/getdoc.cgi?dbname=110_senate_hearings&docid=f:43354.pdf.

[20] *See, e.g.*, Meredith R. Conway, *Money for Nothing and the Stocks for Free: Taxing Executive Compensation*, 17 CORNELL J. L. & PUB. POL'Y 383, 410, 417 (2008) (noting section 162(m) "was not effective in curtailing excessive executive salaries" and also noting the limited effectiveness of section 280G); Drennan, *supra* note 6, at 5 (demonstrating "the failure of 409A" to effectively regulate nonqualified deferred compensation); Hankinson, *supra* note 127 at 783-89 & nn. 108-146 (highlighting examples of ways §§ 280G and 4999 can be circumvented); Kurt Hartmann, Comment, *The Market for Corporate Confusion: Federal Attempts to Regulate the Market for Corporate Control Through the Federal Tax Code*, 6 DEPAUL BUS. L.J. 159, 178-87 (1993) (arguing against use of tax penalties to regulate market for takeovers and noting their weaknesses in discouraging conduct); Michael J. Hussey, *Has Congress Stopped Executives From Raiding the Bank? A Critical Analysis of I.R.C. § 409A*, 75 UMKC L. REV. 437, 439 (2006) (concluding "§ 409A does not adequately address the perceived abuses regarding nonqualified deferred compensation."); Ryan Miske, Note, *Can't Cap Corporate Greed: Unintended Consequences of Trying to Control Executive Compensation through the Tax Code*, 88 MINN. L. REV. 1673, 1680 (2004) (concluding "the federal government will not be successful in capping executive compensation by providing disincentives through the tax code"); Gregg D. Polsky, *Controlling Executive Compensation through the Tax Code*, 64 WASH. & LEE L. REV. 877, 884 (2007) (evaluating efficacy of section 162(m) and concluding it is likely ineffective); Stabile, *supra* note 11, at 94-100 (1998) ("[N]either with respect to ordinary compensation nor with respect to compensation contingent on a change in control has the Code proven a very meaningful curb on executive compensation."); Bruce A. Wolk, *The Golden Parachute Provisions: Time for Repeal?*, 21 VA. TAX REV. 125, 128-29 (2001) (arguing for repeal of the golden parachute provisions because they "not only allow[] golden parachutes to flourish, but achieve[] this counter-productive result in a complex and costly fashion"); Edward A. Zelinsky, *Greenmail, Golden Parachutes and the Internal Revenue Code: A Tax Policy Critique of Sections 280G, 4999 and 5881*, 35 VILL. L. REV. 131, 187-92 (1990) (concluding, in part, that the golden parachute provisions – sections 280G and 4999 – "satisfy none of the tests for identifying an appropriate tax provision").

[21] This article does not discuss or take a position on whether executives are overcompensated or whether executive compensation is an appropriate subject of government regulation. For a discussion of those issues, *see generally* Mark J. Loewenstein, *The Conundrum of Executive Compensation*, 35 WAKE FOREST L. REV. 1, 4 (2000) (evaluating "the principal empirical and theoretical issues surrounding executive compensation").

important question of who bears the economic burden of these tax penalties.[22] This article fills that void by exploring those costs, especially in the context of our national retirement savings policies and their evolving emphasis on the importance of diversifying capital ownership through the growth in defined contribution plans. It shows that tax penalty provisions are a particularly inappropriate policy tool for regulating executive compensation because they are easy for executives to contract around, causing the penalties to ricochet in unintended directions. This article provides a deeper analysis of who bears the burden of these penalties, and reveals that, notwithstanding the uncertainty which surrounds the economic literature on the incidence of increased costs to corporations, the burden likely falls on rank-and-file Americans to a substantial extent and does not significantly fall on the executives that Congress was targeting with the penalties. The burden thus largely falls on individuals that the tax penalties were not meant to penalize.

This identification and humanization of the affected individuals, in particular the recognition that rank-and-file Americans are impacted, helps to reframe the traditional discourse on how Congress and administrative agencies should regulate executive compensation, and why it is important from a tax policy perspective to reconsider this role of the Code. It is also of timely significance as Congress has recently been considering expanding some of these tax penalties in an effort not only to curtail executive compensation levels but also to raise much needed federal revenue, which was not a goal of prior legislation.[23]

To this end, the article proceeds as follows. Part II discusses the core fact that, when it comes to paying taxes, the person nominally making the payment is not always the person who is really forfeiting the money and thereby bearing the financial burden of the payment. Similarly, the person on whom the Code imposes the tax is not always the person that bears its financial burden. This part demonstrates that to assess who is bearing a tax burden, it is necessary to look past both of these factors.

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[22] *See supra* note 20. The literature has largely assumed, with little if any discussion, that shareholders bear the burden. *See* Conway, *supra* note 20, at 421-22 ("Congress has failed to rein in executive compensation through the tax code and the failure resulted in executives receiving even larger amounts of compensation. . . . Ultimately, shareholders bear the cost."); William A. Drennan, *Enron-Inspired Nonqualified Deferred Compensation Rules: "If You Don't Know Where You're Going, You Might Not Get There*, 73 TENN. L. REV. 415, 503 (2006) ("the [section 162(m)] penalty for violating the $ 1 Million Cap falls on the corporation (and indirectly on the shareholders), and not on the overpaid executive"); Murphy, *supra* note 19, at 740 ("Inevitably, it will be the shareholders, and not the executives, who are punished."); Stabile, *supra* note 11, at 88 n.22 (noting potential effect of 162(m) deduction limitation could be "double hit to shareholders"); Wolk, *supra* note 20, at 181 ("So what started out as a means to protect shareholders from rapacious executives has become an added government-imposed financial burden on those very same shareholders."). *But see* Polsky, *supra* note 20 (examining whether the incidence of increased executive compensation costs as a result of §162(m) falls on executives or companies, and concluding it likely falls on companies). This article unpacks that assumption and examines whether and to what extent, if any, others may bear the burden, paving the way for a new line of critique on the use of tax penalties to regulate executive compensation. In a future article, I plan to head down that path and examine the sociopolitical context for enactment of these penalties and the resultant cyclical process of tax legislation regulating executive compensation. I will consider why Congress continues to enact tax penalties on executive compensation when there is general agreement in the scholarly literature that such provisions are largely ineffective at controlling corporate behavior and are inefficient as well.

[23] *See infra* note 199 and accompanying text (noting that executive compensation tax penalties were not enacted to raise revenue) and note 295 (legislative proposals).

Part III focuses on where the Code nominally imposes the burden and the benefit of taxes associated with employee compensation. It first sets forth the rules governing the taxation of compensation in the absence of tax penalties that could alter the consequences under those rules. Part III next examines, in chronological order, the functionality of the tax penalty provisions that have been enacted to shape executive compensation: sections 280G and 4999 which apply to golden parachute payments, section 162(m) which applies to annual compensation, and section 409A which applies to nonqualified deferred compensation.

These penalties come in two forms: a denial of a deduction to the company for compensation it pays or the imposition of additional taxes on the compensation an executive receives. As to the former, many companies have reacted by modifying their compensation practices, but almost all evidence indicates that they did not do so in the way Congress envisioned. In the end, many companies continue to authorize large executive compensation packages that result in the imposition of significant tax penalties. As to the penalties imposed directly on the executive, this part also shows that they are ineffective because they can be contracted around through so-called "gross-up" agreements and other compensation measures. In this way, the executive can avoid bearing the financial burden of the penalties, but in doing so increases the company's compensation costs.

A company, however, cannot bear the financial burden of the penalties imposed on it or other increases in its costs. Only natural persons can bear the economic burden.[24] The question, then, is who bears the economic burden of the penalties. This is the focus of Part IV. As explained therein, increased corporate expenses due to tax penalties lower the corporation's after-tax profits (and hence the shareholders' return on equity) unless the burden is shifted elsewhere and thus offset.[25] The only other options are to shift the cost to consumers through higher prices or to workers through reduced wages or layoffs, or some combination thereof.[26] In sum, the economic burden of these tax penalties is either borne by shareholders, owners of capital, consumers, or workers.

The costs of these tax penalties are effectively an indirect (or hidden) tax on the individuals who ultimately bear the economic burden of the penalties. If the executives who are the target bore the burden in the form of reduced before or after-tax compensation, then the penalties would be successful in penalizing the appropriate individuals. As mentioned above, however, many targeted executives are able largely to shift the burden to others. In that way, the penalties miss their mark. If they are redirected toward other super-rich Americans then, under an ability to pay theory of taxation, policymakers should arguably be less concerned about the harm produced than if they were borne to some degree by those who are less well off.[27] But, Part IV goes on to show that rank-and-file Americans bear a portion of the economic burden. Thus, the costs of the penalties are effectively a tax increase on them.

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[24] *See infra* note 41 and accompanying text.

[25] As discussed in Part IV.C., a lower return on corporate equity could result in all capital owners bearing the burden of increased corporate expenses in the long run under an equilibrium economic incidence model.

[26] These affected categories, as discussed in this article, include vendors and other non-employees that provide services to a corporation.

[27] In this context, "harm" means bearing the economic burden of the penalties.

The risk that tax penalties on executive compensation are not only ineffective, but also run counter to other important domestic policies, in addition to harming one or all of the intended beneficiaries of these regulatory measures, means that they are an inappropriate policy tool that should no longer be used.[28] This does not mean, however, that the federal government should not pursue methods of controlling executive compensation if that is deemed a desirable goal: only that it should aim better to hit its intended target. Part V concludes with a few comments and suggestions in that regard.

II. TAX BURDEN: THE REAL PAYOR VERSUS THE NOMINAL PAYOR

When it comes to paying taxes, the person nominally making the payment is not always the person who is really forfeiting the money and thereby bearing the financial burden of the payment.[29] It is thus necessary to look past the nominal payor to ascertain "where the burden of taxes lies."[30] It is also necessary to look past the person on whom the tax is imposed in the first instance.[31]

In looking beyond the tax exterior, one of three situations is generally revealed. The first is the most transparent: the person who makes the payment is also the person on whom the Code imposes the tax and that same person bears the financial burden as well. A simple example is where a single individual, who is not a business proprietor, owes income tax to the federal

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[28] In other words, the premise behind a Pigouvian-type of tax is that it will correct a negative externality of a market activity or, at least, raise revenue that can be used to respond to the negative externality. With regard to the former, if a penalty has little to no corrective effect, and yet at the same time creates negative unintended and counter-productive effects, then Congress should repeal such a provision. This argument, accordingly, does not necessarily mean that tax penalties as a general proposition should never be used, or even that they should not be used if borne to some extent by innocent parties. It does mean that tax penalties should only be used where they are effective to a substantial extent in meeting their intended purpose. Some would go even further and argue that "tax penalties are policy tools that Congress should grasp only in exceptional cases: when it can establish that the advantages of using the tax system outweigh the limitations inherent in tax penalty provisions." Zolt, *supra* note 12, at 344, 373 ("Tax penalties are simply too blunt an instrument to approximate the optimal fines required to deter efficiently.").

It is generally beyond the scope of this article to discuss the use of tax penalties on executive compensation to raise revenue to counteract the negative effects of the targeted undesirable activity. Nevertheless, the first issue that arises is identifying the specific negative effects Congress was aiming to correct. This will be explored in a future article. *See supra* note 22. Assuming, for now, that growing income inequality was at least one of the motivations for these provisions, then it would appear that, at a minimum, the revenue collected from these penalties is not having a significant countervailing effect as evidence indicates that income inequality continues to grow at an accelerating rate. *See generally* Martin J. McMahon, Jr., *The Matthew Effect and Federal Taxation*, 45 B.C. L. REV. 993 (2004) (exploring evolution of income inequality); Jason Bordoff & Jason Furman, *Progressive Tax Reform in the Era of Globalization: Building Consensus for More Broadly Shared Prosperity*, 2 HARV. L. & POL'Y REV. 327, 360 (2008) ("In the past several decades, except for the latter half of the 1990s, the gains of our nation's growing prosperity have not been broadly shared but have rather accrued largely to those at the very top."); Chye-Ching Huang & Chad Stone, *Average Income In 2006 Up $60,000 For Top 1 Percent Of Households, Just $430 For Bottom 90* Percent, Center on Budget and Policy Priorities, Report, July 30, 2008, at 1 ("[T]he shares of the nation's income flowing to the top 1% and top 0.1% of households were higher in 2006 than in any year since 1928").

[29] *See* JOEL SLEMROD & JON BAKIJA, TAXING OURSELVES: A CITIZEN'S GUIDE TO THE DEBATE OVER TAXES 74-75 (4th ed. 2008) [hereinafter TAXING OURSELVES] (discussing ambiguity over who bears the burden of paying taxes).

[30] *Id.* at 74.

[31] *See id.*

government after filling out an annual income tax return, and then writes a check to the U.S. Treasury for the amount owed, mailing it to the IRS with her tax return. In this case, the Code imposes the income tax on her, she is the one to pay it nominally, and it is her money that is forfeited in payment.[32]

The second type of situation is less transparent, but relatively easy to analyze. Here, the person who makes the payment is not the person on whom the Code imposes the tax. Nevertheless, the person on whom the tax is imposed is the one to bear its financial burden. For example, when an employer withholds money from an employee's paycheck and forwards it on to the IRS as payment of income tax, the employer is neither paying its own income tax nor forfeiting its own money to pay someone else's income tax.[33] Nominally, the employer is the one paying the income taxes to the IRS, but really the employer is facilitating the payment of the employee's income tax obligation.[34] The employer does this by taking ("withholding") the employee's funds and remitting them to the IRS on behalf of the employee.[35] In this way, it is the employee who has less money after paying the income tax that the Code imposes on her.

The third type of situation is the most obscure. In this case, the person who nominally makes the payment may or may not be the person on whom the Code imposes the tax. Either way, the person on whom the tax is imposed does not ultimately bear its financial burden. Instead, the burden is shifted to others.

A classic example of this third situation is the payroll tax system. The Code imposes payroll taxes on both the employer and the employee. Under the most prominent payroll taxes, the social security tax and medicare tax (combined, the "social security taxes"), each party must pay an amount equal to 7.65 percent of the individual employee's wages paid during 2008 up to $102,000, and 1.45 percent of wages above that level.[36] For example, an individual earning $100,000 would pay $7,650 to the federal government, and her employer would also pay $7,650, for a total payment of $15,300.

Notwithstanding the fact that the Code imposes payroll taxes on both the employer and employee, it is widely believed that "workers in competitive labor markets bear through lower

[32] *See* I.R.C. § 1(c) (imposing income tax on unmarried individuals).

[33] *See, e.g.,* George Loewenstein & Ted O'Donoghue, *"We Can Do This The Easy Way or The Hard Way:" Negative Emotions, Self-Regulation, and the Law*, 73 U. CHI. L. REV. 183, 199 (2006) (discussing employers' withholding of income tax from paychecks). *See also* I.R.C. § 3402 ("[E]very employer making payment of wages shall deduct and withhold upon such wages a tax . . . .").

[34] *See, e.g.,* TAXING OURSELVES, *supra* note 29 at 75 (discussing method whereby employer withholds income taxes from employee's paycheck and sends to IRS on behalf of employees); Edward J. McCaffery, *The UCLA Tax Policy Conference: Cognitive Theory and Tax*, 41 UCLA L. REV. 1861, 1879 (1994) (discussing law requiring employer to withhold employee's share of income tax from paycheck).

[35] *See* McCaffery, *supra* note 35, at 1879.

[36] *See* I.R.C. § 3101 (imposing social security (OASDI) and medicare (HI) taxes on employees); I.R.C. § 3111 (imposing social security (OASDI) and medicare (HI) taxes on employers); Social Security Administration News Release (October 17, 2007) available at http://www.ssa.gov/pressoffice/pr/2008cola-pr.htm. (announcing that the taxable wage base for the social security tax in 2008 is $102,000). For the definition of "wages" and "employment," *see* I.R.C. § 3121(a)-(b).

wages the cost of all payroll taxes, including the employer's share."[37] In this way, it is the employee who has less money after the employer pays its payroll taxes, not the employer. Following on the above example, this belief is premised on the theory that the employer would be willing to pay the employee up to $107,650 in a world where there are no social security taxes. However, in the presence of a 7.65 percent tax imposed on employers, it would only be willing to pay the employee up to $100,000, as it would also have to pay $7,650 to the government.[38] In that way, the employer shifts its burden of paying social security taxes to the employee. "The phenomenon that taxes that are ostensibly levied on one group of people may end up being borne by others is known as tax shifting, and who ultimately ends up bearing the burden is called by economists tax incidence."[39]

To extend this discussion of tax shifting and tax incidence a step further, note that artificial legal entities, such as corporations, can act only through natural persons.[40] As such, a corporation cannot bear the burden (or the incidence) of taxes; only natural persons can bear the economic burden.[41] That raises the question of which individuals bear the burden of taxes imposed on artificial legal entities. The answer to that question will be discussed in Part IV, in the specific context of assessing who bears the financial burden of tax penalties imposed as a consequence of executive compensation practices. The next section focuses on where the Code nominally imposes the burden of taxes associated with compensation.

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[37] Yin et al., *Improving the Delivery of Benefits to the Working Poor: Proposals to Reform the Earned Income Tax Credit Program*, 11 AM. J. TAX POL'Y 225, 290 (1994) (citing C. Eugene Steuerle & Paul Wilson, The Taxation of Poor and Lower-Income Workers, 34 Tax Notes 695, 700-01, n.11 (1987)). See also President's Advisory Panel On Tax Reform, SIMPLE, FAIR, AND PRO-GROWTH: PROPOSALS TO FIX AMERICA'S TAX SYSTEM 29 (2005), *available at* http://www.taxreformpanel.gov/final-report/ [hereinafter Tax Reform Report] (noting that "the burden of the employer's portion of the payroll tax is [believed to be] largely passed on to employees in the form of lower wages"); Maureen B. Cavanaugh, Comment, *On the Road to Incoherence: Congress, Economics, and Taxes*, 49 UCLA L. REV. 685, 696-97 (2002) (citing Ronald G. Ehrenberg & Robert S. Smith, MODERN LABOR ECONOMICS: THEORY AND PUBLIC POLICY 84-87 (6th ed. 1997)) (explaining how employees bear burden of payroll tax through lower wages and lower employment levels); McCaffery, *supra* note 34, at 1875-76 (1994) (describing social security contributions by employer as type of hidden tax because employer's contribution comes at cost of lower pay for employee).

[38] *See*, *e.g.*, TAXING OURSELVES, *supra* note 29, at 75 (explaining that employers will adjust salary they are willing to pay to account for taxes imposed on them); McCaffery, *supra* note 34, at 1878-79 (explaining that it does not matter whether employer or employee is target of social security tax because, ultimately, employee only gets money left after taxes are paid).

[39] TAXING OURSELVES, *supra* note 29, at 76.

[40] Trustees of Dartmouth Col. v. Woodward, 17 U.S. 518, 636 (1819) ("A corporation is an artificial being, invisible, intangible, and existing only in contemplation of law."); Providence Bank v. Billings, 29 U.S. 514, 562 (1830) ("The great object of an incorporation is to bestow the character and properties of individuality on a collective and changing body of men.").

[41] *See, e.g.,* ALAN J. AUERBACH, WHO BEARS THE CORPORATE TAX? A REVIEW OF WHAT WE KNOW 2 (Nat'l Bureau of Econ. Research, Working Paper No. 11686, 2005) (noting "cardinal rule of incidence analysis that only individuals can bear the burden of taxation and that all tax burdens should be traced to individuals"); Andrew B. Lyon, CRACKING THE CODE: MAKING SENSE OF THE CORPORATE ALTERNATIVE MINIMUM TAX 49 (1997) ("Clearly only people can ultimately bear the burden of the corporate tax through their roles as savers and investors, workers, and consumers."); Katherine Pratt, *The Debt-Equity Distinction in a Second-Best World*, 53 VAND. L. REV. 1055, 1101 (2000) ("Aggregate views of the corporation began to emerge as economic and legal commentators noted that corporate entities do not bear the economic burden of the corporate tax because only natural persons can bear economic burdens."); TAXING OURSELVES, *supra* note 29, at 78-79 (discussing how corporation's stockholders, employees, or customers bear burden of corporate taxes).

III. THE TAXATION OF COMPENSATION

Executive compensation packages have evolved in an ad hoc manner over the course of the last century in response to changing market forces, firm structure, public opinion, and governmental regulation.[42] Presently, the label "executive compensation" encompasses a wide variety of arrangements that are, in theory, carefully crafted by each company to recruit and retain the best executive talent available, and then to align executive interests with shareholder interests.[43] These are not the only considerations; tax law, corporate law, securities law, and accounting principles all play a role in the design of an executive compensation package.

Tax law, however, did not play a directly regulating role prior to the mid-1980s.[44] Before then, the federal government regulated executive compensation largely through media outside of the Code.[45] This does not mean that the Code did not apply to executives or their employers, and thus did not have any affect on an executive's after-tax compensation (*i.e.*, the final amount the executive has available to spend, save, or invest after taxes are paid). On the contrary, it applied, but in the same way it applied to all taxpayers.[46] In other words, the Code's influence was limited to the rules governing the taxation of all compensation, executive or otherwise; it did not alter the generally applicable rules in order to tax executive compensation differently solely because it was compensation paid to executives.[47]

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[42] *See* Detlev Vagts, *Challenges to Executive Compensation: For the Markets or For the Courts?*, 8 J. CORP. L. 231, 245 (1983) (discussing factors that have shaped modern executive compensation packages); *see also* Marlo A. Bakris, *Executive Compensation Disclosure: The SEC's Newest Weapon in its Arsenal Against Executive Compensation Abuses*, 71 U. DET. MERCY L. REV. 105, 114 (1993) (listing tax laws, government regulations, and "economic changes" as factors in evolution of executive compensation).

[43] For further discussion of the factors involved in setting an executive's compensation, *see generally* LUCIAN BEBCHUK & JESSE FRIED, PAY WITHOUT PERFORMANCE: THE UNFULFILLED PROMISE OF EXECUTIVE COMPENSATION (Harvard Univ. Press 2004). *See also supra* note 4 and accompanying text.

[44] A question that might be raised at this point is whether the 1980s is an appropriate reference date inasmuch as section 162(a)(1), which imposes a reasonableness limit on compensation deductions, was enacted before the 1980s. Note 90, *infra*, explains why this article treats section 162(a)(1) differently than the other Code provisions discussed herein.

[45] Up until the 1980s, these efforts fell into two broad categories: mandated disclosures and salary limits at companies doing business with the government. Discussion of these efforts is beyond the scope of this article, but *see generally* MARK H. LEFF, THE LIMITS OF SYMBOLIC REFORM: THE NEW DEAL AND TAXATION, 1933-1939 at 74-90 (Cambridge University Press 1984) (discussing New Deal attempts to curtail executive compensation levels). Some view the sharp increase in marginal tax rates during the 1930s as an attempt to use the Code to regulate executive compensation. *See* Elson, *supra* note 8, at 938-939 (noting response to executive compensation levels in 1930s was to raise income tax rates on high-income taxpayers and that executive compensation issue was thereafter dormant until 1980s). While this is not exactly untrue, such action was also not limited to affecting executives but applied to all high income taxpayers.

[46] Code section 7701(a)(14) defines the term taxpayer as "any person subject to any internal revenue tax," and Code section 7701(a)(1), in turn, defines the term person to include "an individual, a trust, estate, partnership, association, company or corporation." Thus, here, the term taxpayer is used to refer to both the executive and his employer. The Code applies to both executives and their employers, and through them, executive compensation levels or after-tax executive compensation levels are affected.

[47] Nevertheless, some executives received compensation in forms not generally payable to rank-and-file employees and such compensation, in that way, may have been subject to non-punitive tax provisions not generally applied to rank-and-file employees. *See, e.g.,* I.R.C. § 83 (applying to transfers of property for services, such as restricted stock).

Starting in 1984, however, and then every decade thereafter, Congress has enacted a tax penalty provision aimed at shaping executive compensation.[48] Two of the provisions, discussed in subsection B, impose a penalty on the company paying the compensation (sections 280G and 162(m)), while two others impose a penalty on the executive receiving the compensation (sections 4999 and 409A). Each provision alters what would otherwise be the normal operating tax rules in order to penalize the targeted taxpayer conduct.[49] Thus, before the functionality of the tax penalties can be examined, it is useful to discuss those baseline rules.[50]

A. An Overview

In a compensation transaction, the tax consequences must be determined for both parties to the transaction: the employer (or payor) and the employee (or payee). The rules applicable to each are discussed in turn briefly below. It is assumed, for purposes of this subsection, that the compensation paid to an employee is not subject to any of the tax penalties that are discussed in subsection B.

1. Employees

In computing federal income tax liability, each individual employee must include in gross income the amount he or she receives as compensation for performing services.[51] A wide variety of employee benefits are, however, excluded from gross income (*i.e.*, are not subject to federal income tax), such as payments an employer makes to provide the employee with health insurance or qualified discounts the employer provides on the purchase of its products.[52] With regard to compensation that is not excludable, the critical question is one of timing: when must such compensation be included in gross income.[53]

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[48] It is beyond the scope of this article to analyze why the Code was used to regulate executive compensation in this way. Professor Edward Zelinsky suggests it is easier to enact regulating legislation as tax legislation because it avoids other substantive committees in Congress, has become a yearly affair, and is usually cumbersome and technical, so it is relatively easier to get legislation enacted that might not otherwise pass muster. *See supra* note 20 (commenting, too, that approach is bad because it avoids consideration of the real issues, increases administrative costs, and grants regulatory authority to those lacking expertise in area).

[49] *See supra* note 13 (defining the phrase "normal operating tax rules" for purposes of this article).

[50] This article discusses the tax consequences of both current and deferred compensation. It does not address, however, certain types of compensation found within both categories, such as fringe benefits, stock-based compensation, and life insurance arrangements (split-dollar or corporate-owned). Accordingly, the current compensation discussion is largely limited to base salary, and the discussion of deferred compensation is essentially limited to the deferral of cash to a qualified plan and the deferral of cash or a promise to pay outside of a qualified plan.

[51] I.R.C. § 61(a)(1). *See also* Treas. Reg. §1.61-1(a) ("[G]ross income includes income in any form, whether in money, property, or services.") and Treas. Reg. §1.162-2(d) (compensation paid other than in cash).

[52] *See* I.R.C. § 106 (employer contributions to an accident and health plan) and §132(a)(2) & (c) (qualified employee discount). *See also* Treas. Reg. § 1.162-2(a) (listing Code provisions specifically excluding items from gross income and also provisions specifically including items in gross income).

[53] Under time value of money principles, it is generally more advantageous for a taxpayer to defer the inclusion of income to a later taxable period, but claim deductions in the earliest allowable year. *See generally* William D. Andrews, *A Consumption-Type Or Cash Flow Personal Income Tax*, 87 HARV. L. REV. 1113, 1123-24 (1974); Gregory M. Beil, *Internal Revenue Code Section 197: A Cure For The Controversy Over The Amortization Of Acquired Intangible Assets*, 49 UNIV. MIAMI L. REV. 731, 737 (1995).

The answer depends on the method of accounting that the taxpayer uses.[54] Individuals typically use the "cash receipts and disbursements" method of accounting.[55] Under that method, individual taxpayers generally include an item in income for the taxable year it is received.[56] Thus, wages and other taxable employee benefits that are received as they are earned are currently includable.

Receipt under the cash method, however, is not limited to actual receipt; it includes items that are constructively received as well.[57] Constructive receipt occurs when compensation has been made available to the taxpayer without substantial limitations or restrictions, but the taxpayer chooses to defer actual receipt to a later point in time.[58] In that situation, the taxpayer must include it in income, even though he does not have physical possession of it, because he had control over receipt of the deferred payment and thus received it constructively.[59]

By way of an example, assume Paula is a small business owner who regularly uses a particular repairman, Tom, as needs for his services arise. Both taxpayers use the cash method of accounting. Assume further that Tom does some work for Paula in December of Year 1. If Paula offers to write Tom a check at that time to compensate him for services rendered, and he requests instead that she hold off paying him until January of Year 2, then Tom has constructively received payment in December of Year 1. As such, he is subject to tax on that payment in Year 1, not Year 2 when it is actually received. In this situation, Tom is attempting to postpone the receipt of compensation in order to defer paying taxes on it. There are several reasons a taxpayer might want to do this. One would be that he expects his income will be subject to tax at a lower rate in a later year. Another could be that he wants to take advantage of time value of money principles by deferring inclusion of income.[60] The constructive receipt doctrine acts as an impediment to these types of tax planning.

Congress, however, looks favorably upon some deferred compensation arrangements. To help Americans save for retirement, it has expressly authorized a deferral of income tax on

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[54] *See* James E. Maule, *Deductions: Overview and Conceptual Aspects*, 503 TAX MGM'T PORTFOLIOS (BNA) A46 (2008). For further discussion of tax accounting methods, see *generally* George L. White, *Accounting Methods -- General Principles*, 570 TAX MGM'T PORTFOLIOS (BNA) (2008) (discussing permissible methods of accounting). *See also* I.R.C.§ 446 et seq. (Methods of Accounting).

[55] *See* I.R.C. §446(c)(1) [hereinafter, the "cash method"].

[56] *See* I.R.C. § 451(a).

[57] *See* Treas. Reg. §§ 1.446-1(c)(1)(i), 1.451-1(a), and 1.451-2.

[58] *See* Treas. Reg. § 1.451-2(a) ("Income although not actually reduced to a taxpayer's possession is constructively received by him in the taxable year during which it is credited to his account, set apart for him, or otherwise made available so that he may draw upon it at any time, or so that he could have drawn upon it during the taxable year if notice of intention to withdraw had been given. However, income is not constructively received if the taxpayer's control of its receipt is subject to substantial limitations or restrictions."). There are, of course, certain situations in which a taxpayer may refuse receipt of income without triggering tax consequences, such as refusing to receive a prize. *See, e.g.*, Revenue Ruling 57-374, 1957-2 C.B. 69 ("Where an individual refuses to accept an all-expense paid vacation trip he won as a prize in a contest, the fair market value of the trip is not includible in his gross income.").

[59] *See* Treas. Reg. § 1.451-2(a); *but see* Comm'r v. Giannini, 129 F.2d 638, 641 (9th Cir. 1942) (concluding unqualified refusal to accept further compensation for calendar year, with mere suggestion for its disposition, resulted in no income to taxpayer).

[60] *See supra* note 53.

compensation deferred under a "qualified plan," such as a 401(k) retirement savings plan.[61] These plans are so named because they must meet certain qualification requirements to receive the favorable tax treatment.[62] The qualification requirements are designed, in part, to ensure that employers who sponsor a qualified plan for their employees do so in a broad-based manner.[63]

If the qualification requirements are met, employees receive two principal tax benefits.[64] First, contributions to the plan are not included in the employees' income until received by the employee at some later date.[65] Second, investment earnings on the contributions accumulate tax-free and are not subject to tax until later distributed to the employee.[66]

There are limits, however, to the amount of compensation that can be deferred under a qualified plan.[67] Thus, many employers seeking to provide greater incentives[68] to their executives frequently choose to provide "nonqualified" deferred compensation benefits, which are not subject to a dollar denominated limitation, in addition to qualified benefits.[69]

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[61] *See* I.R.C. §§ 401(a), 401(k), and 501(a). Although there are a number of specific types of qualified plans, there are two broad general categories: defined contribution plans and defined benefit plans. Under § 414(i), a "defined contribution plan" is "a plan which provides for an individual account for each participant and for benefits based solely on the amount contributed to the participant's account, and any income, expenses, gains and losses, and any forfeitures of accounts of other participants which may be allocated to such participant's account." A defined benefit plan is defined under the Code as any plan that is not a defined contribution plan. I.R.C. § 414(j). Generally, a defined benefit plan promises the participant a specific sum (whether stated or based on a formula) at retirement. For more on the differences between defined contribution and defined benefit plans, see *generally* Zelinsky, *supra* note 15 (discussing fundamental differences between defined contribution and defined benefit plans). The discussion in this article is generally limited to defined contribution-type arrangements, whether qualified or nonqualified, for the reasons discussed in note 252, *infra*.

[62] *See* I.R.C. § 401(a). In addition, qualified plans are also governed by the rules of the Employees Retirement Income Security Act of 1974 ("ERISA"), which impose, for example, various reporting and disclosure obligations on employers.

[63] In other words, the plan must cover rank-and-file employees in addition to executives, and benefits must be provided under the plan in a nondiscriminatory fashion. *See* I.R.C. §§ 401(a) & (m) (nondiscrimination) and 410 (coverage and nondiscrimination). Other qualification requirements include rules regarding funding and vesting. *See* I.R.C. §§ 401(a) (funding), 411 (vesting), and 412 (funding).

[64] Qualified plans also provide participants with a significant non-tax benefit. Assets of a qualified plan are required to be held in a trust that cannot be reached by the employer's creditors and "for the exclusive benefit of . . . employees or their beneficiaries." I.R.C. § 401(a).

[65] *See* I.R.C. § 402(a) (taxable when distributed according to section 72). Notwithstanding the foregoing, as of 2006, employers who sponsor certain retirement plans (such as a 401(k) plan) have the option of incorporating a Roth contribution program into their plans. *See* Economic Growth and Tax Relief Reconciliation Act of 2001 (EGTRRA), Pub. L. No. 107-16 § 617(a) (enacting Code § 402A); Pension Protection Act of 2006, Pub. L. No. 109-280 (2006) (making §402A permanent); I.R.C. § 402A . A Roth contribution program allows employees to elect to make all or a portion of their plan contributions on an after-tax basis, with investment earnings and withdrawals being tax-free. *See id.*

[66] *See* I.R.C. §§ 401(a), 402(a), and 501(a).

[67] *See* I.R.C. § 415 (providing an annual aggregate limit on contributions of $46,000 for defined contribution plans in 2008).

[68] *See*, *e.g.*, Michael Doran, Executive Compensation Reform And The Limits Of Tax Policy, 2004 Tax Notes Today (Dec. 29, 2004), LEXIS, 2004 TNT 250-21 (discussing various rationales for deferred compensation packages).

[69] Prior to 2004, the Code did not provide a definition of the phrase "nonqualified deferred compensation plan." Now, Code section 409A provides for purposes of that section, the phrase "nonqualified deferred compensation plan" means "any plan that provides for the deferral of compensation, other than a qualified employer

Nonqualified plans make no attempt to meet the Code's qualified plan requirements.[70] Accordingly, Congress's grant of income tax deferral for amounts deferred under a qualified plan does not extend to compensation deferred under a nonqualified plan.

To sidestep current income taxation, taxpayers deferring compensation under a nonqualified plan must avoid application of the constructive receipt doctrine.[71] They must also avoid application of related doctrines that have been developed by the courts, Congress, and the IRS to deal with similar situations.[72] As a practical matter, it is fairly easy to design a nonqualified plan that avoids these rules and thus sidesteps current inclusion of deferred compensation in the employee's gross income. Such arrangements are generally, but not always, "unfunded."[73] For tax purposes, unfunded means that amounts have not been set aside by the employer for the exclusive benefit of the employee. In other words, the deferred compensation at a minimum remains subject to the claims of the employer's creditors, even if the deferred compensation is segregated from the employer's general assets or held in a trust.[74] Additionally, funded arrangements may avoid current inclusion in gross income if the deferred compensation

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plan, and any bona fide vacation leave, sick leave, compensatory time, disability pay, or death benefit plan." I.R.C. § 409A(d)(1). Section 409A is discussed further *infra* Part III.B.3.

[70] In addition, most nonqualified plans are relieved from the vast majority of ERISA's requirements. *See* 29 U.S.C. §§ 1003(b)(5), 1051(2), 1081(a)(3), and 1101(a)(1). *See also supra* note 62.

[71] *See supra* notes 58-59 and accompanying text (discussing constructive receipt of income).

[72] For example, a similar situation exists where the employee receives a promise by the employer to pay compensation in the future. Receipt of a mere promise to be paid in the future is not generally income to a cash method taxpayer. *See*, *e.g.*, Rev. Rul. 68-606, 1968-2 C.B. 42 ("Certain evidences of indebtedness are property deemed to be equivalent to cash, but not all evidences of indebtedness are property the fair market value of which is includible in the income of a taxpayer on the cash receipts and disbursements method of accounting."). It may, nevertheless, have value. If the employee can realize its value by selling it for cash – in other words, if the promise is transferable – then the promise to pay is a "cash equivalent" and its receipt is taxable. *See id.* (applying cash equivalency doctrine). *See also* Cowden v. Commissioner, 289 F.2d 20, 23-25 (5th Cir. 1961) (discussing cash equivalency doctrine). If the promise is not transferable, but its value can be determined and the employee's right to payment is vested, secured, or not subject to a substantial risk of forfeiture, then it may also be subject to tax on receipt. *See*, *e.g.*, *Sproull* v. Commissioner, 16 T.C. 244, *aff'd* 194 F.2d 541 (6th Cir. 1952) (applying economic benefit doctrine); Rev. Rul. 60-31, 1960-1 C.B. 174 Ex. 4. (same); I.R.C. § 83 (codifying the economic benefit doctrine where property is transferred as compensation for services); §402(b) (applicable to employer contributions to a taxable trust). This is because the employee has received the "economic benefit" of the promise to pay. *See id. See also generally*, Kathryn J. Kennedy, *A Primer On The Taxation Of Executive Deferred Compensation Plans*, 35 J. MARSHALL L. REV. 487 (Summer 2002) (discussing each of the cited provisions and doctrines).

In 2004, Congress enacted Code section 409A, a provision that several commentators view as a supplement to the constructive receipt and economic benefit doctrines. *See infra* note 194. Where applicable, section 409A prescribes a number of specific requirements and also imposes a penalty for failure to meet those requirements. As to the latter, section 409A is one of the tax penalties within the scope of this article and is discussed *infra* Part III.B.3. For more on the new requirements of section 409A, *see generally* David G. Johnson & Elizabeth Buchbinder, *Long-Awaited Final Regulations Under Code Sec. 409A Are Issued As Transition Relief Nears an End*, TAXES--THE TAX MAGAZINE, at 29-35 (Sept. 2007) (discussing basic requirements of 409A).

[73] Only a select group of management or highly compensated employees may participate in an unfunded nonqualified plan. *See* 29 U.S.C. §§ 1051(2), 1081(a)(3), and 1101(a)(1).

[74] Such an arrangement generally avoids current taxation under the constructive receipt doctrine of section 451.

is subject to a substantial risk of forfeiture and is nontransferable.[75] In either case, the employee bears some measure of risk that he or she may not receive the deferred compensation.[76]

In summary, compensation that is paid to an employee as it is earned is currently includable in gross income. Compensation the employee defers receipt of to some point in the future well beyond the period when earned may or may not be currently includable. If the compensation is deferred pursuant to a qualified plan, then income tax is also deferred until the compensation is later received by the employee. If the compensation is otherwise deferred (*i.e.*, nonqualified), then either (1) the employee bears some measure of risk of loss of the deferred compensation and thus it is *not* subject to current inclusion in gross income, or (2) the employee bears no significant risk of loss of the deferred compensation and thus it *is* subject to current inclusion in gross income.

Whenever compensation is ultimately included in income, it will be taxed at ordinary income rates.[77] Congress, however, enacted legislation imposing a penalty tax, in addition to the ordinary income taxes otherwise normally due, on certain components of the typical executive compensation package. In 1984, Congress enacted section 4999, which is applicable to payments made pursuant to a "golden parachute" agreement.[78] Ten years later, Congress enacted section 409A, which is applicable to nonqualified deferred compensation.[79] Both of these provisions are discussed in subsection B.

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[75] Such an arrangement generally avoids current taxation under section 83.

[76] Again, as a practical matter, these arrangements can usually be designed so as to provide a significant amount of security to the employee. Today, the vehicle of choice is usually a "rabbi trust," which is essentially an irrevocable grantor trust. *See* Priv. Ltr. Rul. 8113107 (Dec. 31, 1980) (approving first rabbi trust agreement); Rev. Proc. 92-64, 1992-2 C.B. 422 (providing model rabbi trust agreement). Although security is provided in that the trust is irrevocable by the employer, it still can be reached by the employer's creditors, especially in light of new restrictions imposed by section 409A which limit offshore rabbi trusts and prohibit provisions that would trigger full funding of the deferred compensation upon certain events linked to the employer's financial condition. *See* I.R.C. §§ 409A(b)(1) & (2).

[77] *See generally* I.R.C. §§ 1 (tax imposed) and 55 (alternative minimum tax). Of course this is after application of any available deductions or credits. *See generally* I.R.C. §§ 63 (taxable income defined), & 21-54 ("Credits Against Tax"). Compensation may also be subject to other taxes such as state income taxes or payroll taxes.

[78] *Deficit Reduction Act of 1984*, P.L. 98-369, 98 Stat. 494 (1984) [hereinafter DEFRA]. Note that section 4999 can apply to highly compensated employees of non publicly held companies, but its application is limited. *See infra* note 116.

[79] American Jobs Creation Act of 2004, Pub. L. No. 108-357, 118 Stat. 1418 (2004) [hereinafter AJCA]. Note that section 409A's application is broader than the executive class. *See* I.R.C. §§ 409A(d)(1) &(3) (defining nonqualified deferred compensation plan); Treas. Reg. § 1.409A-1(f) (defining service provider for purposes of section 409A). Subject to exceptions, it applies to anyone receiving nonqualified deferred compensation, within the meaning of the statute, in exchange for providing services, which is one of the criticisms levied against the provision. *See id.* *See also* Drennan, *supra* note 6, at 3-4 ("409A applies to all employers and employees, rather than just the top executives at publicly held corporations!"); Treas. Reg. § 1.409A-2(a)(14) (providing relief from the application of section 409A in certain cases where service providers, such as teachers, engage in the common practice of receiving nine or ten months of compensation over a 12-month period). Nevertheless, the impetus for enactment was certain executive compensation practices that came to light in the aftermath of the collapse of Enron. *See infra* Part III.B.3. In that way, it was aimed mainly at executives even though it could affect some non-executives as well.

2. Employers

Section 162 allows the company a deduction for the compensation it pays to its employees.[80] More specifically, section 162(a) allows companies to deduct from their income all the "ordinary and necessary" business expenses they paid or incurred during the taxable year, including any compensation paid to employees.[81] The employee compensation deduction is, however, limited by section 162(a)(1) to a "reasonable allowance" "for personal services actually rendered."[82] The regulations under section 162 reiterate that "the test of deductibility in the case of compensation payments is whether they are reasonable and are in fact payments purely for

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[80] "Generally, no item is allowable as a deduction unless a statutory provision so provides." Maule, *supra* note 54 at A1. *See also* I.R.C. §§ 63(a) & (b). Further, the courts view deductions as a matter of "legislative grace," and thus "the burden of clearly showing the right to [a] claimed deduction is on the taxpayer." INDOPCO, Inc. v. Comm'r, 503 U.S. 79, 84 (1992) (citation omitted). Even where a provision exists, such as section 162, allowing a deduction, "a variety of limitations and restrictions cause otherwise deductible amounts to be nondeductible." Maule, *infra* at A1. The following is a non-exhaustive list of Code provisions that could apply to limit, restrict, deny, or affect the timing of a compensation deduction: § 83(h) (transfers of restricted property); § 162(a)(1) (reasonableness, discussed *infra*), § 263 (capital expenditures), § 267(a)(2) (payments to a "related" taxpayer), § 404 (deferred compensation, discussed infra), § 421(a)(2) (incentive stock options and employee stock purchase plans). Also, compensation payments made in violation of public policy are not deductible. *See, e.g.*, I.R.C. § 162(c) (disallowing business expense deduction for illegal bribes, kickbacks, and other payments); Anne E. Moran, *Reasonable Compensation*, 390 TAX MGM'T PORTFOLIOS (BNA) A27-A28 (2007) (explaining how compensation payments "that are both reasonable in amount and made for services" are not deductible when in violation of public policy, and listing payments to labor racketeers, bribes and expenses connected to illegal sales of drugs as examples).

[81] Note that section 404 disallows an employer's deduction for deferred compensation that is otherwise allowable under section 162 unless the deferred compensation meets the requirements of section 404 as well. *See* I.R.C. § 404(a). An employer can thus only deduct deferred compensation that satisfies the requirements of both sections 162 and 404.

[82] The reasonable compensation rule applies to current and deferred compensation in the aggregate. *See* Treas. Reg. § 1.404(a)-1(b) ("In no case is a deduction allowable under section 404(a) [for deferred compensation] for the amount of any contribution for the benefit of an employee in excess of the amount which, together with other deductions allowed for compensation for such employee's services, constitutes a reasonable allowance for compensation for the services actually rendered."); Edwin's, Inc. v. U.S., 501 F.2d 675 (7th Cir. 1974) (holding that pension payments must be considered when determining whether total compensation is reasonable).

There is disagreement over the original purpose for enactment of the statutory predecessor to section 162(a)(1) in the Revenue Act of 1918. Some commentators believe it was enacted to expand the scope of section 162(a) to allow a deduction in certain situations where no (or little) compensation was paid for services rendered and "that there is no foundation in the statute for its use as a means of restricting the deduction of amounts which had actually been paid." *See* Erwin Griswold, *New Light on "A Reasonable Allowance for Salaries,"* 59 HARV. L. REV. 286, 290 (1945); Boris I. Bittker & Lawrence Lokken, FEDERAL TAXATION OF EMPLOYEE COMPENSATION ¶ 6.1, at 6-2 (2004) [hereinafter Bittker & Lokken] (suggesting provision may have been added "to permit closely held enterprises to deduct an allowance for excess profits tax even if no salary was actually paid"). Others appear to be of the opinion that it was enacted to codify existing regulatory provisions discussing the nature of deductible compensation (the substance of which remain substantially the same today), and was not meant to allow deductions where no compensation had been paid. *See* Moran, *supra* note 80 at A1-A2. All agree, however, on the following two points related to IRS regulations and practice prior to enactment: (1) companies in the relevant circumstances were allowed to deduct as compensation an amount that had not been paid, and (2) a deduction could be denied for amounts actually paid if in substance the payment was not compensation for services but an otherwise nondeductible distribution such as a dividend. *See id.*; Bittker & Lokken, *supra*, ¶ 6.1 at 6-2.

services."[83] Whether this test has been met is a fact-specific inquiry dependent on a variety of factors.[84]

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[83] Treas. Reg § 1.162-7(a). It thus appears that section 162(a)(1) and the regulations thereunder provide a two-part test for determining the deductibility of compensation: it must be both reasonable and paid purely for services. There appears, however, to be some disagreement over the interaction and relative importance of each prong of the two-part test. Several commentators have noted that the courts tend to focus primarily on the first prong: determining whether the amount of compensation is reasonable. *See* Stabile, *supra* note 11 at 85 ("Although the Regulations seem on their face to envision a two-part test, in reality, the primary inquiry is whether the amount of compensation in question is reasonable, since courts will infer from that conclusion the existence of a compensatory purpose."); Moran, *supra* note 80 at A3 ("The courts rarely invoke the intent test. Rather, the courts typically analyze reasonable compensation issues under the amount test . . . This is because compensatory intent often is inferred upon a determination that the compensation at issue is reasonable."). Meanwhile, others view the two prongs as inextricably linked and therefore one cannot be considered without considering aspects of the other. *See* Bittker & Lokken, *supra* note 82, ¶ 6.1 at 6-3 ("In principle, whether an amount is paid for services and whether it is reasonable in amount are separate issues, but in practice it is virtually impossible to analyze them separately.").

In the end, however, it would seem that there is in substance less disagreement among commentators than initially appears to be the case. *See* Andrew W. Stumpff, *The Reasonable Compensation Rule*, 19 VA. TAX REV. 371, 379 (1999). Even though many perceive the amount test to be of primary importance, all agree that the IRS rarely pursues litigation unless the IRS suspects the payments are not "purely for services" but "camouflage" an otherwise nondeductible distribution such as dividends. *See* Bittker & Lokken, *supra* note 82, ¶ 6.1 at 6-3; Stumpff, *supra* at 380 (discussing use of section 162 to reveal non-compensatory payments disguised to be compensatory); Barbara F. Sikon, Note, *The Recharacterization of Unreasonable Compensation: An Equitale Mandate*, 51 CLEV. ST. L. REV. 301, 303 (2004) ("The deduction limitation of section 162 has been applied historically in a manner that illuminates a singular purpose, that is, to unveil payments of a non-compensatory nature that have been disguised as compensation to create a tax benefit."); Edward A. Zelinsky, *Reasonable Compensation: A Study in Doctrinal Obsolescence*, 58th NYU Inst. 11 (2001) *available at* http://papers.ssrn.com/paper.taf?abstract_id=254928; Meredith R. Conway, *Money for Nothing and the Stocks for Free: Taxing Executive Compensation*, 17 CORNELL J. L. & PUB. POL'Y 383, 392 (2008) ("[Courts] have applied the standard primarily to limit payments by closely held companies where those companies have tried to disguise nondeductible dividends as compensation which would be deductible."). In other words, the second prong is what motivates the IRS. *See, e.g.*, Zelinsky, *supra* ("Thus, in the final analysis, the reasonable compensation doctrine is today an anomaly, in practice a narrowly focused effort to extract a second, entity level tax on the income from those closely-held corporations unable to shift to the now dominant, one-tax regime for closely-held business income."). This may be obscured, however, because the courts in reasonable compensation cases claim to be assessing the amount prong. *See* Stumpff, *supra* at 400 ("If courts were more willing to accept that the true object of inquiry for the deduction question is the character of a payment rather than its amount, they could acknowledge that in certain cases"). In reality, the factors the courts assess to determine whether an amount is reasonable appear to be a proxy for determining whether the amount is really compensation for services or something else entirely. *See id.* at 401 (noting contrast in rule as applied and as stated); Sikon, *supra*. *See also infra* note 84 (discussing reasonable compensation).

[84] *See, e.g.*, Treas. Reg. § 1.162-7(b)(3) ("In any event the allowance for the compensation paid may not exceed what is reasonable under all the circumstances. It is, in general, just to assume that reasonable and true compensation is only such amount as would ordinarily be paid for like services by like enterprises under like circumstances."). The courts generally use one of two approaches to determine whether compensation paid was reasonable under all the circumstances. Some courts consider a variety of factors, such as the employee's qualifications and the employee's compensation in comparison to similar employees in similar companies. *See, e.g.,* Mayson Mfg. Co. v. CIR, 178 F.2d 115, 119 (6th Cir. 1949) (setting forth a number of commonly considered factors). This is referred to as the "multi-factor" approach. Other courts will view the relevant facts through the lens of a hypothetical independent investor to assess whether such an investor, who would presumably be concerned with the rate of return on his investment, would have been amenable to the amount of compensation paid. *See, e.g.,* Elliotts, Inc. v. CIR, 716 F.2d 1241, 1245 (9th Cir. 1983) (independent investor test); Dexsil Corp. v. CIR, 147 F.3d 96, 101, 103 (2d Cir. 1998); Exacto Spring Corp. v. CIR, 196 F.3d 833, 836 (7th Cir. 1999) (criticizing multifactor approach). This is referred to as the "independent investor" approach. For more on the reasonable compensation rule, *see generally* Moran, *supra* note 80. Note that the IRS will not rule on whether compensation is reasonable in amount. *See* Rev. Proc. 2008-3, 2008-1 IRB 110, § 3.01(20).

Notwithstanding the foregoing, section 162(a)(1)'s reasonableness clause has rarely been used to challenge the amount of compensation paid to an employee in an arms length business relationship.[85] Instead, it has been used to police compensation levels where the employer and employee have a suspect relationship, such as where the employee is also a significant stakeholder in the business or a relative of a significant stakeholder.[86] In those situations, the concern is that the company is "artificially increasing employee compensation in an attempt to disburse profits in a deductible form, as opposed to a nondeductible form such as gifts or dividends."[87] This is most likely to occur in the context of a closely held business.[88] Conversely, compensation paid by a publicly held corporation is typically viewed as inherently reasonable.[89] Stated differently, the reasonableness clause has not been employed to limit the deductibility of compensation paid in the ordinary course to public company executives.[90]

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[85] *See, e.g.*, Treas. Reg. § 1.162-7(b)(2) ("Any form of contingent compensation invites scrutiny as a possible distribution of earnings of the enterprise . . . [but] if contingent compensation is paid pursuant to a free bargain . . . it should be allowed as a deduction even though . . . it may prove to be greater than the amount which would ordinarily be provided."); Bittker & Lokken, *supra* note 82, ¶ 6.1 at 6-2 to 6-4 ("If there is no extraneous relationship between employer and employee, the amount fixed by them as payment for the services is almost always ipso facto reasonable, since they meet the willing-buyer, willing-seller criterion used in determining the fair market value of goods and services."); Nathan Knutt, Note, *Executive Compensation Regulation: Corporate America, Heal Thyself*, 47 ARIZ. L. REV. 493, 494 (2005) (noting that courts have been unwilling to scrutinize compensation plans); Moran, *supra* note 80 at A12 ("There does not appear to be any case which holds that compensation paid in a truly arm's length situation was not intended as compensation."); Stumpff, *supra* note 83 at 373-74 (explaining how employers do not feel constrained by section 162(a) because it is rarely enforced); Zelinsky, *supra* note 83 ("While payments to managers of publicly-traded corporations have reached truly Olympian heights, the IRS has yet to challenge the reasonability, and thus the deductibility, of those payments.").

[86] *See* Bittker & Lokken, *supra* note 82, ¶ 6.1 at 6-3; Sikon, *supra* note 81 at 308 ("Challenges through section 162(a) have been reserved for closely held businesses, in which the owner can determine both the amounts and the characterizations of payments to employees."); Stabile *supra* note 11 at 96-97 (noting that reasonable compensation cases arise mostly with closely-held businesses).

[87] Miske, *supra* note 20, at 1676. *See also supra* note 83 (discussing two prong test for determining if compensation is reasonable).

[88] *See, e.g.*, Treas. Reg § 1.162-7(b)(1) ("Any amount paid in the form of compensation, but not in fact as the purchase price of services, is not deductible. An ostensible salary paid by a corporation may be a distribution of a dividend on stock. This is likely to occur in the case of a corporation having few shareholders, practically all of whom draw salaries."); Moran, *supra* note 80 at A3; Bittker & Lokken, *supra* note 82, ¶ 6.1 at 6-3. *See also supra* note 83; Graef S. Crystal, IN SEARCH OF EXCESS: THE OVERCOMPENSATION OF AMERICAN EXECUTIVES 89 (1991) (explaining that IRS targets businesses with small numbers of executives who own most or all shares of company and are capable of self-dealing); Stabile, *supra* note 11, at 85 ("IRS efforts to disallow deductions for compensation have generally been targeted at close corporations, where the executive is essentially setting her own salary and the allegation is that the amounts paid are unreasonable or are really disguised dividends and not compensation."); Vagts, *supra* note 42, at 257.

[89] *See* Moran, *supra* note 80, at A13 ("This suggests that any amount of compensation paid by a publicly held corporation should be per se reasonable. In this situation, the operation of the normal system of commercial checks and balances arguably is adequate to ensure a proper result so that review by the IRS generally is unnecessary.").

[90] On the rare occasions the IRS has attempted to pursue public companies, it has been unsuccessful. *See, e.g.*, Sikon, *supra* note 81, at 308 ("Although large corporations can make excessive salary payments, they are not attacked through section 162(a) because the character of the payments as compensation is not subject to dispute."); Stabile *supra* note 11 at 85 ("There are few cases, none of them recent . . ., in which the IRS has challenged compensation paid to executives of publicly-held companies.").

This article does not view section 162(a)(1) as a tax penalty within its ambit (regulating executive compensation) because the reasonable compensation rule (1) is not generally applied to publicly held companies, which are the focus of this article, and (2) is not used to challenge compensation for being too great in amount, it is

In any event, as above with regard to employee inclusion, determining when a company may deduct compensation is important. In contrast to individuals, corporations typically use the "accrual" method of accounting.[91] Under that method, expenses are deductible when "all the events have occurred that establish the fact of the liability, the amount of the liability can be determined with reasonable accuracy, and economic performance has occurred with respect to the liability."[92] Accordingly, compensation that is required to be paid as the employee earns it, is deductible when so paid. That is when the employer's obligation to pay becomes fixed and determinable, and also when economic performance occurs.[93]

Deferred compensation, however, is generally subject to matching rules. These rules provide that the employer receives a deduction when the employee includes such compensation in income.[94] The result is that employers are effectively put on the equivalent of the cash method of accounting for purposes of deducting deferred compensation.[95] Thus, nonqualified deferred compensation is not deductible until included in the employee's income.[96] On the other hand, compensation deferred under a qualified plan is specifically excepted from application of the matching rules and employers are allowed a current deduction even though the employee has no inclusion, subject to limits.[97]

Setting aside time value of money considerations, the compensation deduction operates to effectively reduce the employer's cost of compensation by an amount equal to the corporation's

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used to challenge amounts that allegedly are not compensation at all. In the latter case, the denial of a compensation deduction is not a penalty because the payment would not have been deductible in the first place if characterized according to its substance.

Most commentators agree that the statutory language of 162(a)(1) would support challenges of executive compensation levels, even in public companies. *See* Stabile, *supra* note 11, at 85 ("Section 162(a)(1) appears to operate as a restriction on the amounts that may be paid to executives. The language of the statute and the regulations certainly gives the IRS the authority to disallow deductions for compensation that is viewed to be unreasonable."); Sikon, *supra* note 81, at 308 (explaining that large, public companies could be challenged but usually are not because there are typically no issues with character of payments); Stumpff, *supra* note 83 at 387 (stating that courts have expressly insisted that public corporations are subject to rule); Zelinsky, *supra* note 83 at 10 ("Nothing in the statute limits the test of reasonability to closely-held corporations or otherwise supports the IRS's de facto interpretation of Section 162(a)(1) as constraining only closely-held corporations."). Assuming, however, that the IRS would want to regularly undertake such challenges, there are a variety of obstacles the IRS would face, such as the business judgment rule and possibly section 162(m) itself. *See generally* Kenneth C. Johnson, Note, *Golden Parachutes and the Business Judgment Rule: Toward a Proper Standard of Review*, 94 YALE L.J. 909 (1985) (discussing effect of business judgment rule on IRS regulation); Stabile, *supra* note 11, at 96-7 ("To the extent [section 162(m) is viewed as defining reasonableness at the $ 1 million level, the addition of that section of the Code may make it difficult for courts to challenge compensation that is less than $ 1 million.").

[91] *See* § I.R.C. 446(c)(2).

[92] Treas. Reg. § 1.446-1(c)(1)(ii). *See also* I.R.C. § 461(h) (economic performance); Treas. Reg. § 1.461-1(a)(2). The accrual method thus focuses on when an expense becomes a fixed and determinable obligation as opposed to the cash method's focus on payment.

[93] Section 461(h)(2)(A)(i) provides that in this situation economic performance occurs as a person provides services.

[94] *See* I.R.C. §§ 404(a)(5), (b) and (d), 83(h), and 267(a)(2).

[95] *See supra* Part III.A.1 (describing cash method of accounting).

[96] *See* I.R.C. § 404(a)(5).

[97] *See* I.R.C. § 404(a)(1)-(4).

marginal tax rate multiplied by the amount of the deductible payment.[98] In a simplified example, assume a corporation pays an employee $1 million and pays tax at a flat rate of 40 percent. Further assume that the corporation has taxable income of $2 million after application of all deductions other than the $1 million payment. If the corporation could not deduct the $1 million payment, it would owe $800,000 in taxes ($2 million x .40).[99] Allowing the corporation to deduct the compensation reduces its tax liability to $400,000 (($2 million -$1 million) x .40). Thus, the section 162(a) deduction reduces to $600,000 the cost of paying the employee $1 million. It also comports with the income tax system's policy of generally taxing net as opposed to gross business income.[100]

But, for reasons discussed below, Congress enacted tax provisions that in effect presume certain levels and types of executive compensation are unreasonable and therefore not deductible.[101] In 1984, Congress enacted section 280G, which applies to golden parachute payments.[102] And in 1993, Congress enacted section 162(m), which applies to compensation more generally.[103]

B. Tax Penalty Provisions Aimed At Shaping Executive Compensation

Congress has become enamored with enacting tax penalties purportedly to discourage executive compensation practices that are, in its view, undesirable. These penalties come in two forms: a denial of a deduction to the employer for compensation it pays or the imposition of additional taxes on the compensation an executive receives. Many companies and their executives, however, do not view these penalties as a significant impediment to crafting desired executive compensation packages. Some maneuver around the penalties, and others willingly choose to incur them.

The following table indicates the provisions that are discussed in this subsection, in chronological order, identifying when they were enacted and on whom the penalty was imposed:

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[98] A taxpayer's marginal tax rate is the rate applied to the last taxable dollar.

[99] This assumes there are no applicable credits, and no estimated taxes have been paid.

[100] Boris I. Bittker, Martin J. McMahon & Lawrence Zelenak, FEDERAL INCOME TAXATION OF INDIVIDUALS ¶11.01[1] at 11-4 (2002).

[101] Under these provisions, nondeductible compensation is still treated as compensation to the recipient for tax purposes. *See* Sikon, *supra* note 81, at 303 (discussing how unreasonable payments are both non-deductible and taxable). This is in contrast to amounts determined to be nondeductible under section 162(a)(1) because the payment was not compensation for services but an otherwise nondeductible distribution. In that case, in the hands of the employee the characterization of amounts received for tax purposes will depend on the circumstances and the substance of the payments. *See* Treas. Reg. § 1.162-8 ("The income tax liability of the recipient in respect of an amount ostensibly paid to him as compensation, but not allowed to be deducted as such by the payor, will depend upon the circumstances of each case. Thus, in the case of excessive payments by corporations, if such payments correspond or bear a close relationship to stockholdings, and are found to be a distribution of earnings or profits, the excessive payments will be treated as a dividend. If such payments constitute payment for property, they should be treated by the payor as a capital expenditure and by the recipient as part of the purchase price. In the absence of evidence to justify other treatment, excessive payments . . . will be included in gross income of the recipient."); *See generally* Sikon, *supra* note 81 (discussing characterization and tax treatment of compensation that is deemed unreasonable).

[102] *See* DEFRA, *supra* note 78.

[103] *See* Omnibus Budget Reconciliation Act of 1993, Pub. L. No. 103-66, 13211, 107 Stat. 312, 469-71.

YEAR ENACTED	TYPE OF COMPENSATION	IMPOSED ON EMPLOYER (deduction denial)	IMPOSED ON EMPLOYEE (additional tax)
1984	Golden Parachute	§280G	§4999
1993	Annual	§162(m)	
2004	Nonqualified Deferred		§409A

1. Golden Parachute Compensation: Sections 280G and 4999

Congress made its first attempt to directly regulate executive compensation via tax penalties when it enacted sections 280G and 4999, which apply to golden parachute agreements.[104] The phrase "golden parachute" is a metaphor for a lucrative executive severance agreement that only becomes payable in the event of a change in the control of the company.[105] Although the terms of any particular golden parachute agreement will vary, "such an agreement generally provides for substantial bonuses and other benefits for top management and certain directors who may be forced to leave the target company or otherwise voluntarily leave upon a change in control."[106] These benefits are often worth in the aggregate upwards of "several times an executive's yearly income."[107]

Golden parachute agreements proliferated in the early 1980s in response to a dramatic increase in the amount of takeover activity.[108] But, as the use of golden parachute agreements

[104] *See* DEFRA, *supra* note 78.

[105] More specifically, it is an agreement to make payments or provide other benefits to an executive if the company experiences a change in ownership, effective control, or the ownership of a substantial portion of its assets. *See* I.R.C. § 280G(b)(2)(A)(i); *see also generally* William R. Spalding, *Golden Parachutes: Executive Employment Contracts*, 40 WASH. & LEE L. REV. 1117, 1117-22 (1983) (explaining golden parachute agreements).

[106] BLACK'S LAW DICTIONARY 692 (6th ed. 1990). In addition to cash, a golden parachute may provide continuing insurance coverage, a stock grant, or accelerated vesting of stock options. *See* Stabile *supra* note 11. For more on the panoply of benefits that fall under the rubric of golden parachute agreements, *see generally* Wilson and McGowan, *Golden Parachutes,* 396 TAX MGM'T PORTFOLIOS (BNA) (2008). While termination is not a requirement under the golden parachute provisions, such agreements typically, but not always, have a termination clause requiring that the executive lose his job as a result of the change in control before payment under the agreement is triggered. *See* Johnsen, *supra* note 90, at 910 (explaining "most golden parachutes currently in effect have three key components: (1) a change-of-control clause, (2) a termination clause, and (3) a compensation clause."); Zelinsky, *supra* note 20, at 141-44 (discussing various golden parachute definitional issues). The termination clause could require that the executive be dismissed outright, or it could allow the executive to voluntarily terminate his employment with the acquirer for "good reasons," such as a situation where the executive is effectively forced out. *See* Johnsen, *supra*, at 911-12. In any event, "[t]he reality is that most top-level managers of target firms are gone within three years of the acquisition." Bruce A. Wolk, *The Golden Parachute Provisions: Time for Repeal?*, 21 VA. TAX. REV. 125, 127 (2001); *See also* Spalding, *supra* note 105 at 1132 (noting that change of control "normally" results in change in executive personnel).

[107] Spalding, *supra* note 105, at 1120.

[108] *See* STAFF OF JOINT COMM. ON TAXATION, 98th CONG., GENERAL EXPLANATION OF THE REVENUE PROVISIONS OF THE DEFICIT REDUCTION ACT OF 1984, 199 (Comm. Print 1984) [hereinafter DEFRA Blue Book] (explaining that golden parachute provisions were enacted in response to heightened merger and acquisition activity); Henry F. Johnson, *Government Regulation of Business: Golden Parachutes Revisited*, 23 WAKE FOREST L. REV. 121 (1988) (referring to golden parachutes as "roadblocks" that have been "created" to deter "unwanted takeovers"); Johnsen, *supra* note 106, at 909 (explaining that "risk-shifting nature of golden parachutes makes them the most reasonable . . . alternative[] for dealing with the disequilibrium caused by increased takeover activity"); David V. Maurer, *Golden Parachutes – Executive Compensation or Executive Overreaching?*, 9 J. CORP. L. 346

gained momentum, so too did rigorous debate as to their propriety: in particular, whether golden parachutes are ultimately good or bad for corporations, shareholders, and the overall economy.[109] Congress stepped into this fray, and in 1984 determined excessive golden parachutes in many instances inappropriately hinder acquisitive activity and impose direct and indirect costs on shareholders.[110] Congress also concluded golden parachutes, "as a matter of policy, should be strongly discouraged."[111] Congress ultimately decided to use the Code to do so.[112]

At the time, and as discussed above, corporate deductibility for parachute payments was subject only to the reasonable compensation limits of section 162(a)(1).[113] Assuming a payment was reasonable and thus deductible, section 162 operated to effectively reduce the cost of the payment.[114] The Senate Finance Committee objected to the tax law subsidizing the cost of golden parachute payments in this way:

> The committee . . . is concerned that in many instances golden parachute contracts do little but assist an entrenched management team to remain in control. They also may provide corporate funds to subsidize officers or other highly compensated individuals. The committee is unwilling to permit the tax law to be used as a subsidy in such situations. In fact, the committee believes that a tax penalty should be enacted in those situations.[115]

(1984) (attributing abundance of parachute provisions to increased merger activity and noting that golden parachutes were "all but unheard of ten years [prior]"); Richard P. Bress, Note, *Golden Parachutes: Untangling the Ripcords*, 39 STAN. L. REV. 955, 957-958 (1987) ("Golden parachutes became popular during a period of unprecedented takeover activity as a means of providing senior executives with enhanced security.") (footnote omitted).

[109] *See* Zelinsky, *supra* note 20, at 134, 148-49 (noting that golden parachutes were among the most hotly contested issues surrounding the takeover wave of the 1980s); Spalding, *supra* note 105, at 1121-22 (noting debate over propriety in spite of parachute popularity); Henry F. Johnson, *Those 'Golden Parachute' Agreements: The Taxman Cuts the Ripcord*, 10 DEL. J. CORP. L. 45, 48 (1985) ("The opinions are lining up on either side of the issue as to whether [golden parachutes] are beneficial or detrimental to the concern's future existence" & "commentators have been unable to agree on the validity and usefulness of golden parachutes.").

[110] *See* DEFRA Blue Book, *supra* note 108 at 199-200. According to the Joint Committee on Taxation, Congress was concerned about three possible effects of large golden parachutes: (1) in a takeover, they would result in the target's shareholders being paid less for their stock, (2) they could discourage potential buyers, and (3) they could encourage management to pursue a transaction that was not in the best interest of the shareholders in order to reap the financial rewards of a parachute. *See id.*

[111] *Id.*

[112] Congress did consider non-tax legislation. For example, the SEC submitted to Congress the Tender Offer Reform Act of 1984 which "curbed certain management practices in contests for corporate control, such as . . . 'golden parachutes' . . . ." P. John Kozyris, *Corporate Takeovers at the Jurisdictional Crossroads: Preserving State Authority over Internal Affairs while Protecting the Transferability of Interstate Stock through Federal Law*, 36 UCLA L. REV. 1109, 1129 (1989). *See also* Exchange Act – Tender Offers – Advisory Comm. Recommendations – SEC Response, [1983-1984 Transfer Binder] Fed. Sec. L. Rep. (CCH) ¶ 83,511, at 86,675-76 (Mar. 28, 1984) ("SEC will support legislation on a number of points, including . . . the banning of 'golden parachutes' during a tender offer."). This act, however, did not pass. *See* Allen E. Kelinsky, Comment, *Promoting Shareholder Equality in Stock Accumulation Programs for Corporate Control*, 36 AM. U. L. REV. 93, 122 (1986).

[113] Note that section 162(a)(1) is rarely applied to public companies, and where the IRS has attempted to do so it has been unsuccessful. *See supra* note 90.

[114] *See supra* notes 98-100 and accompanying text. *See also infra* notes 133-136 and accompanying text.

[115] S. COMM. ON FINANCE, 98TH CONG., DEFICIT REDUCTION ACT OF 1984, EXPLANATION OF PROVISIONS APPROVED BY THE COMM. ON MAR. 21, 1984 195 (COMM. PRINT 1984) [hereinafter DEFRA SENATE REPORT].

Congress accordingly enacted two new Code provisions to penalize parachute payments above a defined level: section 280G, which applies to companies, and section 4999, which applies to individuals.[116] In short, section 280G disallows a deduction for any "excess parachute payment."[117] In other words, section 280G essentially presumes such payments are unreasonable.[118] A company may rebut this presumption if it can establish by clear and convincing evidence that the payments are reasonable compensation within the context of section 280G.[119] In this regard, however, Congress has stated "only in rare cases, if any, will any portion of a parachute payment be treated as reasonable compensation."[120]

If a company does make excess parachute payments, the cost to the corporation is, at a minimum, the foregone tax savings that a deduction would have produced. In other words, the amount of taxes owed is increased due to the disallowed deduction. Assuming a corporate rate

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[116] *See* DEFRA *supra* note 78. It should be noted that section 280G, and thereby section 4999, is limited in application. First, it only applies to parachute payments made to a "disqualified individual." I.R.C. § 280G(b)(2). A disqualified individual is defined to include an employee or independent contractor who is also either a shareholder, an officer, or a highly compensated individual. *See* I.R.C. § 280G(c). A highly compensated individual is defined as one "who is (or would be if the individual were an employee) a member of the group consisting of the highest paid 1 percent of the employees of the corporation or, if less, the highest paid 250 employees of the corporation." *Id.* Second, it does not apply to payments made to a disqualified individual if the company is a small business company (as defined in section 1361(b) but without regard to paragraph (1)(C)) or the stock of the company is not readily tradeable and three-quarters of the shareholders have approved the payments. *See* I.R.C. § 280G(b)(5).

[117] More specifically, a "parachute payment" is defined as a payment in the nature of compensation that is contingent on a change in control, and also is in an amount greater than or equal to three times a "base amount." I.R.C. § 280G(b)(2)(A). The base amount is the executive's average annualized taxable compensation for the last five years or however long the executive has worked for the company if shorter. *See* I.R.C. § 280G(b)(3) & (d)(2). The difference between the base amount and the parachute payment is the "excess parachute payment" and is nondeductible. I.R.C. § 280G(a) & (b)(1). Thus, a corporation providing an executive with an excess parachute payment may not deduct an amount greater than the base amount.

For example, where a corporation makes a parachute payment of $3 million to an employee with a base amount of $1 million, the excess parachute payment is $2 million and is nondeductible. *See* H.R. CONF. REP. at 816-817 [hereinafter DEFRA CONFERENCE REPORT]. If, instead, the parachute payment was $2.9 million, then there would be no excess parachute payment and thus no deduction denial under section 280G. *See* Zelinsky, *supra* note 20 at 159 (noting that this scheme can produce significant disparities in deductibility from small changes in compensation); Wolk, *supra* note 106 at 130.

[118] DEFRA CONFERENCE REPORT, *supra* note 117, at 816-17. According to the Conference Committee Report, the presumption of unreasonableness reflects the view of Congress that affected executives are rarely "under-compensated." *Id.* at 817.

[119] *See* I.R.C. § 280G(b)(4). Amounts that the taxpayer can establish by clear and convincing evidence are reasonable compensation for personal services actually rendered before the change in control are not treated as part of an excess parachute payment, but they are first offset by the base amount. *See* I.R.C. § 280G(b)(4)(B). Thus, in the first example provided in note 117, should the taxpayer establish by clear and convincing evidence that $1.5 million was reasonable compensation for services rendered before the change in control, the excess parachute payment would be reduced to $1.5 million (excess parachute payment – (reasonable compensation – base amount) or $2 million - ($1.5 million - $1 million)). *See* DEFRA CONFERENCE REPORT, *supra* note 117 at 817; Treas. Reg. § 280G-1, A-39(b)(ex. 1). In addition, amounts that the taxpayer can establish by clear and convincing evidence are reasonable compensation for personal services to be rendered on or after the date of the change in control are not treated as parachute payments at all. *See* I.R.C. § 280G(b)(4)(A). For more on the types of evidence considered clear and convincing in these situations, *see* Treas. Reg. § 280G, Q&A 40-44. *See also generally* Jamie Dietrich Hankinson, *Golden Parachute Tax Provisions Fall Flat: Tax Gross-Ups Soften Their Impact to Executives and Square D Overinflates Their Coverage*, 34 STETSON. L. REV. 767, 778 (2005).

[120] DEFRA CONFERENCE REPORT, *supra* note 117 at 817.

of 40 percent, this results in a 66.67 percent increase in the effective cost of the payment. [121] Put differently, disallowing a deduction for an expense effectively raises the corporation's cost of that item to the full original cost.[122] Unless the increased cost is shifted elsewhere and thus offset, it will ultimately reduce the corporation's after-tax profits (*i.e.*, the bottom line).[123]

For its part, section 4999 imposes a nondeductible 20 percent tax on any person who receives an excess parachute payment.[124] So, if the excess parachute payment was $1 million, then the executive's excise tax would be $200,000.[125] This is in addition to paying the taxes that are normally generated by compensation payments, such as income and payroll taxes.[126] Together, sections 280G and 4999 were expected "to make excessive parachute payments financially prohibitive" for a corporation to offer and an executive to accept.[127]

To limit exposure to these dual notional penalties some companies carefully design their golden parachutes to come within the deductibility parameters set by section 280G.[128] Alternatively, some choose to pay an executive more on a current annual basis to compensate for the lack of, or limits on, golden parachute protection.[129] More often, however, companies

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[121] This can be explained mathematically by the formula: Marginal Rate /(1-Marginal Rate) = increase in cost of expense by denial of a deduction (.40/.60 =.6667).

[122] *See* Zolt *supra* note 12 at 353.

[123] The Corporation's profits are decreased by the marginal tax rate times the expense denied.

[124] *See* I.R.C. §§ 4999 (imposes 20 percent tax) and 275(a)(6) (disallows deduction for twenty percent tax imposed). The corporation must withhold the tax from its payment to the individual if the payment constitutes "wages" within the meaning of section 3401 of the Code. *See* I.R.C. § 4999(c)(1).

[125] This reduction in the after-tax benefit would in theory discourage an executive from contracting for a golden parachute above the level defined by section 280G. If the parachute payment is just $1 less than three times the executive's base amount then the additional tax does not apply. In that way, the executive could in theory receive more after-taxes, even though the initial payment amount is less, if the additional tax is avoided. This incentive to stay within the limits of section 280G has not worked because executives are able to contract out of the penalty. *See infra* notes 129-132 and accompanying text.

[126] In most cases, only the medicare portion of the executive's payroll taxes will need to be paid on any parachute payment as it is likely that the executive's taxable wages for purposes of the social security tax will have already exceeded the taxable maximum, which is $102,000 for 2008. *See supra* note 36.

[127] Stabile, *supra* note 12 at 91. *See also* Jamie Dietrich Hankinson, *Golden Parachute Tax Provisions Fall Flat: Tax Gross-Ups Soften Their Impact to Executives and Square D Overinflates Their Coverage*, 34 STETSON. L. REV. 767, 778 (2005) (referring to 280G and 4999 as "two pronged attack" and noting that Congress intended provisions to work together to reduce largesse of parachutes); Wolk, *supra* note 106 at 126 (describing that Congress had wanted to enact penalties against golden parachute payments, which became two new Code provisions: § 280G and § 4999). Graef Crystal, a compensation expert, commented as follows on the enactment of the golden parachute provisions: "this is the first time in my memory that Congress . . . created what can only be considered a class of 'Extraordinary Income' for a compensation payment -- one that is taxed at higher rates than ordinary income." *Manger's Journal: Congress Thinks it Knows Best About Executive Compensation*, WALL ST. J., July 30, 1984, at 1.

[128] *See, e.g.*, Dana M. Leonard, Comment, *Golden Parachutes and the Draconian Measures Aimed at Control: Is Internal Revenue Code Section 280G the Proper Regulatory Mode of Shareholder Protection*, 54 U. CIN. L. REV. 1293, 1306-07 (1986) (discussing how § 280G merely imposes limits on rather than banning parachute payments and firms' ability to avoid § 280G restrictions "by limiting the [parachute] payments to amounts less than three times the employee's base amount."); *see also* Miske, *supra* note 20 at 1680 (discussing how § 280G essentially codified a "salary multiple" to be used in calculating golden parachutes to stay within its limits and how firms often set this multiple at "299 percent of the executives' base compensation.").

[129] *See* Stabile, *supra* note 12, at 92; *see also* Johnson, *supra* note 108, at 63 (discussing firms' maneuvers to evade § 280G including, for example, paying executives cash signing bonuses). This is also costly to the company

purposely forego a deduction in order to provide an executive with greater benefits. Many companies go even further and reimburse the executive for the 20 percent excise tax incurred.[130] These additional payments, referred to as gross-up compensation, are also treated as excess parachute payments, and thus are nondeductible by the corporation and subject to the 20 percent excise tax in addition to taxes otherwise normally due on the executive's compensation.[131] A full gross-up will pay these taxes as well.[132] Thus, the incidence (or economic burden) of the 20 percent penalty tax is effectively shifted from the executive to the corporation.

This practice, which Congress presumably did not anticipate, is more costly than it initially appears. Gross-up payments, in combination with the denial of a deduction under section 280G, can triple a company's after-tax cost of an excess parachute payment.[133] For example, assume, as above, a $1 million excess parachute payment. Further assume an individual income tax rate of 40 percent. If the executive's company agrees to pay the federal income and excise taxes on the excess parachute payment, then the executive receives, after

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because the payments are mandatory rather than contingent on a change in control that might never occur. Even in the presence of a parachute agreement, an executive's base salary might be raised so that the base on which parachute payment status is determined is likewise raised. This would reduce the likelihood that future payments will be subject to the penalties, but still increases the company's overall compensation costs as compared to what the compensation level might be in the absence of the penalties.

[130] *See Executive Compensation: Backdating to the Future*: *Hearing Before the Senate Finance Comm*., 109th Cong. 2 (2006) [hereinafter *Backdating Hearing*] (testimony of Steven Balsam, Professor of Accounting, Temple University) ("From my reading of executive compensation contracts and disclosures, I have found many corporations are willing to not only forgo deductions for excess parachute payments as defined under section 280(g) [sic], but are also grossing up the executive's compensation to pay for the excise taxes levied on the executive."). A recent study shows that "two-thirds of CEOs and 60% of other named executive officers are entitled to have their severance increased to cover the extra taxes [of exceeding limits]." *See* Perri Capell, *CEO Compensation Survey (A Special Report); Terminated? Who Cares? Severance-pay Packages for CEOs appear to be Coming Down; But Slowly*, WALL ST. J., Apr. 14, 2008, at R4; Joann S. Lublin & Scott Thurm, *Money Rules: Behind Soaring Executive Pay, Decades of Failed Restraints; Instead of Damping Rewards, Disclosure, Taxes, Options Helped Push Them Higher; Return of Golden Parachutes*, WALL ST. J. Oct. 12, 2006, at A1 ("By 2004, 77% of 1,000 public concerns tracked by consulting firm Tower Perrins offered [gross-ups].").

[131] *See* Wolk, *supra* note 106 at 140; *see also* George B. Paulin, *Executive Compensation and Changes in Control: A Search for Fairness*, COMP. & BENEFITS REV., Mar.-Apr. 1997, at 30, 33 ("[Al]l gross-ups become additional excess parachute payments themselves, subject to the excise tax and not deductible to the company."). Paulin explains that "the gross-up payments must also be grossed up, and these gross-ups must also be grossed up, and so on." *Id.*

[132] There are gross-up provisions that provide less than a full gross-up. For more information on those provisions, as well as full gross-ups and how to compute them, *see generally* Wolk, *supra* note 106, and Wilson & McGowan, *supra* note 106.

[133] *See id*. at A39 ("[B]ecause gross-ups usually cost about 200% of the excise tax amount (plus the amount of the excise tax itself, for a total payment to or for the benefit of the executive of approximately 300% of the excise tax), they increase the § 280G 'penalty' paid by the corporation."); *See also* Wolk, *supra* note 106 at 140 ("Because the [gross-up] is itself subject to the excise tax, the taxes rapidly pyramid, making gross-ups extraordinarily costly."); Hankinson, *supra* note 127, at 771, 788 (explaining "gross-ups eliminate the punitive effect on the executive by imposing greater costs on the corporation" and using example to show how, in addition to loss of corporate tax deduction, "the total cost to the corporation of [a] $3,000,000 golden parachute payment, when the payment is grossed up for the executive's excise and individual income taxes, increases to $9,000,000."). The justifications companies provide for paying gross-ups include the following: "allows corporations the freedom to design change in control plans and agreements without the need to worry about benefit cutbacks and the anger and frustration they engender;" and "gross-ups have the overwhelming advantage of helping to focus management's attention on running the business in the very difficult pre-merger period." Wilson & McGowan, *supra* note 106, at A39.

taxes, $1 million. As far as the executive is concerned it is as if the penalty tax does not exist.[134] But to provide the executive with $1 million after taxes, the company must spend $2.5 million: $1 million to the executive and $1.5 million to the IRS for taxes.[135] And this is not the only cost the company incurs; the company is also denied a deduction for the $2.5 million payment, which implicitly costs the company $1 million.[136] Thus, it costs the company $3.5 million in total to pay the executive $1 million after taxes.

In sum, Congress wanted to discourage companies from authorizing golden parachute payments above a defined level. Congress implemented its plan by using the Code to impose penalties on payments that are, in its view, excessive. The theory was that the tax penalties would in most instances render them too costly to authorize or receive. The reality is many companies continue to authorize golden parachutes that, if triggered, would provide payments above the limit defined as reasonable by Congress. In that way, these companies have voluntarily assumed potentially greater costs than Congress imposed.

The irony of course is that Congress purportedly wanted to protect shareholders from the direct and indirect costs of golden parachutes.[137] More surprising, however, is that although it was apparent at or shortly after enactment that the golden parachute provisions were not only ineffective but also suffered from a variety of defects, they became the archetype for regulating executive compensation via tax penalties.[138]

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[134] *See id.* ("The employee will be in the same economic position as if an excise tax did not exist.").

[135] This can be explained mathematically by the formula: Pre-Tax Pay = After-Tax Pay/(1-tax rate). This formula is applied here as follows: $2,500,000 = $1,000,000/(1-.40-.20). *See*, *e.g.*, Boris I. Bittker & Lawrence Lokken, FEDERAL TAXATION OF INCOME, ESTATES AND GIFTS ¶ 5.8.2 (2008) (providing formula and noting that "all federal income taxes reimbursed by a tax reimbursement agreement are taxed, regardless of the number of rounds involved"); Wolk, *supra* note 20, at 139-40.

[136] This can be explained mathematically by the formula: Cost of Foregone Deduction = Expense x Tax Rate. Here, the $2,500,000 nondeductible compensation payment multiplied by an assumed 40% tax rate results in a foregone deduction worth $1,000,000.

[137] *See supra* note 115 and accompanying text (discussing concerns over golden parachute payments).

[138] Section 280G has been widely criticized as an ineffective deterrent of the use of golden parachutes to repel takeovers. *See* Wolk, *supra* note 106 at 127-28 (noting that because provision imposes penalties only on excessive payments actually made to employees, section 280G does not deter parachutes large enough to actively discourage takeover); Hankinson, *supra* note 127 at 783-89 & nn. 108-146 (highlighting examples of ways §§ 280G and 4999 can be circumvented); *see also generally* Meredith R. Conway, *Money for Nothing and the Stocks for Free: Taxing Executive Compensation*, 17 CORNELL J.L. & PUB. POL'Y 383, 417-19 (noting limited effectiveness of § 280G).

As one commentator noted soon after the provisions were passed, "Congress has, as usual, made an opening move in a corporate chess game and neglected to consider its opponents' countermoves." Graef S. Crystal, *Congress Thinks It Knows Best About Executive Compensation*, WALL ST. J., July 30, 1984, at 16. Shortly after enactment of the two provisions, others hypothesized that indemnification provisions in executive contracts would arrange for the corporation to bear the 20% excise tax. *See* Edwin T. Hood & John J. Benge, *Golden Parachute Agreements: Reasonable Compensation or Disguised Bribery?*, 53 UMKC L. REV. 199, 213-14 (1985) (assessing effects of § 280G and § 4999 and referring to provisions as "rather draconian").

2. Annual Compensation: Section 162(m)

In 1993, Congress enacted section 162(m), which applies to annual compensation paid to executives.[139] It was enacted in response to intense popular sentiments regarding executive compensation levels.[140] During the late 1980s and early 1990s, most Americans believed executives were over-compensated.[141] At the time, there was a palpable widening gap between America's rich and poor, and an economic recession that was adding to the disparity.[142] Intense media coverage of contemporary executive pay practices, depicting the sharp contrast between the situation of highly-paid executives and that of ordinary Americans, only further intensified public sentiments.[143] These sentiments stemmed not only from the belief that executives were excessively compensated, but also from the belief that executives as a whole were unaffected by or even prospering despite the flagging performance of their companies.[144]

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[139] Omnibus Budget Reconciliation Act of 1993, Pub. L. No. 103-66, 13211, 107 Stat. 312, 469-71. In the same legislation, Congress also enacted changes to the Code that more broadly affected high-income taxpayers, such as raising the ordinary income tax rate for some taxpayers who were previously in the highest rate bracket and removing the cap on the Medicare portion of payroll taxes. Pub. L. No. 103-66, sections 8201, 8202, & 8207.

[140] *See infra* note 155 ("Recently, the amount of compensation received by corporate executives has been the subject of scrutiny and criticism. The committee believes that excessive compensation will be reduced if . . . ."). *See also e.g.* Andrew R. Brownstein & Morris J. Panner, *Who Should Set CEO Pay? The Press? Congress? Shareholders?*, HARV. BUS. REV. 28, May-June 1992 (noting that not since 1930s had compensation earned the attention of as many public officials as it did in the early 1990s); Louis M. Thompson, Jr., *The SEC Targets Executive Pay*, 15 Directors & Boards No.4, at 48, June 22, 1991 (editorializing that it "did not take a whiz kid" to realize that Congress would get involved with such an "emotionally charged issue" as excessive compensation in time of recession); Murphy, *supra* note 19, at 740 ("Section 162(m) . . . was a response to the populist desire to penalize highly paid executives.").

[141] *See* Derek Bok, *The Cost of Talent* 95 (The Free Press (1993) (recounting media descriptions of executive salaries as "'[m]ind-numbing,'" . . . and "'eyepopping,'" and noting that "[b]y 1990, almost everyone seemed to agree that executive pay had reached unseemly heights.").

[142] For information on American economic cycles, see National Bureau of Economic Research, *Business Cycle Expansions and Contractions*, http://www.nber.org/cycles/cyclesmain.html. In the decade leading up to the enactment of § 162(m), executive pay suddenly grew at a pace nearly four times that of the average worker. *See* Mark A. Sargent & Dennis R. Honabach, *Executive Compensation Disclosure Rules*, PROXY RULES HDBK. 4:1 (2006) (citation omitted). This was in contrast to the five immediately prior decades (from the Great Depression era to the mid-to-late 1970s), during which executive compensation levels remained relatively steady in relation to the pay of the average worker. *See* Linda J. Barris, *The Overcompensation Problem: A Collective Approach to Controlling Executive Pay*, 68 Ind. L. J. 59, 62 (1992) (explaining that in 1990 executives were earning 85 times the salary of an average factory worker, up from 42 times the salary of an average wage-earner at beginning of decade); Vagts, *supra* note 42, at 246. Additionally, in 1986 Congress reduced the highest marginal tax rate to 28 percent from its already historic low since 1931 of 50 percent; just 25 years earlier, the highest marginal rate was 90 percent. *See* Tax foundation, Federal Individual Income Tax Rates History, 1913-2008, *available at* http://www.taxfoundation.org/taxdata/show/151.html.

[143] *See, e.g.,* Brownstein & Panner, *supra* note 140 (noting that recession had turned executive compensation into "front page news"); Murphy, *supra* note 19 at 713 (recounting media fixation on executive compensation and explaining that issue reached "national prominence" during 1991); Bok, *supra* note 141.

[144] *See generally* Sargent & Honabach, *supra* note 142 (noting comparatively larger increases in CEO compensation during 1980s than shareholder returns and growing disconnect between pay and performance). *See also* Jill Abramson & Christopher J. Chipello, *Compensation Gap: High Pay of CEOs Traveling with Bush Touches a Nerve in Asia*, WALL ST. J., Dec. 30, 1991 at A1 (reporting gross disparity between salaries of American executives and those of their highly productive Japanese counterparts: despite American economic downturn, executives traveling with President Bush to Japan earned an average of $2 million in previous year, while Japanese executives earned an average of $300,000-$400,000). *See also supra* note 19.

The congressional response to these sentiments was section 162(m), which disallows a deduction for annual compensation that might otherwise be allowable as an ordinary and necessary business expense under section 162(a)(1).[145] Specifically, section 162(m) prohibits a deduction in excess of $1 million for compensation paid by a publicly held corporation to its CEO and the three other highest paid officers at the company.[146] In other words, regardless of the amount paid, the deduction is limited to $1 million.[147] Compensation in excess of $1 million is thus *in effect* deemed unreasonable.[148]

There are, of course, exceptions to this rule. Commissions, performance-based compensation, qualified retirement plan contributions, and nontaxable fringe benefits are all specifically excepted from the $1 million deduction limitation.[149] The most significant of these exceptions is the one for performance-based compensation. Compensation is performance-based only if it is "payable solely on account of the attainment of one or more performance goals."[150] Such goals must be "established by a compensation committee composed of outside directors, approved by shareholders, and certified by the company's compensation committee as having been met."[151]

It also noteworthy that the $1 million limit only applies with regard to the specified executives if they are employed as such on the last day of the taxable year.[152] A company, therefore, "may give an executive any amount of non-performance compensation, however large, and still not fall within the reach of Section 162(m) – as long as the payment of this amount is deferred until the executive's departure."[153] As a result, most executive retirement plans (commonly referred to as nonqualified deferred compensation), which are large and commonplace, are not limited by section 162(m).[154]

The Senate Finance Committee believed "excessive compensation [would] be reduced if the deduction for compensation (other than performance-based compensation) paid to the top executives of publicly held corporations [was] limited."[155] Section 162(m) thus appears to have

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145 This approach is similar to section 280G which was enacted a decade earlier. *See supra* Part III.B.1.

146 *See* I.R.C. §§ 162(m)(1) & (2) and § 162(m)(3), as interpreted by IRS Notice 2007-49. For purposes of section § 162(m), a publicly held corporation is "any corporation issuing any class of common equity securities required to be registered under Section 12 of the Securities Exchange Act of 1934." I.R.C. § 162(m)(2).

147 The $1 million limit is lowered (but not below zero) by the amount of any excess parachute payment which would have been considered compensation within the meaning of section 162(m) if section 280G had not disallowed a deduction. *See* I.R.C. §§ 162(m)(4)(A) & (F).

148 In fact, the heading of section 162(m) reads as follows: "Certain excessive employee remuneration."

149 *See* I.R.C. § 162(m)(4).

150 I.R.C. § 162(m)(4)(C).

151 Stabile, *supra* note 11, at 87. Treasury regulations elaborate that a performance goal "must state, in terms of an objective formula or standard, the method for computing the amount of compensation payable to the employee if the goal is attained." Treas. Reg. § 1.162-27(e)(2)(ii).

152 *See* I.R.C. § 162(m)(3).

153 *See Backdating Hearing*, *supra* note 130, at 4 (testimony of Lucian A. Bebchuk, Professor of Law, Economics, and Finance, Harvard Law School)

154 Adding the value of this type of compensation to a CEO's "aggregate salary during the CEO's service roughly triple[s] the amount of the CEO's non-performance pay." *Id.* *See also supra* notes 67-76, 96 and accompanying text for background information on nonqualified plans, and *infra* Part III.B.3 for a discussion of section 409A, which imposes a broad range of restrictions on nonqualified plans and penalties for noncompliance.

155 *See* 1993 U.S.C.C.A.N. 877.

two aims: (1) to curtail levels of executive pay, and (2) to encourage a stronger connection between pay and performance.[156] Stated differently, section 162(m) attempts to affect both "the amount [and] type of compensation paid to executives."[157] Neither of these goals appears to have been met. As contemporaneously predicted and subsequently borne out, section 162(m) has not restrained compensation levels,[158] and "has been at best, only marginally effective . . . in making [executive pay] more responsive to performance."[159]

To begin, it appears 162(m)'s initial effect was to lead companies whose CEOs earned less than $1 million to increase base salary levels to $1 million.[160] Furthermore, although section 162(m) was designed to discourage corporations from paying excessive non-performance-based executive compensation by making it more costly to do so, as was seen with section 280G, many companies are all too willing to forego a deduction in order to pay whatever compensation they decide is best.[161]

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[156] *See id.* Notably, Senate hearings from 1991 and 1992 feature a familiar refrain amongst committee members regarding the need to tie pay to performance. *See, e.g., Executive Compensation: Hearing Before the Subcomm. on Taxation of the S. Comm. on Finance*, 102d CONG. 2 (statement by Sen. Boren, Chairman, S. Subcomm. on Taxation) ("Of course, this is an economy founded on free enterprise principles . . . [s]o we would be less concerned about the amount . . . paid to executives if we believed that pay tracked performance.").

[157] Stabile, *supra* note 11, at 95-99 (assessing "potential effectiveness of the Code as an increased constraint on the amount or type of compensation," and concluding that regardless of the outcome, "it should not be so used" because "[c]ompensation is a matter for the market and private parties").

[158] *See, e.g.*, Murphy, *supra* note 19, at 739 ("I predict that 162(m) will . . . result in higher rather than lower levels of executive compensation). A recent report prepared for Congress in preparation for a hearing on issues related to the tax treatment of executive compensation commented "[s]tudies have indicated that the deduction limitation may have led to some substitution away from salary compensation toward performance-based compensation, but that growth in overall executive compensation has not been reduced." Compensation Report, *supra* note 4.

[159] *See Backdating Hearing*, *supra* note 130, at 1 (testimony of Steven Balsam, Professor of Accounting, Temple University) ("I'd also like to state up front that, based upon my own research, the research of others, and anecdotal reports, that section 162(m) has been at best, only marginally effective in limiting executive pay or in making it more responsive to performance."); *id*. at 1 (testimony of Nell Minow, Editor, The Corporate Library) ("The data show that the disparity between pay and performance is enormous and growing."); Nancy L. Rose & Catherine Wolfram, Regulating Executive Pay: Using the Tax Code to Influence Chief Executive Officer Compensation, 20 J. LAB. ECON. 138, 141 (2002).

[160] *See CEO Compensation: Hearing Before the Senate Comm. on Commerce, Sci. & Transp.*, 108th CONG. (2003) [hereinafter *CEO Compensation Hearing*] (testimony of Brian Hall, Associate Professor, Harvard Business School) ("The pay trend ... makes it look as if [162(m)] were passed with the intention of accelerating, not curbing, CEO pay increases."); *Backdating Hearing*, *supra* note 130 at 1 (testimony of Nell Minow, Editor, The Corporate Library) ("When the tax code was changed to prevent executive compensation of over $1 million to be deducted unless it was tied to performance . . . everyone got a raise to $1 million.").

[161] *See Backdating Hearing*, *supra* note 130, at 1 (testimony of Steven Balsam, Professor of Accounting, Temple University) ("For example in 2005 my research indicates that at least 250 corporations paid one or more executives salary, i.e., non performance-based compensation, in excess of $1 million, 988 paid one or more executives total cash compensation in excess of $1 million, and 1,335 paid one or more executives total compensation in excess of $1 million. . . . In research conducted using data from the mid-1990's, Jennifer Yin and I found that nearly 40 percent of corporations admitted to forfeiting deductions because of section 162(m). My prediction is that this percentage is much higher today. Especially as corporations shift from stock options to restricted stock in the wake of Statement of Financial Accounting Standards 123R which required the expensing of stock options.") (Referring to Steven Balsam & Qin J. Yin, Explaining Firm Willingness to Forfeit Tax Deductions Under Internal Revenue Code § 162(m): The Million Dollar Cap, 24 J. ACCT. & PUB. POL'Y 300, 322-23 (2005)). *But see* Polsky, *supra* note 20, at 913 (concluding that under a particular management model – the managerial power model – "it would be rare for firms (particularly high-profile ones) to forfeit significant amounts of deductions"

More significantly, the performance-based exception had at least three notable effects on executive compensation.[162] First, "[e]ven for those companies for whom preserving the deduction is important, the performance-based compensation exception to the $ 1 million limit renders section 162(m) virtually meaningless."[163] As an initial matter, satisfying the performance-based requirements is not challenging. Treasury regulations provide that a performance goal does not need to be "based upon an increase or positive result under a business criterion and could include, for example, maintaining the status quo or limiting economic losses."[164] Furthermore, once the threshold requirements have been met, there is no limit to the amount of performance-based compensation that can be deducted.[165]

Second, overall compensation levels increased instead of decreasing or merely remaining relatively steady.[166] The increase is, in part, attributable to the need to add a risk premium[167] to the amount of compensation paid to executives receiving performance-based pay.[168] It is also attributable to the fact that performance-based pay often ended up being more lucrative than originally anticipated.[169] Performance-based pay can be awarded in a variety of forms, such as cash or stock, but the quintessential form is the stock option.[170] This is so because a stock

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because of "the potential negative public response"). The SEC requires companies to disclose their policy regarding compliance with § 162(m). *See* Executive Compensation Disclosure; Securityholder Lists and Mailing Requests, Exchange Act Release No. 7032, 55 SEC Docket 1352 (Nov. 22, 1993).

[162] In addition, a number of commentators have catalogued a variety of other section 162(m) flaws: the $1 million limit is arbitrary, not indexed for inflation, and inflexible as to the circumstances of individual companies. *See* Miske, *supra* note 20, at 1687-89; Murphy, *supra* note 19, at 738-40; Polsky, *supra* note 20, at 920-25; Stabile, *supra* note 11, at 97.

[163] Stabile, *supra* note 11, at 88. *See also* FRANK PARTNOY, INFECTIOUS GREED: HOW DECEIT AND RISK CORRUPTED THE FINANCIAL MARKETS 156 (Times Books 2003) (referring to performance-based exception as "a loophole large enough to fly a private jet through.").

[164] Treas. Reg. § 1.162-27(e)(2)(i). Thus, while it cannot be certain to be met when set, the bar can be set fairly low so that the likelihood of meeting the goal is high. *See id.*

[165] The general rules of section 162(a) continue to apply, but recall that section 162(a)(1) is rarely applied to public companies, and where the IRS has attempted to do so it has been unsuccessful. *See supra* note 90.

[166] *See supra* note 158. *See also* Mark A. Sargent, *Lawyers in the Perfect Storm*, 43 WASHBURN L. J. 1, 9 (2003-2004) ("Beginning around 1990, stock options began to take off as the principal method of compensating senior executives, dwarfing cash salary payments in significance. Once installed throughout corporate America, stock option arrangements caused executive compensation to balloon wildly."). *But cf.* Richard A. Booth, *Executive Compensation, Corporate Governance, and the Partner-Manager*, 2005 U. ILL. L. Rev. 269, 279-281 (2005) (noting that "despite perceptions to the contrary, executive pay has not increased significantly as a percentage of corporate income in the last twenty-five years"). Also, the regulations under section 162(m) prohibit "discretion to increase the amount of compensation payable that would otherwise be due upon attainment of the goal." Treas. Reg. 1.162-27(e)(2)(iii)(A) (1994). This rule not only encourages boards to set a high maximum, since it cannot later be increased, but commentators have also pointed out that boards rarely scale back pay. *See* Polsky, *supra* note 20, at 911; Murphy, *supra* note 19, at 739.

[167] In theory, an executive receiving all or a portion of his pay based on performance risks receiving little or no pay if the company does not perform as expected. To offset this risk, a premium is added to the amount of compensation paid to the executive if the company performs well, increasing overall compensation above the level that would have been paid absent the presence of performance-based risk.

[168] *See* Polsky, *supra* note 20, at 887-88; Murphy, *supra* note 19, at 739.

[169] *See* Polsky, *supra* note 20, at 909 (noting that the public often fails to appreciate the value of stock option privileges at the time of grant and the time value component of an option). *See generally* Partnoy, *supra* note 163, at 156-159.

[170] *See* Polsky, *supra* note 20, at 889; Murphy, *supra* note 19, at 738; Partnoy, *supra* note at 163, at 156.

option's value is inherently tied to the performance of the corporation's stock if granted with an exercise price equal to or greater than fair market value at the time of the grant: it is only valuable if the stock price rises.[171] Stock options became significantly more popular after the enactment of 162(m).[172] This timing happened to coincide with the beginning of a stock market boom and thus led to incredibly handsome rewards for executives – certainly in comparison to ordinary workers.[173]

Third, the shift to performance-based compensation as a significant if not the largest portion of an executive compensation package "encourage[d] executives to focus on and manipulate short-term earnings at the expense of long-term value creation" that is in the interests

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[171] *See* Treas. Reg. § 1.162-27(e)(2)(vi)(A). Stock appreciation rights are also inherently performance-based if the amount of "compensation the employee could receive is based solely on an increase in the value of the stock after the date of the grant or award." *Id.*

[172] *See, e.g.*, *Backdating Hearing*, *supra* note 130, at 1 (testimony of Nell Minow, Editor, The Corporate Library) ("When the tax code was changed to prevent executive compensation of over $1 million to be deducted unless it was tied to performance, . . . everyone got boat-loads of options. The very definition of a "mega-grant" had to be changed, so it now can be as much as eight times the CEO's base pay and bonus."); Partnoy, *supra* note at 163, at 157 ("FASB officials knew that the $1 million cap on non-performance-based pay would lead companies to switch to stock options."); James R. Repetti, The Misuse of Tax Incentives to Align Management-Shareholder Interests, 19 Cardozo L. Rev. 697, 708-09 (1997). *But See* See Lora Cicconi, Blaming the Tax Code for the Backdating Scandal, 114 Tax Notes 1129, 1140 (March 19, 2007).

[173] *See* Sargent, *supra* note 166. Conversely, executive fortunes do not appear to be similarly impacted by stock market bust cycles. *See, e.g.,* Steven A. Bank, *Devaluing Reform: The Derivatives Market and Executive Compensation*, 7 DEPAUL BUS. L.J. 301, 312 (Spring/Summer 1995) ("A final criticism of stock options is that they carry no downside risk for the executive. As one observer noted, '(i)t's as if the executive got the company to agree to the following coin toss: Heads, I win big; tails, I lose nothing.'"); Linda Barrett, *Unsharing the Wealth: Recent Economic Volatility Has Greatly Impacted Executive Compensation*, 54 RUTGERS L. REV. 293, 319-20 (Fall 2001) ("The problem with [an options repricing] plan is that it gives an executive little incentive to implement strategies to increase the company's stock price thus rewarding the executive even if the company's performance is poor."); Linda J. Barris, *The Overcompensation Problem: A Collective Approach To Controlling Executive Pay*, 68 IND. L.J. 59, 66 (Winter 1992) ("Many compensation packages are constructed so that the executive profits in good times and is protected in bad. If stock prices decline, the executive may lose his bonus, but he may have the ability to renegotiate the option portion of his existing plan to lower the strike price, the price at which the option can be exercised. Thus, the executive is rewarded regardless of his or the corporation's performance and is simultaneously insulated from the ravages suffered by fellow shareholders if stock value declines."); Susan J. Stabile, *Viewing Corporate Executive Compensation Through a Partnership Lens: A Tool To Focus Reform*, 35 WAKE FOREST L. REV. 153, 216 (Spring 2000) ("Repricing protects executives from losses, while allowing them to profit if the stock price merely rises back to the original exercise price."). *But cf.* Booth, *supra* note 166, at 283-4 (asserting that repricing may serve valid business purposes). In fact, the stock market crash of 1929 and the early years of the ensuing depression did not even negatively affect the compensation level of many executives. Most bonus payments, of course, disappeared as profits did, but salaries remained largely intact. *See* Detlev Vagts, *Challenges to Executive Compensation: For the Markets or For the Courts?*, 8 J. CORP. L. 231, 246 (1983) (explaining that stock market crash had "mild[] effects" on executive salaries, which remained "stable"); George T. Washington, *The Corporation Executive's Living Wage*, 54 Harv. L. Rev. 743 (1941) (explaining that bonus payments "either ceased or were sharply reduced."). Indeed, some managers received salary increases to compensate for lost incentive pay. *See id.* at 743 (noting that executives were compensated with increased salaries in 1930 and 1931). More recently, "in 2000[, w]hile shareholders got hammered, many compensation committees scrambled to cushion their chief executives from feeling any real pain, granting massive blocks of new stock options in some cases and in others forgiving corporate loans." Business Week (April 16, 2001) available at http://www.businessweek.com/magazine/content/01_16/b3728013.htm.

of shareholders.[174] In some cases, executives trying to manage their company's earnings, and hence stock price, even committed accounting fraud.[175]

In the end, a tax provision can only encourage or discourage behavior. It can neither prevent companies from paying excessive compensation nor compel a particular compensation structure; it can only make it more costly for a company to do what it wants to do. This does not seem troublesome to the companies: despite all the ways to get around the 162(m) limit, a number of companies continue to pay compensation that is not deductible.[176]

3. Nonqualified Deferred Compensation: Section 409A

Recently, Congress responded to another surge in negative popular sentiment regarding executive compensation levels and practices with the enactment of section 409A.[177] It applies to nonqualified deferred compensation arrangements, and penalizes certain practices that were publicly revealed and widely disapproved during various corporate scandals in the early 2000s, in particular the collapse of Enron Corporation.[178] Those practices, under the rules governing the taxation of compensation, pushed the limits on securing an executive's deferred compensation while also providing the executive with the benefit of income tax deferral.[179]

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[174] Murphy, *supra* note 19, at 739. *See also* JCT Enron Report, *infra* note 182, at 3 ("Although the intent of many of Enron's stock-based compensation programs was to align the interests of shareholders and executives, the Enron experience raises a potential conflict between short-term earnings from which executives can reap immediate rewards and longer-term interests of shareholders."); Sargent, *supra* note 166, at 12-13 (discussing the argument that an "over-reliance on stock option compensation [] has led to an equally unhealthy preoccupation with short-term maintenance of stock prices").

[175] *See* Partnoy, *supra* note at 163, at 157; Sargent, *supra* note 166, at 10 ("the use of stock options created an incentive to use accounting devices designed to prop up the stock price").

[176] *See supra* note161 (noting forfeited deductions). *See also* Polsky, *supra* note 20 at 900-901 (discussing why companies might forfeit deductions, including the possibility that it makes more after-tax economic sense).

[177] *See* AJCA, *supra* note 79 (discussing scope of Act).

[178] *See*, *e.g.*, *Press Release*, United States Senate Committee on Finance, *Floor Speech of Chairman Grassley on Tax Loophole Closers in JOBS Act*, Oct. 11, 2004, *available at* http://finance.senate.gov/press/Gpress/2004/prg101104.pdf (last visited Aug. 22, 2008) (referring to nonqualified deferred compensation legislation as "Enron reforms"); *infra* note 182, at 12 ("Enron's compensation arrangements received considerable media attention in the aftermath of the Enron bankruptcy"); William A. Drennan, *Enron-Inspired Nonqualified Deferred Compensation Rules: "If You Don't Know Where You're Going, You Might Not Get There*, 73 TENN. L. REV. 415, 417-18 (2006) (noting that scandals surrounding "Enron, WorldCom, Global Crossing, Tyco, HealthSouth, and others" were met with large amounts of publicity and that such publicity "created an environment conducive to fundamental reforms in . . . corporate governance."); Ethan Yale and Gregg D. Polsky, *Reforming the Taxation of Deferred Compensation*, 85 N.C. L. REV. 571 (2007) (referring to executive pay as "topic of significant interest" for academics, journalists, and legislators, in aftermath of scandals surrounding Enron and New York Stock Exchange Chairman Richard Grasso). Prior to the enactment of Code section 409A, Congress enacted the Sarbanes-Oxley Act of 2002, which was aimed at corporate governance, accounting, and corporate fraud issues.

[179] *See* JCT COMPENSATION REPORT, *supra* note 4 at 2 ("Prior to the enactment of section 409A, the tax treatment of nonqualified deferred compensation was governed by general tax principles. Several practices had developed that allowed executives deferral of income inclusion, but inappropriate degrees of security and control over amounts deferred. Section 409A was intended to address these practices.").

Section 409A is broader than any other provision discussed in this article. Subject to exceptions, it can apply to any taxpayer who defers compensation under a nonqualified plan; it is not limited to executives. *See supra* note 79. Nevertheless, the impetus for enactment was certain executive compensation practices that came to light in the aftermath of the collapse of Enron.

As discussed in subsection A, if compensation is deferred outside of a qualified plan, it may or may not be subject to current income taxation even though receipt has been deferred.[180] The tax consequences will depend on the extent to which the taxpayer's interest in the compensation is secured. There are two possibilities: either (1) the employee in some way risks losing the deferred compensation and as a result is not subject to current income taxation on it, or (2) the employee does not significantly risk losing the deferred compensation and as a result it is subject to current income taxation.[181] The nonqualified plans Enron offered its executives did not subject them to current taxation, and yet events revealed that their interests in plan funds were fairly well protected.[182]

Enron executives, aware of the company's impending financial crisis, took early distributions totaling more than $53 million from their nonqualified plans within weeks of Enron filing for bankruptcy.[183] Around the same time, normal administrative procedures prevented employees from making changes to the investments in their qualified 401(k) retirement plans for two and one-half weeks.[184] Many rank-and-file Enron employees had invested a significant percentage of their plan balance in Enron stock, and by the time the "blackout" period was over they had lost not only their jobs but also a considerable amount of their retirement savings.[185]

The revelation that Enron executives had received handsome benefits while employees lost their savings prompted both public resentment and Congressional concern.[186] The Senate Finance Committee commissioned an investigation into that and other matters.[187] The resulting

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[180] *See supra* notes 61-76 and accompanying text (discussing the taxation of deferred compensation).

[181] *See id.* (same).

[182] *See* STAFF OF THE J. COMM. ON TAXATION, 108th CONG., REPORT OF INVESTIGATION OF ENRON CORPORATION AND RELATED ENTITIES REGARDING FEDERAL TAX AND COMPENSATION ISSUES, AND POLICY 2 (2003) [hereinafter JCT ENRON REPORT], *available at* http://www.gpo.gov/congress/joint/jcs-3-03/vol1/index.html.

[183] *See* JCT ENRON REPORT, *supra* note 182, at 14, 627. These distributions drained Enron of available cash just prior to bankruptcy. *See id.* at 636. They were, however, also recoverable under bankruptcy law. *See* Drennan, *supra* note 22, at 442-43.

[184] *See* JCT ENRON REPORT, *supra* note 182, at 38. A change in recordkeepers triggered the "blackout" period. Such changes are "a normal part of qualified plan operations." *Id.*

[185] In the aggregate, 62 percent (or roughly $1.3 billion dollars) of 401(k) plan assets were invested in Enron stock. *See* James J. Choi et al., *Are Empowerment and Education Enough?: Under-Diversification in 401(k) Plans* 3 (2005), available at http://www.brookings.edu/es/commentary/journals/bpea_macro/forum/200509bpea_laibson.pdf. During the blackout period, "the price of Enron stock fell from $15.40 to $9.98." JCT ENRON REPORT, *supra* note 182, at 38. Enron's demise also affected employees' interests in the Enron Employee Stock Ownership Plan. *See Id.* at 13.

[186] *See, e.g.,* Michael J. Hussey, *Has Congress Stopped Executives From Raiding the Bank? A Critical Analysis of I.R.C. § 409A*, 75 UMKC L. REV. 437 (2006) (noting that "sharp contrast" between executive bailouts and average employee hardship in Enron collapse caused "general outcry over nonqualified deferred compensation"); Eric D. Chason, *Deferred Compensation Reform: Taxing the Fruit of the Tree in its Proper Season*, 67 OHIO ST. L. J. 347 (2006) (recounting how nonqualified deferred compensation "grabbed headlines" in wake of Enron scandal).

[187] The staff of the Joint Committee on Taxation ("JCT") (comprised of economists, attorneys, and accountants who, on a nonpartisan basis, assist Members in both houses of Congress on tax legislation) was directed to report on "the compensation arrangements of Enron employees, including tax-qualified retirement plans, nonqualified deferred compensation arrangements, and other arrangements, in order to analyze the factors that may have contributed to the loss of benefits and the extent to which losses were experienced by different groups of employees." *See* JCT ENRON REPORT, *supra* note 182, at 2.

Enron Report found that broad interpretations of then-current law allowed Enron executives to delay payment of income taxes on their nonqualified deferred compensation until it was received, even though events indicated they maintained security and control over the amounts deferred, including the ability to request early withdrawals when the company was in financial distress.[188]

Congress subsequently enacted section 409A to address nonqualified plan practices it considered inappropriate.[189] Like section 4999 two decades earlier, Congress imposed an additional tax on executives who defer compensation under a plan that does not meet the requirements of section 409A. More specifically, participants in plans that fail to satisfy section 409A's requirements are immediately subject to current taxation, plus interest, on all compensation deferred under the plan to the extent the compensation is not subject to a substantial risk of forfeiture or has not been previously included in gross income.[190] Section 409A also imposes an additional twenty percent tax on the non-complying compensation that was included in the participant's income for the taxable year.[191]

In light of Congress's prior tax penalty enactments in the area of executive compensation -- either denying a deduction to the corporation or imposing an additional tax on the executive, use here of an additional tax makes some sense because the compensation at issue is already nondeductible by the company until included in the executive's income.[192] In fact, the Enron Report commented:

> Enron allowed its executives to defer significant amounts of compensation even though Enron had to forego a current deduction with respect to such amounts. The fact that Enron was apparently indifferent to the deferral of its deduction provides further support for the need for changes to the tax treatment of nonqualified deferred compensation. Changes to the present-law rules regarding the taxation of deferred compensation would reduce the amount of income deferred.[193]

[188] *See id.* at 40 . The nonqualified plans avoided current income inclusion for the executives presumably by, inter alia, subjecting receipt of the deferred compensation to a substantial limitation or restriction: early withdrawals incurred a 10 percent forfeiture penalty (a "haircut") and also resulted in the executive being prohibited from participating in the plan for three years. *See id*. at 622. These practices raised additional concerns regarding the deferred compensation statutory structure which is designed to provide qualified plans significantly more favorable tax treatment than nonqualified plans in order to encourage employers to sponsor retirement plans for the benefit of their rank-and-file employees. In that regard the Enron Report commented that: "Enron's deferred compensation plans allowed executives to receive benefits similar to those of qualified plans. To the extent that it is possible for executives to defer taxes and have security and flexibility through nonqualified arrangements, this undermines the qualified retirement plan system. If executives can obtain the result they desire through the use of nonqualified plans and arrangements, there will be less incentive for companies to maintain qualified plans, which will result in rank and file employees losing pension coverage." *Id.* at 40.

[189] *See supra* note 179.

[190] *See* I.R.C. § 409A(a)(1). The interest rate is one percentage point above the underpayment rate. *See* I.R.C. § 409A(a)(1)(B)(ii).

[191] *See* I.R.C. § 409A(a)(1)(B)(i)(II).

[192] *See supra* note 96 and accompanying text.

[193] *See* JCT Enron Report, *supra* note 182 at 40. It should be noted that the deferral of a deduction does not necessarily increase the cost of the compensation. *See generally* Daniel I. Halperin, *Interest in Disguise: Taxing the "Time Value of Money*", 95 YALE L.J. 506, 520-24 (1986); Ethan Yale & Gregg D. Polsky, 85 N.C.L. Rev. 571, 625 (2007).

Section 409A has drastically changed the nonqualified deferred compensation landscape by imposing a broad range of specific restrictions on everything from making deferral elections to receiving distributions.[194] If section 409A had been in existence during the time of Enron, and if Enron had chosen to comply with its rules, then Enron's executives generally would not have been permitted under the terms of their nonqualified plans to withdraw funds as Enron headed toward financial disaster. This is because of section 409A's distribution, acceleration, and funding requirements. Under section 409A, a nonqualified plan must restrict the circumstances under which a participant can receive distributions from the plan to six events delineated in the statute.[195] Although one such listed event permits distributions that occur at a time specified when the compensation is deferred, another section 409A provision ensures that the specified time cannot later be accelerated.[196] Section 409A also immediately taxes compensation deferred under a plan that allows plan assets to become secured in the event the employer experiences a change in financial health.[197]

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[194] *See, e.g.,* Doran, *supra* note 68 at 3 (referring to section 409A as "direct attempt by Congress to control the taxation of nonqualified deferred compensation"); Kristen B. Stewart & W. Brent Vanderbrook, *Nonqualified Deferred Compensation Arrangements After the Enactment of Code §409A*, 35 JAN. COLO. LAW. 53 (2006) (referring to 409A as bringing about "significant changes" in taxation of NQDC and opining that Congress had "changed virtually every aspect" of taxation of such plans). Notwithstanding the foregoing, section 409A applies in addition to rather than instead of prior deferred compensation tax law. *See* H.R. CONF. REP. NO. 775, 108th CONG., 720, 735 (2004). *See also* Chason, *supra* note 186, at 347 (opining that 409A "merely tightens and clarifies the doctrines that had already governed executive pensions."); Richard Ehrhart, *Section 409A – Treasury "Newspeak" Lost in the "Briar Patch"*, 38 J. MARSHALL L. REV. 743, 743-44 (2005) (commenting that Congress had added "supplemental requirements to the constructive receipt doctrine" but did not alter or reverse prior law).

Section 409A has been widely criticized for being overly complex, over inclusive, and failing to address the most significant issues underlying nonqualified deferred compensation. *See, e.g.*, Drennan, *supra* note 178, at 435-46 (asserting that problem demonstrated by Enron's NQDC plans was not NQDC itself but failure of Enron board to engage in arm's-length bargaining); Hussey, *supra* note 186, at 438 (referring to section 409A as "unwieldy and confusing" and asserting that section 409A does little to prevent executives from using NQDC); Yale & Polsky *supra* note 193 ("[T]he federal tax rules governing [deferred] compensation are fundamentally flawed and must be extensively overhauled."); Ethan Yale & Daniel Halperin, *Deferred Compensation Revisited*, 114 TAX NOTES TODAY, Mar. 5, 2007, at 939-45 ("[With Section 409A,] [t]axpayers now face extremely complicated rules that are focused on the least important considerations and that overlook the most important.").

[195] *See* I.R.C. § 409A(a)(2)(A). This provision provides that the requirements of section 409A are not met unless "the plan provides that compensation deferred under the plan may not be distributed earlier than--

(i) separation from service as determined by the Secretary (except as provided in subparagraph (B)(i)),

(ii) the date the participant becomes disabled (within the meaning of subparagraph (C)),

(iii) death,

(iv) a specified time (or pursuant to a fixed schedule) specified under the plan at the date of the deferral of such compensation,

(v) to the extent provided by the Secretary, a change in the ownership or effective control of the corporation, or in the ownership of a substantial portion of the assets of the corporation, or

(vi) the occurrence of an unforeseeable emergency."

In addition, "key employees" of publicly traded corporations may not receive distributions by reason of a separation from service "before the date which is 6 months after the date of separation from service (or, if earlier, the date of death of the employee)." I.R.C. § 409A(a)(2)(B).

[196] *See* I.R.C. §§ 409A(a)(2)(A)(iv), 409A(a)(3)(prohibiting acceleration except as provided in regulations), and Treas. Reg. § 1.409A-3.

[197] *See* I.R.C. § 409A(b)(2)(A).

Although enacted in 2004, the IRS has repeatedly issued transition relief delaying the date on which plans must be in compliance with section 409A due to its complexity. At present, the compliance deadline is December 31, 2008.[198] It is accordingly too early to determine definitively how executives and their employers are reacting to the potential for significant tax penalties under section 409A. Anecdotal evidence does suggest, however, that companies are entering into gross-up agreements under which the incidence of any taxes and interest would be shifted from the executive to the company. In the end, companies can choose to provide and executives can choose to accept plans that do not meet the requirements of section 409A and thus incur the penalties thereunder.

4. In Summary

None of the tax provisions discussed above were aimed at raising revenue for the federal fisc.[199] They were instead each aimed at behavior modification to influence aspects of executive compensation. And companies have modified their corporate practices in response to these tax penalties, but almost all evidence indicates that they did not do so in the way Congress envisioned.

Sections 280G and 4999 were enacted to discourage companies from authorizing golden parachute payments above a defined level. Congress's stated motivation was to protect shareholders from the direct and indirect costs of excessive executive compensation in the form of golden parachutes. But these provisions do not and have not prevented companies from authorizing golden parachutes above the limit allowed by the Code without penalty.

Section 162(m) was enacted to discourage public companies from paying compensation above a defined level unless it was tied to the company's performance. This time Congress was motivated to respond to an American public that was angered over immense executive compensation packages at a time when many Americans were struggling to make ends meet. Nevertheless, according to a recent report prepared for Congress, "[s]tudies have indicated that the deduction limitation may have led to some substitution away from salary compensation toward performance-based compensation, but that growth in overall executive compensation has

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198 *See* I.R.S. Notice 2007-78, 2007-41 I.R.B. 780, as revoked and superseded by I.R.S. Notice 2007-86, 2007-46 I.R.B. 990.

199 "While raising revenue is always a legitimate use of the Code, it does not appear to be the goal which Congress is seeking to achieve." Stabile, *supra* note 11, at 100 (discussing sections 280G and 162(m)). *See also* STAFF OF THE JOINT COMM. ON TAX'N, 103d CONG., ESTIMATED BUDGET EFFECTS OF THE REVENUE RECONCILIATION PROVISIONS OF H.R. 2264 (THE OMNIBUS BUDGET RECONCILIATION ACT OF 1993) AS AGREED TO BY THE CONFEREES (1993) (forecasting cumulative revenue increase over the first five fiscal years of section 162(m) of $335 million); Meegan M. Reilly, *Former Treasury Official Discusses Executive Compensation Cap*, 62 TAX NOTES 747 (1994) (recounting observations of former Treasury benefits tax counsel Catherine Creech that section 162(m) was "not intended to be a revenue-raising provision, but a behavior-shaping provision"); DEFRA Senate Report, *supra* note 115, at 197 (noting that sections 280G and 4999 were expected to generate less than $5 million in revenue); Wolk, *supra* note 9, at 127 (asserting that golden parachute legislation uses tax code to "discourage certain business arrangements" rather than to raise revenue); JOINT COMM. ON TAX'N, ESTIMATED BUDGET EFFECTS OF THE CONFERENCE AGREEMENT FOR H.R. 4520, THE "AMERICAN JOBS CREATION ACT OF 2004," Oct. 7, 2004, at 9, *available at* http://www.house.gov/jct/x-69-04.pdf (estimating Section 409A would bring revenue increase of $158 million in its first year).

not been reduced."[200] Other studies also suggest that, despite a requirement to the contrary, compensation levels are not responsive to company performance. In the end, companies continue to pay compensation that is not deductible.

Section 409A was also enacted in response to popular sentiment. The public was in an uproar over Enron's pay practices in general and its deferred compensation practices in particular. Enron's deferred compensation practices allowed executives to access their retirement plans and deplete Enron's assets while rank-and-file employees were locked out of accessing their retirement plans. In response, Congress enacted section 409A to discourage companies from establishing nonqualified deferred compensation plans that would allow an executive to have a significant degree of control over amounts deferred. While it is too early to make any certain claims regarding section 409A, prior experience suggests that it will share the experience of its predecessors and thus do little to prevent executives from finding a way around the rules to whatever end they desire, or else their employers will pay any imposed penalties.

Leading scholars are in agreement that tax legislation attempting to control executive compensation has yielded many unintended consequences, but has not reduced overall compensation levels or been effective in achieving other legislative goals. This result would ultimately not matter as much if the unintended consequences were of neutral or positive effect. A number of scholars, however, have noted the ways in which these unintended consequences have created counter-productive tendencies, such as increasing overall compensation paid to executives. In the end, those unintended consequences and any imposed tax penalties end up costing the company more. The next section considers the effects of these additional costs, and highlights how, as an overall matter, the provisions have negative effects on people other than the highly paid executives, and can even exacerbate the increasing trend of income inequality.

IV. THE ECONOMIC BURDEN OF TAX PENALTIES ON EXECUTIVE COMPENSATION

For a variety of reasons discussed in the corporate governance literature, corporate boards continue to authorize large executive compensation packages that result in the imposition of tax penalties.[201] These tax penalties increase the company's expenses: tax penalties that disallow or limit a deduction for an expense increase the company's cost for that item of expense, as do tax penalties that impose an additional tax that is paid by the company through the operation of a gross-up agreement.[202] The company's expenses are further increased by attendant costs, such as the growth of performance-based pay, excess burdens (*e.g.*, transaction costs), and deadweight losses.[203] Indeed, increased transaction costs are incurred even if a company and its executives agree to set compensation at a level and in a manner that avoids the Code's penalty provisions.

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[200] JCT Compensation Report, *supra* note 4.

[201] *See, e.g.*, Lucian Bebchuk & Jesse Fried, PAY WITHOUT PERFORMANCE: THE UNFULFILLED PROMISE OF EXECUTIVE COMPENSATION (2004).

[202] *See supra* Part III. B. *See also generally* Polsky, *supra* note 20.

[203] *See, e.g.*, ANDREW CHAMBERLAIN & GERALD PRANTE, WHO PAYS TAXES AND WHO RECEIVES GOVERNMENT SPENDING? AN ANALYSIS OF FEDERAL, STATE AND LOCAL TAX AND SPENDING DISTRIBUTIONS, 1991-2004 36 (Tax Foundation, Working Paper No. 1, 2007) [hereinafter Tax Foundation Paper] ("In addition to tax collections, taxes generally result in what economists refer to as 'excess burdens' in the form of tax compliance costs, as well as various efficiency losses in the marketplace known as 'deadweight losses.'").

In that case, the costs will be related to ensuring the compensation package is in fact within the delineated boundaries of the penalty provisions, as opposed to costs related to justifying a package that falls outside of those boundaries and incurs penalties.[204]

These additional costs may be counter-balanced by other gains. It could be argued that executive compensation packages that incur penalties but allow for the recruitment and retention of preferred CEOs is more economically efficient overall.[205] Perhaps companies choosing not to observe the Code's negative incentives are better off for having done so: possibly, after penalties are paid, the company has still earned an increased net positive return as compared with other scenarios where no penalties are incurred. But even if that were the case, it would not mean that it is the best result that can be achieved. The company is still incurring economically inefficient costs and would presumably be even better off in the absence of the penalties and related costs.

A corporation, however, is a creature of state law, an artificial legal entity that can only act through natural persons.[206] As such, a corporation cannot bear the ultimate burden (or the incidence) of these expenses; only natural persons bear the economic burden.[207] The questions that remain are which individuals bear the burden and in what proportion.

The literature analyzing who bears the incidence of entity-level taxation, and in what proportion, is rich and deep. Economists have been debating these issues for nearly a century, and yet there is very little consensus.[208] Most economists generally do agree, however, that there are four non-mutually exclusive categories of individuals who could bear the incidence: shareholders, owners of capital, consumers, or workers (including vendors and other non-employees that provide services to the corporation).[209]

Using the literature regarding the incidence of the corporate tax as a proxy for the incidence of increased corporate taxes and other expenses due to tax penalties, these increased

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[204] *See generally* Polsky, *supra* note 20 (discussing various costs firms might contend with in presence of section 162(m) regardless of whether they are ultimately subject to section 162(m)).

[205] *See id.* at 890. There, of course, could be less economically motivated reasons as well. *See supra* note 201.

[206] *See supra* note 40.

[207] *See supra* note 41.

[208] *See*, *e.g.*, Auerbach, *supra* note 41, at 2 ("While the ultimate incidence of the tax remains somewhat unresolved, there have been many advances over the years in our thinking about how to assign the corporate tax burden; we don't have all the answers, but we do have a much better idea where to look for them."); WILLIAM M. GENTRY, A REVIEW OF THE EVIDENCE ON THE INCIDENCE OF THE CORPORATE INCOME TAX 3, 5 (Dep't of the Treasury, Office of Tax Analysis, Working Paper No. 101, 2007) [hereinafter OTA Paper] (explaining some reasons why determining the incidence of the corporate tax is difficult); Jane G. Gravelle & Kent A. Smetters, *Does the Open Economy Assumption Really Mean That Labor Bears the Burden of a Capital Income Tax?*, 6 ADVANCES IN ECONOMIC ANALYSIS & POLICY, Iss. 1, Art. 1 (2006), *available at* http://www.bepress.com/bejeap/advances/vol6/iss1/art3 ("The incidence of the corporate tax is one of the most controversial issues in tax analysis"); William A. Klein, *The incidence of the Corporation Income Tax: A Lawyers View of a Problem in Economics*, 1965 WES. L. REV. 576 (1965) (assessing conflicting economic literature on who bears incidence of corporate tax from perspective of tax lawyer); Joseph A. Pechman, FEDERAL TAX POLICY, 141 (5th ed. 1987). Economists do agree that the burden must be traced to individuals. *See*, *e.g.*, *supra* note 207.

[209] *See* OTA Paper, *supra* note 208, at 1, 4; Pechman, *supra* note 208, at 141-45. Owners of capital include "all individuals who earn capital income (dividends, interest, rents, and capital gains) from both corporate and noncorporate sources." Tax Reform Report, *supra* note 37, at 34.

costs are also borne in some combination by shareholders, owners of capital, consumers, or workers.[210] This Part provides a deeper analysis of the individuals in each of these categories and considers how the incidence of the tax penalties could affect each of them. It shows that each category is comprised of a diverse group of individuals and thus reveals that, notwithstanding the uncertainty surrounding the incidence literature, the burden likely falls on rank-and-file Americans to a substantial extent and does not significantly fall on the executives that Congress was targeting with enactment of the penalties. To the extent targeted executives bear a portion of the burden in their capacity as members of these categories, the impact is diminished due to its dispersion among the many other individuals in the relevant category or categories.[211] Thus, the penalties largely miss their mark and fall on individuals that the tax penalties did not intend to penalize.[212]

A. Incidence in General

Very generally, if shareholders bear the incidence of taxation, they do so in the form of a lower rate of return on their equity: meaning, a lower share value or reduced dividend payments. Likewise, owners of capital would bear the burden in the form of a lower rate of return on their capital assets. Consumers would bear it in the form of higher prices, and workers in the form of lower real wages or layoffs.

Whether, and in what proportion, any of these individuals bear the burden of corporate taxes is subject to considerable debate.[213] This is because "[t]he actual burden of the corporate income tax depends on a complicated set of behavioral reactions to the tax."[214] Nevertheless, an identifiable burden must be assumed to allow the federal government or others to conduct tax distribution analyses purportedly showing how tax burdens and benefits are distributed across the population.

Assumptions regarding the distribution of the corporate tax burden vary by organization.[215] While the most commonly used assumption is that individuals bear the burden

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[210] The corporate tax incidence literature is possibly an imperfect substitute because there is a degree of choice present with regard to incurring executive compensation tax penalties that is not available in the pure corporate tax setting. Further, choosing to incur penalties could in some situations make more economic sense than not incurring the penalties. *See supra* note 205 and accompanying text. Nevertheless, it is accepted that the corporate tax incidence literature is an appropriate proxy in similar situations where tax rules may cause a difference "in tax payments *within* the corporate sector." Andrew B. Lyon, CRACKING THE CODE: MAKING SENSE OF THE CORPORATE ALTERNATIVE MINIMUM TAX 53 (1997) (emphasis in original).

[211] *See* Vada Waters Lindsey, *The Widening Gap Under the Internal Revenue Code: The Need for Renewed Progressivity*, 5 FLA. TAX REV. 1, n.199 (2001) ("If the corporate tax is borne by employees in the form of lower compensation, the CEOs and other high-ranking corporate executives seem to escape this financial burden.")

[212] The individuals who are being penalized most likely do not realize they are being penalized, as they are hidden taxes. *See, e.g.,* McCaffery, Cognitive Theory and Tax, *supra* note 43, at 1874-86 (discussing fully hidden taxes such as social security contributions and the corporate tax).

[213] *See supra* note 208. For a discussion of some of the reasons why the incidence question is so difficult to answer, *see generally* OTA Paper, *supra* note 208 at 4-5.

[214] OTA Paper, *supra* note 208 at 4-5

[215] The Congressional Budget Office, Treasury Department, and some research organizations assign the burden of corporate taxes to individuals on the basis of their total capital asset ownership. *See* OTA Paper, *supra* note 208 at 2. Other research organizations assign 70 percent of the burden to labor and 30 percent to owners of capital, or run alternative scenarios using different assumptions. *See* Tax Foundation Paper, *supra* note 203 at 83.

in proportion to their total capital asset ownership, recent empirical studies "suggest that labor may bear a substantial burden."[216] In the end, most economists would agree that owners of capital bear some part of the economic burden.[217] Many would also agree that at least part, if not most, of the burden is shifted at some point to workers (*i.e.*, to labor).[218]

B. Shareholders

If a company absorbs the corporate tax, thus lowering the company's after-tax profits (*i.e.*, the bottom line), then its shareholders will initially bear the burden in the form of a smaller after-tax return on their corporate equity.[219] This would generally occur where an entity-level tax was imposed on businesses operating in corporate form assuming that there previously had been no such tax imposed under the law.[220] In that case, the theory goes, shareholders would not be able to shift the tax onto others for a period of time following the imposition of the tax because the prices paid for labor and charged for products and services would have already been set.[221]

Just as it is necessary to look past the nominal payor of taxes to determine which individual or category of individuals really bears the financial burden, it is necessary to look through categories of individuals to learn more about the characteristics of the individuals in that group. Unfortunately, share ownership information is notoriously difficult to come by.[222] Various organizations, however, have conducted surveys or other studies from which it is possible to extrapolate share ownership information. These surveys show that the characteristics

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According to Professor Michael Graetz, "It is standard practice in government analyses either to assume the U.S. corporate income tax is split 50-50 by owners of capital and consumers or to treat the incidence of the tax as uncertain." Michael J. Graetz, *Taxing International Income: Inadequate Principles, Outdated Concepts, and Unsatisfactory Policies*, 54 TAX L. REV. 261, 302 n.170 (2001). Assumptions have also varied within an organization over a period of time. *See* Gravelle & Smetters, *supra* note 208.

[216] *See* OTA Paper, *supra* note 208, at ii.

[217] *See* Auerbach, *supra* note 41; Pechman, *supra* note 208.

[218] *See* Lyon, *supra* note 210, at 52; Klein, *supra* note 208 at 602; OTA Paper, *supra* note 208 at 1, 5.

[219] *See* Auerbach, *supra* note 41 at 4-5 ("Perhaps the simplest and oldest theory of corporate tax incidence is that the tax falls on corporate shareholders in proportion to their ownership. . . . But even this simple method of assigning the burden of the corporate tax is not so simply applied"); Lyon, *supra* note 210, at 51. *See also* Bebchuk & Fried, *supra* note 201, at 46 ("Excessive compensation does not hurt shareholders directly; it hurts them indirectly, through their equity interests in the firm.").

[220] *See* Auerbach, *supra* note 41; Arnold C. Harberger, *The Incidence of the Corporation Income Tax*, 70 J. POL. ECON. 215 (1962); TAXING OURSELVES, *supra* note 29.

[221] *See* Pechman, *supra* note 208, at 142. Hereinafter, the term "product" will be used to refer to both products and services. Note, however, that incidence analysis results may vary depending on whether the product is tradeable or non-tradeable. *See generally,* Arnold C. Harberger, *The Incidence of the Corporation Income Tax Revisited*, National Tax Journal, 305-6 (June 2008).

[222] *See* Lawrence Mishel, Jared Bernstein & John Schmitt, *The State of Working America 1998-99* 266-67 (Econ. Pol'y Inst. ed., Cornell U. Press 1999) [hereinafter *State of Working America*] (discussing how information on ownership of stock through vehicles such as mutual funds, defined-contribution pension plans and individual retirement accounts is harder to come by than information on direct holdings); Mihir A. Desai, Dhammika Dharmapala & Winnie Fung, *Taxation and the Evolution of Aggregate Corporate Ownership Concentration* 36 (Nat'l Bureau of Econ. Research, Working Paper No. 11469, 2005), available at http://www.nber.org/papers/w11469 [hereinafter Desai NBER Paper].

of shareholders have changed substantially over the last few decades.[223] Americans' savings patterns are a significant contributing factor to these changes.

Since the 1980s, Americans have changed the way in which they invest, or save, for retirement, health care, education, and other expenses.[224] The country has moved from the defined benefit paradigm of employer-provided pensions to a defined contribution paradigm of individual saving accounts, such as 401(k) accounts, individual retirement accounts (IRAs), health savings accounts (HSAs), and 529 educational savings accounts.[225] This means that rank-and-file Americans, through institutional mediators, are now investing indirectly in public companies in ever-greater numbers and amounts.

As recently as 1982, only 20 percent of American households owned stock (directly or indirectly).[226] Today, by contrast, over 50 percent of American households own stock indirectly through an employer-sponsored defined contribution-type plan alone.[227] The number of active participants in private defined contribution plans has grown from 11 million in 1975 to 52 million in 2004.[228] And those numbers do not include individuals investing in an IRA, a defined contribution plan offered by a governmental employer, or other types of savings assets such as life insurance or annuities.[229]

As defined contribution plans have risen in prominence, defined benefit plans have faded in prominence.[230] The last bastion of defined benefit plans is governmental employers, and even there they are beginning to lose favor.[231] In 1985 retirement savings assets totaled $2.3 trillion,

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[223] *See, e.g.*, Desai NBER Paper, *supra* note 222 (discussing evolution of shareholders).

[224] *See* Zelinsky, *supra* note 152, at 453 ("Pension cognoscenti have frequently remarked on the stagnation of defined benefit pensions and the concomitant rise of defined contribution plans. I suggest that, over the last generation, something even more fundamental has occurred, something that can justly be called a paradigm shift. Americans today primarily conceive of and implement retirement savings in the form of individual accounts. Such accounts have become primary instruments of public policy, not just for retirement savings, but increasingly for health care and education as well."); Edward A. Zelinsky, The Defined Contribution Paradigm: Why It Happened and Why Social Security Accounts Didn't (At Least Not Yet), (draft article March, 2006), available at http://www.law.ucla.edu/home/index.asp?page=2327 (exploring causes underlying defined contribution paradigm and speculating as to its future). *See also* 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, 24-27 (Fall 1993).

[225] *See supra* note 61 (discussing deferred compensation).

[226] *See* INVESTMENT COMPANY INSTITUTE AND THE SECURITIES INDUSTRY ASSOCIATION, EQUITY OWNERSHIP IN AMERICA 1, 7 [hereinafter Equity Ownership] (2005).

[227] *See id.*

[228] *See* U.S. Dep't of Labor, Employee Benefits Sec. Admin., *Private Pension Plan Bulletin Historical Tables* E8, Feb. 2008. During the same time period, active participants in defined benefit plans fell from 27 million to 20.6 million. *See id.*

[229] *See id*.

[230] From 1985 to 2002, the total number of PBGC-insured defined benefit plans decreased from a high of more than 114,000 to 32,321. PBGC Pension Insurance Data Book 2002, 44 & 72. In addition, pension plan freezes, where the plan either ceases future benefit accruals or to admit new participants, "are fairly common today." U.S. GOVN'T ACCOUNTABILITY OFFICE, DEFINED BENEFIT PENSIONS PLAN FREEZES AFFECT MILLIONS OF PARTICIPANTS AND MAY POSE RETIREMENT INCOME CHALLENGES 2 (2008).

[231] "With few exceptions, defined benefit pension plans still provide the primary pension benefit for most state and local workers. About 90 percent of full-time state and local employees participated in defined benefit pension plans as of 1998." U.S. GOVN'T ACCOUNTABILITY OFFICE, STATE AND LOCAL GOVERNMENT RETIREE

of which defined contribution assets were only $0.7 trillion or about 30 percent.[232] Today, total retirement assets are $17.6 trillion, of which defined contribution assets are $9.2 trillion or roughly 52 percent.[233] The vast majority of these assets are invested in stock.[234] In this way, Americans have shifted, along with savings plans, into the role of shareholders, albeit in an indirect manner.

Without question, the lowest-income Americans do not significantly participate in share ownership, either directly or indirectly.[235] Savings in defined contribution tax-preferred vehicles "tends to increase with families' income and net worth."[236] There is also no question, however, that the composition of public company shareholders has changed substantially over the course of the last few decades. In 1962, the top 1 percent of wealthiest Americans owned 64 percent of public company shares. By 1998 that figure had dropped to 37 percent.[237] During that period, middle-income Americans experienced the greatest increase in stock ownership as compared to other income classes.[238] As Professor Edward Zelinsky has noted, "the defined contribution paradigm is very much a middle and upper-middle class phenomenon."[239]

For several reasons, many retirement policy experts expect the increase in defined contribution plans vis-à-vis defined benefit plans to continue; there will also likely be an increase in participation by the lower-income population.[240] To begin, new defined benefit plans are not being created.[241] Meanwhile, existing defined benefit plans are being terminated or frozen, with

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BENEFITS CURRENT FUNDED STATUS OF PENSION AND HEALTH BENEFITS 4 (2008) [hereinafter STATE AND LOCAL REPORT]. But, a few states do now "offer defined contribution or other types of plans as the primary retirement instrument." *Id.*

[232] Investment Company Institute, 2008 Investment Company Fact Book 87 Figure 7.1 (2008). The .7 trillion figure does not include investments in fixed and variable annuity reserves at life insurance companies other than annuities held by IRAs, 403(b) plans, and 457 plans. It also does not include defined benefit pension plan assets.

[233] *See id.*

[234] *See* Equity Ownership, *supra* note 226, at 1, 10-12.

[235] Of the nation's poorest, 11.7 percent do own stock either directly or indirectly. *See* Brian K. Bucks, Arthur B. Kennickell & Kevin B. Moore, *Recent Changes in U.S. Family Finances: Evidence From the 2001 and 2004 Survey of Consumer Finances*, FEDERAL RESERVE BULLETIN, 2006, at A19 [hereinafter *Survey of Consumer Finances Report*]. This figure does not include insurance or annuities, which comprise a significant portion of the financial assets of low-income Americans. However, in 1998, households with income of $25,000 or less owned only 3.5 percent of public company stock. *See* NYSE SHARE OWNERSHIP 2000 25, Table 8, available at http://www.nyse.com/pdfs/shareho.pdf [hereinafter NYSE SHARE OWNERSHIP 2000].

[236] *Survey of Consumer Finances Report*, *supra* note 235, at A24. Participation and amount of savings also increases with level of education, age, marriage, and "white non-Hispanic" ethnicity. *See id.*

[237] *See* State of Working America, *supra* note 222, at 263.

[238] The percentage of stock owned by those in the third and fourth income quintiles increased from 7 percent in 1962 to 23 percent in 1998. *See id*.

[239] *See* Zelinsky, *supra* note 14, at 39.

[240] *See, e.g.,* U.S. GOVN'T ACCOUNTABILITY OFFICE, LOW DEFINED CONTRIBUTION PLAN SAVINGS MAY POSE CHALLENGES TO RETIREMENT SECURITY, ESPECIALLY FOR MANY LOW-INCOME WORKERS 27 (2007) [hereinafter GAO SAVINGS REPORT] ("Recent regulatory and legislative changes and proposals could have positive effects on DC plan coverage, participation, and savings . . . [and] automatically enrolling new employees in plans as a default could have a significant positive impact on DC balances, especially for low-income workers whose jobs offer a plan").

[241] *See State and Local Report*, *supra* note 231.

employees being shifted into defined contribution plans.[242] Even a few state and local governments are moving new hires into defined contribution arrangements.[243]

There is also a concerted effort underway in both the public and private sectors not only to get Americans to save more, but also to get more Americans to start saving, especially lower-income Americans.[244] In 2006, the Pension Protection Act[245] made it easier for employers to automatically enroll employees in 401(k) defined contribution plans.[246] This means that if an employee does not want a portion of his or her income to be invested in the plan, he or she needs to affirmatively opt out of the plan. In addition, the default contribution rate must be at least 3 percent of the individual's pay, and thereafter must automatically increase 1 percent annually up to 6 percent of pay.[247] Studies indicate that automatic enrollment, combined with individual inertia, will increase participation and savings rates for low and middle-income individuals.[248] In other words, individuals who might not have actively chosen to participate absent automatic enrollment will not take the initiative to withdraw.

The PPA also made permanent the "Saver's Credit," which provides a nonrefundable credit against federal income tax of up to $1,000 based on contributions made by an eligible low or middle-income taxpayer to a retirement savings plan.[249] It also authorized the direct payment

[242] *See id.*

[243] *See id.*

[244] America's personal savings rate remains one of the lowest among industrialized nations. *See* The Organization for Economic Cooperation and Development, Main Economic Indicators (Paris: OECD, Jan. 2004).

[245] PUB. L. NO. 109-280, 120 STAT. 997 (2006) [hereinafter PPA].

[246] PPA at § 902. The PPA also introduced more stringent defined benefit plan funding rules, which some expect will accelerate shifts to defined contribution plans. *See* PPA §§ 101, 102, 111, 112, 202, 211, and 212. *See, e.g.,* U.S. GOVN'T ACCOUNTABILITY OFFICE, LOW DEFINED CONTRIBUTION PLAN SAVINGS MAY POSE CHALLENGES TO RETIREMENT SECURITY, ESPECIALLY FOR MANY LOW-INCOME WORKERS 27 (2007) [hereinafter GAO Savings Report] ("Recent regulatory and legislative changes and proposals could have positive effects on DC [defined contribution] plan coverage, participation, and savings . . . [and] automatically enrolling new employees in plans as a default could have a significant positive impact on DC balances, especially for low-income workers whose jobs offer a plan"); MCKINSEY & COMPANY, REDEFINING DEFINED CONTRIBUTION 6 (2008) [hereinafter MCKINSEY REPORT] ("the [PPA] made substantial changes to DB [defined benefit] ground rules, including reducing interest smoothing and introducing more stringent funding requirements. These changes are expected to further accelerate the inexorable shift to DC plans.").

[247] It has been projected that this and other factors wil1 lead to the doubling of the defined contribution market by 2015. *See id.* at 2.

[248] *See* Zelinsky, *supra* note 14, at 527. The McKinsey Report predicts that "as early as 2010, the proportion of sponsors using auto enrollment and default products will double to about 60 percent," and "an estimated 80% to 90% of individuals remain enrolled in their plan." *See supra*, note 246, at 6. Among low- and moderate-income workers, automatic enrollment typically raises employee 401(k) participation rates from the 60-65% range to the 85% plus range (Choi et al, National Tax Journal, June 2004).

Automatic enrollment is not a panacea. *See, e.g.,* GAO SAVINGS REPORT, *supra* note 246 ("Research suggests that employees exhibit inertia regarding plan participation and contributions, which can reduce DC savings by failure to participate or increase savings over time."); Emma C. Eriksson, Note, *The Pension Protection Act of 2006: Is it Too Late to Save Traditional Pension Plans?*, SUFFOLK UNIV. L. REV. 133, 153 (2007) ("[L]ingering issues of individuals failing to provide sufficient funding to their accounts and fails to utilize sound investing strategies"); Brigitte C. Madrian & Dennis F. Shea, *The Power of Suggestion: Inertia in 401(k) Participation and Savings Behavior*, CXVI QUARTERLY J. ECON. ISSUE 4, 1149 (Nov. 2001) (noting tendency to retain default contribution rate and fund allocation).

[249] *See* I.R.C. § 25B and PPA § 812. The credit phases out and is reduced to zero for married taxpayers filing jointly if their adjusted gross income is over $50,000 (indexed for inflation). *See* I.R.C. § 25B(b). Many of those

of tax refunds to IRAs upon the taxpayer's election.[250] Further, recently proposed legislation "would require employers to automatically enroll employees in a payroll deduction IRA unless the employee opts out" to increase savings by workers whose employers do not sponsor a retirement plan.[251]

In the final analysis, even "if universal savings remain admittedly distant, an unprecedented transformation of ownership has nonetheless come about."[252] Thus, while a small number of super-rich Americans own a significant percentage of public company shares, a large and increasing number of rank-and-file Americans, in the aggregate, also indirectly own a significant percentage of public company shares.[253] In that way, if the tax penalties are borne by

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otherwise eligible for the Saver's Credit, however, do not owe much or any federal income tax and thus cannot benefit from a nonrefundable tax credit. According to one analysis mentioned in the GAO Savings Report, "because the credit is nonrefundable, only about 17 percent of those with incomes low enough to qualify for the credit would receive any benefit if they contributed to a plan." *Supra* note 246 at 36. For a discussion of the issues affecting the retirement savings of low-income Americans*, see generally* Elizabeth Bell, Adam Carasso, and C. Eugene Steuerle, *Strengthening Private Resources of Retirement Savings for Low Income Families*, (The Urban Inst. Opportunity and Ownership Project, No. 5, 2005), *available at* http://www.urban.org/uploadedpdf/311229_private_sources.pdf.

[250] PPA § 830(a).

[251] *See*, *Press Release*, U.S. House Comm. on Ways and Means, *Neal Announces Hearing on Individual Retirement Accounts (IRAs) and their role in our retirement system*, June 19, 2008, *available at* http://waysandmeans.house.gov/hearings.asp?formmode=printfriendly&id=7087 (last visited Aug. 22, 2008) ("Our proposal could raise the national savings rate by nearly $8 billion annually."); H.R. 2167, 110th CONG (2008).

[252] STEPHEN DAVIS, JON LUKOMNIK, & DAVID PITT-WATSON, THE NEW CAPITALISTS 5 (Harvard Bus. Sch. Press 2006) (referring to participants in both defined benefit and defined contribution plans). Thus far this article has only considered defined contribution-type plans because participants in defined contribution plans receive no more or less from the plan than the value of their account, which will vary with the performance of its underlying investments. In that way, they are directly affected by share performance and are considered the indirect share owners. Many defined contribution plan participants also have a significant amount of choice in terms of where to invest their assets. Participants of defined benefit plans, on the other hand, are promised a specified sum regardless of the investment performance of plan assets. Defined benefit investment gains and losses accordingly accrue to the employer and not the individual participant.

Notwithstanding the foregoing, defined benefit plan participants are certainly interested in the investment performance of plan assets, and an argument can be made that they should be considered share owners to some extent. *See* Auerbach, *supra* note 41, at 6-7 (making such an argument). Investment losses that trigger significant funding liabilities on the part of the employer can threaten the viability of the plan, resulting in the participants receiving less than originally promised even though private defined benefit plan participants are insured to some extent by the Pension Benefit Guarantee Corporation. Should a public pension plan fail to have sufficient assets to meet its obligations, taxpayers would likely be called upon to bail out the plan, in which case there is a wider individual interest in public pension plan investment performance.

[253] *See, e.g.,* NYSE SHARE OWNERSHIP 2000, *supra* note 235, from which the following table is derived:

Income Range	Percent of Shares Owned	Aggregate
Under $15,000	0.8	0.8
$15-$25,000	2.7	3.5
$25-$50,000	8.9	12.4
$50-$75,000	13.7	26.1
$75-$100,000	10.9	37
$100-$250,000	27.7	64.7
Over $250,000	35.3	100

shareholders then, to a not insignificant extent, they are being borne by the wrong Americans.[254] They were aimed at executives, and they have largely missed that mark. To the extent targeted executives are hit in their capacity as shareholders, the impact is diminished due to its dispersion among all shareholders. This dispersion has a more significant negative impact on rank-and-file Americans because generally their share value is a higher percentage of their overall wealth.

Moreover, the intended beneficiaries of the tax penalty provisions were either shareholders, rank-and-file Americans, or both.[255] These are the very individuals who are potentially bearing the actual burden of a penalty that was not meant to penalize them. It is thus ironic that Congress encourages Americans to prepare for their retirement needs by investing their assets largely in public companies through the mutual funds offered in their retirement plan or IRA.

C. Capital Owners

Famed economist Arnold C. Harberger's seminal equilibrium incidence model theorized that, over time, the incidence of the corporate tax would shift to all owners of capital, as the tax caused investment patterns to adjust back and forth between investments where the corporate tax is present and where it is not.[256] More specifically, under certain assumptions, the lower after-tax return on corporate equity would prompt investors to move their capital into non-corporate investments. The increase in non-corporate investment and the concomitant decrease in corporate investment would, in turn, cause the return on non-corporate investments to fall and corporate investments to rise.[257] Some investments would then be shifted back to the corporate sector until equilibrium is achieved and the after-tax return on corporate and non-corporate investment is the same.[258] In that way, "all capital, not just corporate capital, [] bears the tax."[259]

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[254] Although a large number of those rank-and-file Americans are investing through tax-preferred savings vehicles, they can nevertheless bear the incidence in the form of a lower retirement account balance because of either lower dividend payouts or lower share value.

[255] *See supra* Part III.B (discussing various tax penalty provisions).

[256] *See* Arnold C. Harberger, *The Incidence of the Corporation Income Tax*, 70 J. POL. ECON. 215 (1962). Harberger's model assumes capital is freely mobile within a closed-economy, meaning capital does not flow between countries.

[257] *See id.* The return on corporate investments is presumed to rise in relation to charging "higher prices for the reduced supply of goods produced by corporations." Lyon, *supra* note 210, at 51

[258] *See* Harberger, *supra* note 256. *See also* Lyon, *supra* note 210, at 52 (discussing significance of this finding). This argument becomes more complicated in a world of international capital markets (*i.e.*, an open-economy). If capital can be invested anywhere in the world, then in theory the burden of corporate taxes cannot be borne by capital because it can move to other countries where a greater rate of return can be earned. Thus, to maintain corporate profit and thereby capital investment, corporations must either increase revenues by raising prices or decrease expenses by paying less for its factors of production. *See generally* Pechman, *supra* note 208, at 143-44. *See also generally* Arnold C. Harberger, *The ABCs of Corporation Tax Incidence: Insights into the Open-Economy Case*, TAX POLICY AND ECONOMIC GROWTH, 51-73 (1995); Arnold C. Harberger, *The Incidence of the Corporation Income Tax Revisited*, National Tax Journal, 305-6 (June 2008). Notwithstanding the foregoing, "some open-economy models have found similar results" as Harberger's closed-economy model. Tax Foundation Paper, *supra* note 203, at 86. *See also* Gravelle & Smetters, *supra* note 208. The equilibrium theory still has its critics, though. *See generally* OTA Paper, *supra* note 208, at 19.

[259] Auerbach, *supra* note 41, at 8 (describing Harberger model). Conversely, shareholders alone may bear the tax in the long run if investment can be financed through debt, the interest on which is deductible, instead of equity. *See* Pechman, *supra* note 208, at 144. In the long run, the tax may also be shifted to consumers or workers. *See* OTA Paper, *supra* note 208, at 26.

More data has been collected, and distributional analyses prepared, for this category of individuals than any other. As such, the burden of the corporate income tax is presented in the table below in three different ways, providing different perspectives from which to consider the data. The table first provides the percentage of a household's total tax burden that went to pay the corporate tax. Next, the table shows the effective (or average) rate of tax paid by each quintile on corporate income. Finally, it shows the portion of the total corporate tax burden borne by each quintile. The income quintiles are based on comprehensive household income, meaning the figures include, *inter alia*, the value of government transfer payments and in-kind benefits such as food stamps and housing assistance.

Quintiles of Comprehensive Household Income (2004)						
	Bottom 20% (up to $17,699)	**Second 20% ($17,700 to $30, 199)**	**Third 20% ($30,200 to $44,599)**	**Fourth 20% ($44,600 to $66,499)**	**Top 20% ($66,500 and over)**	**Top 1% ($276,200 and over)**
Percentage of Overall Tax Burden	9.0%	4.0%	4.0%	5.0%	17%	30%
Effective Tax Rate	0.4%	0.4%	0.6%	0.8%	4.2%	9.5%
Share of Corporate Tax	0.6%	1.5%	3.0%	6.5%	87.3%	58.6%

Source: Congressional Budget Office[260]

Based on the foregoing data, whether the corporate tax is considered fair depends on one's perspective and normative tax policy philosophy. From an "ability to pay" perspective, the corporate tax does not look terribly fair to the individuals in the lowest-income quintile as a significantly greater share of their tax burden went to pay the corporate tax than the next three income quintiles. The corporate tax looks steeply progressive, however, from the perspective of each quintile's share of the tax because it rises from 0.6 percent to 87.3 percent. Even so, close to 50 percent of the burden in 2004 was borne by individuals outside of the executive class (*i.e.*, those with comprehensive household income of $276,199 or less). In the middle of the fairness spectrum is the effective tax rate that applies to the corporate income of each quintile. In that case, the rate rises gradually until the top quintile.

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[260] *See* HISTORICAL EFFECTIVE FEDERAL TAX RATES: 1979 to 2005 (using 2004 data), *available at* http://www.cbo.gov/ftpdocs/88xx/doc8885/EffectiveTaxRates.shtml. These numbers change significantly if different assumptions are used. For example, the following table divides the income quintiles on a cash money basis and provides the results based on the assumption that roughly 70 percent of the corporate tax is borne by labor and 30 percent is borne by owners of capital:

Quintiles of Household Cash Money Income (2004)					
	Bottom 20%	**Second 20%**	**Third 20%**	**Fourth 20%**	**Top 20%**
Percentage of Overall Tax Burden	6.3%	8.4%	8.2%	8.2%	8.1%
Effective Tax Rate	.81%	1.94%	2.31%	2.57%	2.78%
Share of Corporate Tax	3.4%	10.0%	15.1%	22.8%	48.7%

Source: Tax Foundation Paper, *supra* note 203.

Accordingly, if increased corporate taxes from tax penalties are dispersed to all owners of capital like the corporate tax in general, then such taxes, while borne in greater proportion by the wealthy, are also borne by those who are less well off.[261] With regard to the latter, increased corporate taxes cause the less well off greater harm from the perspective of their ability to shoulder the burden.[262] They also run counter to Congress's pro-savings policies.

D. Consumers

The extent to which the corporate tax can be shifted forward to consumers in the form of higher prices is subject to considerable debate in the economic literature and there are a number of conflicting theories among economists.[263] One theory assumes markets are perfectly competitive and focuses on a company's response to shifts in available capital as a result of increased taxes. If the corporate tax induces reduced rates of return that push capital toward non-corporate investments where a higher rate of return can be earned,[264] then the resultant contraction of capital theoretically results in less productivity (*i.e.*, less supply) and thus higher prices in the corporate sector.[265] There should also be a concomitant reduction in prices for non-corporate products in response to the capital infusion and resultant increased supply of goods.[266] This model, accordingly, is comprised of individual consumers who are better off as a result of lower prices and other consumers who are worse off as a result of higher prices.[267] The incidence of the corporate tax, however, supposedly has not shifted to consumers here because as a class their total expenditures do not change, only the distribution of their expenditures among class members.[268]

An alternative theory considers the extent to which consumers are able and willing to substitute a lower priced product for a higher priced product or simply choose not to buy a product or a replacement.[269] Some have argued that, in an ideal world of perfectly competitive markets and profit-maximizing firms, companies should not be able to raise prices to reflect higher taxes without losing sales and thus lowering profits.[270] Others, who acknowledge the real

[261] *See* Lyon, *supra* note 210 (noting similarity of analysis between corporate tax incidence and differences in tax payments among corporations for various reasons).

[262] It should be noted that "ability to pay" is a normative tax policy notion.

[263] *See* M. KRZYZANIAK & R. MUSGRAVE, THE SHIFTING OF THE CORPORATION INCOME TAX 1-3 (1963); *see also* Pechman, *supra* note 208, at 143 (describing the debate); Klein, *supra* note 208, at 577-85 (same).

[264] *See supra* Part IV.C.

[265] The higher prices, in turn, ultimately increase the return on corporate investments. *See* Klein, *supra* note 208 at 577.

[266] *See* Lyon, *supra* note 210, at 51.

[267] *See* Klein, *supra* note 208, at 583; Lyon, *supra* note 210, at 51.

[268] *See id*. "Consumers of goods produced in the corporate sector are made worse off by the higher prices for these goods. At the same time, consumers of goods produced by the other sectors of the economy are made better off because of the greater supply of goods produced by these sectors. The net effect of these changes on progressivity is difficult to assess, because individuals in all income groups consume goods produced by both sectors. As a first approximation, price effects might be assumed to have little overall impact on incidence." *Id.*

[269] *See* Pechman, *supra* note 208, at 143.

[270] *See* Klein, *supra* note 208, at 584-585; J. PECHMAN & B. OKNER, WHO BEARS THE TAX BURDEN? 35 (1974).

world may be less than ideal, have argued "companies have the ability to pass taxes forward and set what they consider to be reasonable prices."[271]

In theory, a company's pre-existing customer base could absorb increased taxes by continuing to buy the company's product at its higher price. This would be the case if there were no suitable substitution for the product and the company's consumers were unwilling to forego purchasing the product.[272] In the specific context of increased corporate costs due to tax penalties on executive compensation, the characteristics of the individuals who ultimately bear the burden depend to some extent on the nature of the product. For example, if the company produces exclusively high-end products, then its customers are likely well off. If instead, the company produces exclusively low-end products, then the majority of its customers are likely less well off. In the real world, most public companies provide a mix of products and thus have a mixed customer base that, demographically speaking, likely includes a significant number of rank-and-file Americans.[273]

On the other hand, a company's customers could be willing to forego purchasing its product entirely even though there is no substitute for it.[274] In this situation, the increased taxes cannot be shifted to the company's consumers. Instead, the company must establish a price point that maintains a customer base (or level of demand) sufficient to offset the increased taxes plus loss of revenue from departing customers or customers who buy less.[275] Unless that balance can be found, some of the tax will be shifted to the other categories of individuals. Likewise, if consumers could substitute a lower priced product from another company for the higher priced product, the increased taxes could not be shifted entirely to the company's consumers, and instead must be borne by other categories of individuals.

In the end, given America's demographics and the mass production of multiple product lines by many large public companies, to the extent increased corporate taxes due to tax penalties on executive compensation can be shifted to consumers instead of others, then it is likely rank-and-file Americans bear the burden in some not insignificant way.

E. Workers

Lastly, a company can shift corporate taxes backward by paying less for its non-capital factors of production, the most significant of which is labor.[276]

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[271] *See* KRZYZANIAK & MUSGRAVE, *supra* note 263. *See also* Klein, *supra* note 208, at 584-585.

[272] *See* Gravelle & Smetters, *supra* note 208, at 3 (arguing that domestic capital may bear the burden of a corporate income tax in an open economy where there is imprfect product substitution).

[273] *See* Kimberly A. Pace, *The Tax Deductibility of Punitive Damage Payments: Who Should Ultimately Bear the Burden for Corporate Misconduct?*, 47 ALA. L. REV. 825, 857 (1996). This does presume a minimally sufficient level of income to be able to absorb the higher price. Lower-income Americans are also the most likely income group to be most affected by, and thus avoid, higher prices.

[274] TAXING OURSELVES, *supra* note 29, at 74.

[275] *See id.*

[276] *See* Lindsey, *supra* note 211, at n.199 ("If the corporate tax is borne by employees in the form of lower compensation, the CEOs and other high-ranking corporate executives seem to escape this financial burden."). It should be noted that, under some models, labor may not be affected by increased corporate taxes. For example, if demand for particular consumer goods is highly inelastic, then prices should rise instead. *See* Gravelle & Smetters, *supra* note 208.

There are two alternative theories regarding the manner in which the corporate income tax may affect workers.[277] The first theory assumes markets are perfectly competitive and focuses on a company's response to shifts in available capital as a result of increased taxes.[278] Here, the effect on labor of changes in capital intensity is not all that dissimilar in a closed or open economy. In a closed-economy, the corporate tax induces reduced rates of return that result in the movement of capital to companies where a higher rate of return can be earned.[279] The resultant contraction of capital results in less productivity and thereby reduced wages.[280] In an open-economy, "[i]f capital is mobile (and labor is immobile) across jurisdictions, then labor's share of the tax burden can be high."[281]

The second theory recognizes that, outside of economic models, markets may be less than perfectly competitive. In that case, there may be some room for workers and employers to negotiate how the corporate tax burden is allocated.[282] That allocation will depend on the relative elasticities of the parties.[283]

If labor can be outsourced or moved to another country, then Americans who work in affected industries would likely bear a greater portion of the burden. It could be in the form of unemployment or reduced wages due to a flood of employees creating or contributing to a competitive market for remaining jobs utilizing workers with that particular skill-set. Even if it is assumed that a company cannot move its labor force to a cheaper location, workers could still bear a greater portion of the burden if the job market is competitive. In that case, it would not be easy for these workers to find better paying jobs or, similarly, their jobs could easily be filled with workers willing to earn the same or less.[284] A similar result obtains if, from a practical perspective, the workforce is not terribly mobile and thus captive.[285]

Alternatively, in the unlikely event reduced wages caused workers to decide en masse that they prefer leisure over low wages and to accordingly leave the workforce, the resultant

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[277]This discussion ignores any interrelated effects on consumer prices.

[278] *See* OTA Paper, *supra* note 208, at 6, 23.

[279] *See supra* Part IV.C.

[280] *See* OTA Paper, *supra* note 208, at 6 .

[281] *Id.* at 16. Recent empirical studies, assuming "that capital is mobile and consumers are willing to substitute tradable goods produced in different countries imply that labor can bear more of the incidence of the corporate tax than capital bears." *Id.* Indeed, one study reported that a "1 percent increase in corporate tax rates is associated with nearly a 1 percent drop in wage rates." *Id.* (quoting Hassett, Kevin A. and Aparna Mathur, *Taxes and Wages* 25 (Am. Enter. Inst. for Pub. Policy Research, Working Paper No. 128, 2006)). Another found "that 61% of any additional [corporate] tax is passed on in lower wages in the short run and around 100% in the long run." *Id.* (quoting Arulampalam, Wiji, Michael P. Devereux, and Giorgia Maffini, *The Incidence of Corporate Income Tax on Wages*, abstract, (Mimeo, University of Warwick, 2007)). A third study calculated "that a one percentage point increase in the average US corporate tax rate would reduce aggregate wage earnings by roughly 4.2 times the additional corporate income tax revenue collected. While an effect of this magnitude seems quite large, it is consistent with the corporate tax creating considerable amounts of economic distortion in addition to the revenue collected." *Id.* at 10 (reviewing Felix, R. Alison, *Passing the Burden: Corporate Tax Incidence in Open Economies* Chapter 1 (Ph.D. Dissertation, University of Michigan, 2007).

[282] *See* OTA Paper, *supra* note 208 at 6 & 23.

[283] *See id.*

[284] *See supra* note 38 (noting employers will make salary adjustments based on taxes imposed on them).

[285] *See id.*

lower supply of workers with a particular skill-set could create greater demand and thus increased wages for workers in those industries.[286] If that were the case, the burden would have to be shifted to or shared with other categories of individuals. Similarly, with an elastic and mobile labor market, the corporate tax could not be shifted onto workers because theoretically they would leave the company for better paying jobs elsewhere.

In recent years, empirical research has suggested ever more strongly that labor bears a significant portion, if not all, of the corporate tax.[287] Extending those results to increased corporate taxes due to tax penalties on executive compensation, then, means that the burden is also borne significantly by rank-and-file Americans. On a purely quantitative basis, at any given large public company, the vast majority of workers do not belong to the executive class.

F. In Summary

The foregoing is quite simplified and does not account for every possible scenario or interaction among categories. As observed by one scholar: "the problem of tracing any of the various consequences of the tax is exceedingly complex, involving virtually endless interrelationships between narrower, but still thorny and unresolved, problems from almost every subfield of economics."[288] Nonetheless, two patterns emerge: (1) the incidence of increased corporate taxes and other expenses is a zero-sum situation among the categories of individuals who could possibly bear the burden, and (2) rank-and-file Americans comprise a substantial portion of each category of individuals. Thus, even though the data and theoretical economic models are inconclusive, it does not matter to a significant extent for purposes of this article precisely where the burden falls. In each scenario, rank-and-file Americans, along with super-rich executives and other members of that class, ultimately bear the burden of the executive compensation tax penalties either as shareholders, owners of capital, consumers, or workers.[289]

It could be argued that this finding is unimportant because the tax penalties are causing only trivial harm.[290] At present, only section 162(m) could apply on a yearly or regular basis: section 409A has not gone into effect yet although it could thereafter apply on a yearly basis, and

[286] *See* OTA Paper, *supra* note 208, at 24 ("[T]ax incidence can also depend on whether labor supply within a country varies due to changes in wage rates. The variation in labor supply could arise from changes in labor force participation decisions (including retirement decisions), hours worked conditional on being in the labor force, or changes in human capital (which can affect the effective amount of labor generated by a given number of hours worked)."). *See also generally* Martin J. McMahon, Jr. & Alice G. Abreu, *Winner-Take-All Markets: Easing the Case for Progressive Taxation*, 4 FLA. TAX REV. 1, 58 (1998) (discussing the elasticity of the labor supply in general and commenting, as well, on the elasticity of secondary wage earners).

[287] *See supra* note 281. In fact, Harberger eventually came to the conclusion that labor likely bears almost the entire burden in the long run. *See* Arnold C. Harberger, *The ABCs of Corporation Tax Incidence: Insights into the Open-Economy Case*, TAX POLICY AND ECONOMIC GROWTH, 51-73 (1995). *But see* Jane G. Gravelle & Thomas L. Hungerford, Corporate Tax Reform: Should We Really Believe the Research?, 2008 Tax Notes Today (Oct. 28, 2008) (arguing that recent claims that the burden of the corporate tax falls to some extent on labor instead of capital owners "are not supported by empirical data.").

[288] Klein, *supra* note 208, at 578.

[289] This article does not aim to enter the debates over corporate integration or the fairness (in particular, progressivity or lack thereof) of the corporate tax system as a whole. The focus here is instead on assessing the use of tax penalties on executive compensation as a policy tool.

[290] *See* Elson *supra* note 8, at 950 (discussing – pre sections162(m) and 409A – possible insignificance of harm to company of executive overcompensation from a macro view).

the golden parachute provisions are only triggered by a change in control. Further, section 162(m) applies only to a small subset of executives.[291] Additionally, the tax penalties have significantly less impact on corporations with net operating losses that do not owe taxes.[292] Thus, the amount of revenue raised by the tax penalty provisions aimed at shaping executive compensation might only take pennies from each individual bearing the burden.[293]

The economic costs of the tax penalties, however, are not limited to the amount of revenue raised.[294] Further, the amount of revenue raised for the fisc may presently be small, but that may not always be the case. The tax penalty burden could rise significantly in the not too distant future if current legislative proposals expanding the reach of sections 162(m) and 409A are successfully enacted.[295]

History shows that these proposals are not likely to reduce overall executive compensation levels. They can, however, increase a company's compensation costs and thereby penalize individuals other than the targeted executives. Indeed, in contrast to prior motivations in enacting tax penalties on executive compensation, proponents of these proposals tout their revenue raising capability. And they may only be the beginning of legislative efforts to raise money in ways that seem fair, such as taxing super-rich executives.[296]

Perceptions, however, do not always conform with reality. To answer the central question of this article, no one can be certain precisely who is harmed by the tax penalties on executive compensation, but it is likely a large and varied group of individuals that includes many rank-and-file Americans. This answer, in turn, raises the question whether anyone other than executives should bear the burden, and whether the answer to that question changes if the tax penalties ultimately produce only a micro burden on other affected individuals. The answer to both of these questions should be no.

Even if the tax penalties have only a micro-effect, they are still raising revenue from the wrong people. The amount of harm produced at the individual level should be relatively unimportant. More important is that, collectively, rank-and-file Americans bear a significant portion of the economic burden instead of executives who are the target of these tax penalties. Furthermore, because public criticism of executive compensation practices was significant

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[291] *See supra* note 146 and accompanying text. Sections 280G and 4999 are broader than section 162(m), but they are still limited in application. *See supra* note 116. Section 409A has the broadest potential reach. *See supra* note 79.

[292] A recent government study found that many domestic corporations and foreign corporations doing business in the United States paid no federal income taxes from 1998 through 2005. *See* U.S. GOVN'T ACCOUNTABILITY OFFICE, COMPARISON OF THE REPORTED TAX LIABILITIES OF FOREIGN- AND U.S.-CONTROLLED CORPORATIONS, 1998-2005 (2008).

[293] The IRS claims it does not collect data on how much revenue is collected via additional taxes such as section 4999.

[294] *See generally* OTA Paper, *supra* note 208; Polsky, *supra* note 20.

[295] *See, e.g.*, H.R. 2 110th Cong. (2007) (expanding the class of individuals who are subject to the section 162(m) $1 million cap on deductible compensation and also seeking to limit the annual aggregate amount of compensation that can be deferred under a nonqualified plan); S. 349, 110th Cong. (2007) (same); S. 2866, 110th Cong. 2d Session (2008) (seeking to limit the annual aggregate amount of compensation that can be deferred under a nonqualified plan).

[296] *See supra* note 212 (noting penalized party is often not aware of penalty).

enough to get Congressional attention in the first place, the impact of any resultant legislation should not be dismissed as trivial any more than the public would accept dismissing the original issue as trivial.

V. CONCLUSION

At times like the present, executives are pilloried if they appear unaffected by, or to be profiting in some way from or even contributing to, the economic distress felt by most Americans.[297] Public opinion seems to insist that legislators "do something" in response. In recent times, that response tends to take the form of tax penalties aimed at executive compensation.

Tax penalties on executive compensation may be good politics, but they are an inappropriate policy tool that should no longer be used. Legal scholars are in general agreement that these provisions have not been effective in reducing overall executive compensation levels or other legislative goals.[298] Furthermore, some have shown that tax penalties in general and those imposed on executive compensation in particular are inefficient behavior deterrents.[299] Importantly, this article shows that they also cause indiscriminate injuries to a large number of citizens, including those who are far from being members of the super-rich executive class, and thus they are also inequitable.[300]

This does not mean, however, that the federal government should not pursue methods of controlling executive compensation if that is deemed a desirable goal: only that it should aim better to hit its intended target. Indeed, the repeal of existing tax penalties should only be done in the context of other complementary reforms to prevent executives of the companies freed from these costs from capturing the resultant savings for their own benefit. Although tax penalties do not thus far appear to be an effective restraint, that does not mean that other types of restraint should not be pursued.[301]

If Congress truly wants to do something about excessive executive compensation levels, it could target the compensation directly by, for example, imposing criminal penalties on executives receiving compensation in violation of whatever rules it establishes.[302] Although

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[297] *See* Leff, *supra* note 45, at 74-76 (noting comments by politicians during the Great Depression calling executives "'greedy pigs'" and claiming they commit "robbery" of businesses in their control); *supra* note 19; *supra* note 173.

[298] *See supra* note 20.

[299] *See* Zelinsky, *supra* note 20; Zolt, *supra* note 11.

[300] Thus, in the final analysis, tax penalties on executive compensation fail to satisfy the goals of a good tax system. They are not only an ineffective method of controlling executive compensation, they also generate inefficiencies, come in the form of complex statutory and regulatory provisions, and are inequitable. *C.f. supra* note 28.

[301] Or, perhaps, the use of tax penalties should be refined in some way.

[302] *See, e.g.,* Public Company Accounting Reform and Investor Protection (Sarbanes-Oxley) Act of 2002, Pub. L. No. 107-204, 116 Stat. 745 § 402, §802 (codified in scattered sections of 15, 18 U.S.C.) (imposing criminal penalties for making personal loans to executives, or destroying, altering or falsifying records). *But cf. generally* Richard Booth, *What Is a Business Crime?*, 3 J. BUS. & TECH. L. 127 (2008) (discussing the use of criminal penalties in the business setting and noting that corporate governance is a "singularly bad subject matter for criminal sanctions.").

such action may be extreme, less severe forms of direct action are also problematic because direct action conflicts with widely held American laissez-faire, meritocratic and entrepreneurial ideals. Congress could perhaps flip its current approach and positively incentivize desirable compensation structures, but implementing an effective, equitable, and administrable system could prove difficult.

Alternatively, Congress could undertake efforts to deal with the root problems giving rise to popular sentiments regarding executive compensation levels instead of legislation aimed at the symptoms of these problems. The root problems appear to include economic polarity (*i.e.*, extreme wealth and income disparities) combined with economic turmoil. It is difficult, however, for legislators even to mention much less enact the types of policies that would deal with rather than obscure those issues: for example, a more progressive income tax rate structure, eliminating capital gains tax preferences, payroll tax reforms, income tax base broadening through loophole closures, or strengthening the transfer tax system.

Even if tax penalties aimed at executive compensation were effective (which this article shows they are not) at reducing levels of compensation and other legislative goals, they would do little if anything to help average Americans struggling to get by in times of economic turmoil. Of course, the irony is that these struggles were the catalyst for enactment of the tax penalties in the first place.[303] To be sure, there were additional reasons for each provision enacted.[304] But, in each case, Congress was also motivated to respond to rank-and-file Americans upset over executive compensation excesses.

More troubling is the realization that in some way rank-and-file Americans bear a remarkable portion of the economic burden instead of executives who are the target of these tax penalties. While a small number of super-rich Americans do bear a significant percentage of the burden, a large number of rank-and-file Americans, in the aggregate, also bear a significant percentage of the burden. Thus, the costs of the penalties are effectively a tax increase on rank-and-file Americans in addition to wealthier Americans.

Even worse, the operative effect of the tax penalties runs counter to the federal government's retirement savings policies if the harm is indeed borne to some extent by shareholders or owners of capital. Congress foregoes significant tax revenues in order to encourage Americans to prepare for their retirement needs by investing largely in public companies through the mutual funds offered in their tax-preferred retirement plans or IRAs.[305] But the goal of retirement security is undermined if plan asset values are depressed to some extent as a result of the tax penalties.

Setting aside for now the important questions regarding whether the growing income inequality problem can be solved by targeting executive compensation or whether it is appropriate to attempt to control the market for executives, at a minimum the government ought

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[303] *See supra* Part III.B (examining penalty provisions in detail).

[304] *See id.*

[305] The projected tax expenditure for fiscal year 2008 is roughly $120.5 billion. *See* EMPLOYEE BENEFITS RESEARCH INST., TAX EXPENDITURES AND EMPLOYEE BENEFITS: ESTIMATES FROM THE FY 2009 BUDGET (2008).

not harm those whom it is endeavoring to help. This article demonstrates that Congress did exactly that when it enacted tax penalties on executive compensation.