



2012

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Recommended Citation

Gregg D. Polsky, *Fixing Section 409A: Legislative and Administrative Options*, 57 Vill. L. Rev. 635 (2012).
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2012]

FIXING SECTION 409A: LEGISLATIVE AND
ADMINISTRATIVE OPTIONS

GREGG D. POLSKY*

IN 2004, in response to perceived deferred compensation abuses by Enron executives,¹ Congress enacted section 409A.² Section 409A imposes a significant tax penalty on deferred compensation arrangements that do not meet its numerous technical requirements.³ Thus, the effect of Section 409A is strict federal regulation of deferred compensation arrangements. This Article argues that the strict regulation of deferred compensation under section 409A is an unqualified mistake and presents various options for improvement.

While some deferred compensation arrangements generate substantial tax benefits as compared to analogous current compensation, others are not tax-advantaged.⁴ Section 409A still allows tax-advantaged deferred compensation arrangements to generate their tax benefits; it simply requires that the plans satisfy its technical requirements.⁵ Thus, section

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1. See Dana L. Trier, *Rethinking the Taxation of Nonqualified Deferred Compensation: Code Sec. 409A, the Hedging Regulations and Code Sec. 1032*, TAXES, Mar. 2006, at 141, 165 (noting that section 409A was stimulated by Joint Committee on Taxation's Report on Enron).

2. See American Jobs Creation Act of 2004, Pub. L. No. 108-357, § 885, 118 Stat. 1418 (codified at I.R.C. § 409A (2012)).

3. See *id.* Technically, section 409A imposes the penalty on noncompliant *nonqualified* deferred compensation arrangements. See I.R.C. § 409A(d)(1)(A) (empting qualified plans). Qualified deferred compensation arrangements, such as 401k plans, provide an explicit tax subsidy in exchange for satisfying a number of technical conditions. An important condition is that the plans must not discriminate in favor of highly compensated employees. In addition, the amount of compensation that can be deferred under qualified plans is substantially limited. Nonqualified plans, on the other hand, do not receive an explicit tax subsidy (though, as discussed below, they still may be tax-advantaged), can (and usually do) discriminate in favor of highly compensated employees, and are not subject to limitations as to amounts that can be deferred. Because section 409A applies only to nonqualified plans, when this Article uses the term "deferred compensation," it means only nonqualified deferred compensation.

4. See Gregg D. Polsky & Brant J. Hellwig, *Taxing the Promise to Pay*, 89 MINN. L. REV. 1092, 1142-44 (2005) (providing example where, because of equivalent tax rates for employer and employee, deferred compensation and current compensation are taxed identically); Ethan Yale & Gregg D. Polsky, *Reforming the Taxation of Deferred Compensation*, 85 N.C. L. REV. 571, 579 n.23 (2007) (noting that, if employer's investment income tax rate is higher than employee's investment income tax rate, deferred compensation will be tax disadvantageous).

5. See Eric D. Chason, *Deferred Compensation Reform: Taxing the Fruit of the Tree in its Proper Season*, 67 OHIO ST. L.J. 347, 349 (2006) ("Perhaps at the margin, fewer

(635)

409A does not remove the tax advantage of deferred compensation in the vast majority of cases. Furthermore, section 409A applies to even those deferred compensation arrangements that are not tax-advantaged; in those cases, section 409A merely adds significant compliance costs without any corresponding benefit to the tax system. In addition, section 409A's scope is extremely wide, capturing a large number of non-tax-motivated arrangements that many people would not characterize as deferred compensation, which results in a trap for the unwary or unsophisticated. Finally, section 409A's requirements are extremely intricate and complex. The intricacy means that taxpayers lose the flexibility to structure deferred compensation arrangements that best meet their legitimate business objectives, while the complexity means that even careful, well-advised taxpayers may commit costly technical violations.

In short, section 409A does not even come close to solving the tax problems associated with deferred compensation. At the same time, it tightly regulates all deferred compensation plans, an extremely large and varied group of contractual arrangements, resulting in large costs with very little corresponding benefit to the tax system. Section 409A is a failure.

This Article discusses the section 409A failure and explores the various options that Congress and the tax administrators have for dealing with it. Part I describes the concept of deferred compensation, the pre-section 409A taxation of deferred compensation, the potential tax benefits of deferred compensation, and the impetuses for Congress's enactment of section 409A. Part II summarizes section 409A's provisions, while Part III catalogues its problems. Part IV discusses the options for reforming section 409A. Part V concludes.

I. BACKGROUND

A. *Traditional Taxation of Deferred Compensation*

In tax parlance, deferred compensation generally refers to compensation that is received and taxed after the services giving rise to the right to compensation have been performed. For instance, an employer might agree to pay an employee \$100,000 in ten years for work performed this year. In that case, the employee, despite earning the right to income this year, would receive and be taxed on the compensation in Year Ten.

To achieve deferral of taxation, taxpayers historically had to successfully navigate around the tax doctrines of constructive receipt and economic benefit.⁶ If they did, then the following tax consequences generally

executives and corporations will bother passing through § 409A's gates. For those who make it through, the economics are unchanged."); Trier, *supra* note 1, at 165 (noting that section 409A left intact traditional nonqualified deferred compensation regime).

6. See PAUL R. MCDANIEL ET AL., FEDERAL INCOME TAXATION 1078–80 (6th ed. 2008). Another doctrine, the cash equivalence doctrine, is also relevant, though it

R

2012]

FIXING SECTION 409A

637

would result: (1) the service provider would not realize gross income until she received cash, (2) during the deferral period, the service recipient would include in gross income the investment yield on amounts set aside to pay the deferred compensation, and (3) upon payment of the deferred compensation, the service recipient would take a deduction in the amount of the payment.⁷ In contrast, if current compensation were paid (or if either of the tax doctrines were triggered), then (1) the service provider would realize immediate gross income in an amount equal to the present value of the payment rights, (2) during the deferral period, the service provider would include in gross income the investment yield on this present value,⁸ and (3) the service recipient would receive an immediate deduction equal to the present value of the payment rights. These results are summarized in the table below.

	IMMEDIATE TAX CONSEQUENCES UPON EARNING OF DEFERRED COMPENSATION	TAXATION OF INVESTMENT YIELD DURING DEFERRAL PERIOD	TAX CONSEQUENCES UPON PAYMENT OF THE DEFERRED COMPENSATION
DEFERRED TAXATION	No tax consequences to either party	Service recipient taxed on the investment yield	Service provider taxed on the payment; service recipient receives corresponding deduction
CURRENT TAXATION	Service provider taxed on the fair market value of the compensation; service recipient receives corresponding deduction	Service provider taxed on the investment yield	No tax consequences to either party

is much more narrow, and therefore much less significant, than the other two. For discussion of the cash equivalence doctrine, see Polsky & Hellwig, *supra* note 4, at 1113–15.

7. See McDANIEL ET AL., *supra* note 6, at 1077.

8. Note that the investment yield would be taxed when it is realized under the service provider's method of accounting; likewise the service recipient would be taxed on the investment yield when it is realized under the service recipient's method of accounting if the arrangement satisfied the requirements for deferred taxation. Thus, if the deferred compensation were invested in stock that later appreciates, the investment yield (i.e., gain) would generally be taxed only when the stock is sold.

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B. *Constructive Receipt and Economic Benefit*

To achieve the desired treatment, deferred compensation has to avoid current taxation under the doctrines of constructive receipt and economic benefit.⁹ The constructive receipt doctrine provides that taxpayers are deemed to be in receipt of an item of income before they actually receive the item. The constructive receipt doctrine applies when an item of income is made available to the taxpayer without substantial restriction or limitation.¹⁰ To avoid implicating the constructive receipt doctrine, deferred compensation plans generally require that any decision to defer income be made before the related services are performed, and the decision must be irrevocable. Thus, an election to irrevocably defer \$100,000 of Year Two salary (for example, until Year Ten¹¹) would typically have to be made in Year One. While an expansive application of the constructive receipt doctrine might have captured such a deferral election, the IRS has blessed timely initial deferral elections.¹²

To avoid the economic benefit doctrine, rights to future payment must be “unfunded.”¹³ This means that the service provider must remain in the position of a general unsecured creditor. Any attempt to secure the promise or otherwise insulate the service provider from the risk of the service recipient’s insolvency triggers the economic benefit doctrine, resulting in current taxation of the rights to future payment.

The classic economic benefit situation is where the service recipient pays the deferred amounts into a trust or escrow account either to secure the service provider’s right to future payment or to serve as the source of the future payment.¹⁴ In either case, the service provider is insulated

9. For a full discussion of these doctrines as they relate specifically to deferred compensation, see Brant J. Hellwig, *Nonqualified Deferred Compensation and the Pre-Statutory Limits on Deferral*, in *FEDERAL INCOME TAXATION OF RETIREMENT PLANS* 13–19 to 13–34, 13–37 to 13–57 (Alvin D. Lurie ed., 2008).

10. See Treas. Reg. § 1.451-2(a) (1979).

11. The amount paid in Year Ten would be the \$100,000 of compensation deferred plus a specified yield on that amount. The yield can be fixed or variable.

12. See Rev. Proc. 92-65, 1992-33 I.R.B. 16. While the law regarding initial deferral elections is relatively clear, this is not the case for agreements to postpone income beyond the original due date. Several cases have allowed taxpayers to extend original due dates without triggering constructive receipt as long as the decision to defer was made before the due date. See generally *Comm’r v. Oates*, 207 F.2d 711 (7th Cir. 1953) (holding that constructive receipt doctrine did not apply where extension of original due date was requested as result of non-tax business exigencies); *Veit v. Comm’r*, 8 T.C. 809, 818 (1947) (holding that constructive receipt doctrine did not apply where supplemental agreement to further defer payments was “bona fide” and made at “arm’s length”). The line of reasoning in these cases has the potential to undermine basic principles behind the constructive receipt doctrine because of the great flexibility it affords.

13. See Polsky & Hellwig, *supra* note 4, at 1116–25.

14. See Rev. Rul. 60-31, 1960-1 C.B. 174 (providing example of professional football player who negotiates for signing bonus to be placed in escrow for subsequent distribution to him; ruled that player realized current economic benefit when funds were contributed to escrow account).

R

2012]

FIXING SECTION 409A

639

against the risk of the service recipient's insolvency.¹⁵ As a result, the economic benefit doctrine applies.

In summary, to avoid current taxation, deferred compensation arrangements historically had to provide for timely and irrevocable deferral elections and ensure that service providers bore the risk of the service recipient's insolvency during the deferral period. These conditions were relatively easy to satisfy if the parties desired deferred taxation treatment.

C. *The Tax Advantage of Deferred Compensation*

Parties can be expected to negotiate for deferred compensation (as compared to current compensation) when the tax benefits from deferred compensation outweigh its non-tax costs. The costs are easy to see. First, given the irrevocable nature of the deferral election, the service provider loses the liquidity and flexibility that she would have if she instead had received current compensation and directly invested the current compensation for her own account.¹⁶ Second, deferred compensation arrangements require the service provider to put her current compensation at the risk of the service recipient's insolvency, which is often not a desirable position for the service provider.¹⁷

Describing the tax benefit from deferred compensation is more complicated. To evaluate the tax benefit, one must look at both sides of the transaction. As several commentators have shown, any net benefit to the parties generally stems from the difference in the tax rate that applies to the investment yield during the deferral period.¹⁸ If the employee receives current compensation, then she invests that compensation for her own account, and the investment yield is taxed at the *employee's* rate. If the employee receives deferred compensation, then the employer invests the compensation for the employee's account, and the investment yield is taxed at the *employer's* rate. While the top marginal tax rates for individual employees and corporate employers are both currently thirty-five per-

15. If, however, the assets of a trust are, by the trust's terms, available to the service recipient's creditors, then there is no such insulation and the economic benefit doctrine does not apply. Trusts with such terms are called "rabbi trusts." See Yale & Polsky, *supra* note 4, at 576 n.16.

16. Instead, in a deferred compensation arrangement, she has effectively invested her current compensation indirectly through her employer, with a resulting loss of liquidity and flexibility during the deferral period.

17. This is not a desirable position because service providers make a large investment of human capital in the employer resulting in suboptimal diversification. See Gregg D. Polsky, *Controlling Executive Compensation Through the Tax Code*, 64 WASH. & LEE L. REV. 877, 889 (2007). Deferred compensation arrangements exacerbate this problem.

18. See Eric D. Chason, *Executive Compensation and Tax Neutrality: Taxing the Investment Component of Deferred Compensation*, 31 CARDOZO L. REV. 1667 (2010); MICHAEL DORAN, EXECUTIVE COMPENSATION REFORM AND THE LIMITS OF TAX POLICY (2004); Daniel I. Halperin, *Interest in Disguise: Taxing the "Time Value of Money"*, 95 YALE L.J. 506 (1986); Yale & Polsky, *supra* note 4.

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cent,¹⁹ their effective tax rates on investments sometimes differ. A corporation may have net operating losses, which drive down its effective tax rate on income recognized in the current year. Corporations are allowed a dividends-received deduction,²⁰ which drives its effective tax rate on dividends below that of the fifteen percent tax rate currently enjoyed by individuals.²¹ Corporations also pay no tax on the gains from the sale of their own shares,²² while individuals pay a fifteen percent tax rate on those gains.

Thus, deferred compensation is tax-advantaged if the employer's investment tax rate is lower than the employee's investment tax rate. In all other cases, the taxation of deferred compensation is the same as that of current compensation or else deferred compensation is tax-disadvantaged. Given the non-tax costs of deferred compensation described above, one would expect to see deferred compensation only when it is tax-advantaged.²³

Several commentators have explored ways to neutralize the tax treatment of current and deferred compensation. The tax laws could be changed to impose the accrual method on employees who have rights to deferred compensation.²⁴ Alternatively, a proxy tax could be imposed on the employer's investment income attributable to compensation that is deferred.²⁵ This proxy tax would approximate the tax that would have been imposed on the employee had she received current compensation and then invested the compensation for her own account. Each of the two methods—accrual taxation or a proxy tax—would in theory neutralize the tax consequences between current and deferred compensation. However, neutralization would be somewhat complex. While simplifying assumptions and exceptions (particularly for defined benefit plans) would be necessary to make either method administratively feasible, these nods to administrability would make the proposals not perfectly neutral in prac-

19. Compare I.R.C. § 1 (2012) (providing tax rates for individuals), with I.R.C. § 11 (2012) (providing rates for corporations).

20. See I.R.C. § 243 (2012).

21. See *id.* § 1(h)(11).

22. See *id.* § 1032.

23. However, it is possible that in some cases cognitive error may cause transacting parties to have a tax preference for deferred compensation even in situations where deferred compensation is not tax advantaged or may in fact be tax disadvantaged, based on the intuition that paying tax later is always better than paying tax earlier. Cf. Gregg D. Polsky, *High Volatility, Negative Correlation, and Roth Conversions*, 130 TAX NOTES 821, 821 (2011) (suggesting that taxpayers may irrationally choose not to make Roth conversions based on intuitive preference for paying tax later rather than earlier, even though Roth conversions are often wealth-maximizing).

24. See, e.g., DORAN, *supra* note 18. Sections 457(f) and 457A impose accrual method taxation on certain nonqualified deferred plans set up by tax-indifferent service recipients, like tax-exempt organizations or foreign taxpayers. R

25. See, e.g., Halperin, *supra* note 18. For a comparison between the accrual tax and proxy tax approaches, see Yale & Polsky, *supra* note 4, at 592–99. R

2012]

FIXING SECTION 409A

641

tice. Nevertheless, the proposals would go a long way towards reducing the tax advantage of deferred compensation but they would introduce additional complexity into the tax system.

D. *The Perceived Enron Abuses*

Despite the potential tax advantage of deferred compensation and its easy availability, no legislative proposals to fundamentally change the tax treatment of deferred compensation were seriously considered until the Joint Committee of Taxation's investigation into the collapse of Enron.²⁶ That investigation uncovered a number of tactics that Enron employed to allow its executives to receive the tax advantage of deferred compensation while substantially mitigating the associated nontax costs.²⁷ Recall that the nontax costs of deferred compensation are (i) the inflexibility that stems from irrevocable deferral decisions, and (ii) the subjecting of the deferred compensation to the risk of employer insolvency.

Enron sought to mitigate these costs in two ways. First, Enron allowed its executives to take early distributions at their election so long as they took a ten percent forfeiture or "haircut." These arrangements arguably avoided the constructive receipt doctrine because, while funds could be received at any time, the ten percent haircut was thought to constitute a substantial restriction or limitation on early distributions. Second, Enron allowed its executives to make subsequent deferral elections that extended payouts beyond their original distribution date as long as they made the elections sufficiently in advance of these dates. Various court cases had held that subsequent deferrals could be made without triggering constructive receipt,²⁸ and Enron's subsequent deferral arrangements were arguably sanctioned by these cases, though the IRS might have disagreed.

Accelerated distributions and subsequent deferrals reduced the non-tax costs from deferring compensation. Both added flexibility. Accelerated distributions allowed participants to withdraw money whenever they wanted (subject of course to the ten percent haircut), while subsequent deferrals allowed participants to extend the initial deferral period. Accel-

26. See Trier, *supra* note 1, at 165 (noting that enactment of section 409A was most significant development in taxation of nonqualified deferred compensation in past twenty-five years). There has been some legislative tinkering around the edges with regard to nonqualified deferred compensation plans of tax-indifferent service recipients. In 1978, Congress enacted section 457, which imposed accrual taxation on certain deferred compensation plans of state and local governments, and in 1986, extended section 457 to apply to certain plans of other tax-exempt service recipients. In addition, shortly after section 409A was enacted, Congress passed section 457A, which imposes accrual taxation on nonqualified deferred compensation arrangements of certain foreign employers.

27. See STAFF OF J. COMM. ON TAXATION, 108TH CONG., REPORT OF INVESTIGATION OF ENRON CORPORATION AND RELATED ENTITIES REGARDING FEDERAL TAX AND COMPENSATION ISSUES, AND POLICY RECOMMENDATIONS 40 (Comm. Print 2003).

28. For a further discussion of cases that address the triggering of constructive receipt, see *supra* note 12 and accompanying text.

erated distributions also reduced the risk of insolvency because participants could accelerate distributions if the service recipient's financial prospects appeared dim. Instead of going down with the ship, participants could bail out early and forfeit only ten percent of their account balance.

The accelerated distribution provisions seemed particularly egregious in the context of the Enron collapse. The Joint Committee investigation had found that \$53 million had been distributed to Enron insiders within the two months preceding bankruptcy. Under bankruptcy law, however, these accelerated distributions were preferences that could be recouped for the benefit of all creditors. And, in fact, these accelerated distributions were attacked as preferences by Enron's bankruptcy estate.²⁹ Thus, while it might have initially appeared that the deferred compensation participants could bail out early and get ninety cents on the dollar, they ended up being treated like all other unsecured creditors.

It is thus very ironic that Enron became the poster child of nonqualified deferred compensation abuse. In hindsight, the deferred compensation participants (and certainly all of those who took accelerated distributions on the eve of bankruptcy) would have been far better off had they initially elected to receive current compensation.³⁰ In other words, Enron's deferred compensation participants gambled—to get the tax advantage of deferred compensation—and lost badly.

Nevertheless, Enron became Exhibit A for the proposition that the nonqualified deferred compensation rules were broken and stimulated the supposed legislative solution of section 409A.

II. SUMMARY OF SECTION 409A

As the previous section described, the pre-409A conditions for achieving deferred taxation treatment for compensation were very easy to satisfy. Participants had to make timely and irrevocable elections to defer, and they had to subject their future payment rights to the risk of the service recipient's insolvency. Section 409A tightened up these conditions, providing for extremely detailed rules regarding the timing of the deferral election,³¹ permissible distribution dates and events,³² and the location of assets that would be the source of future payments.³³ Any failure to satisfy

29. See Motion of the Official Employment-Related Issues Committee for an Order, Pursuant to Sections 105(a), 1103(c) and 1109(b) of the Bankruptcy Code, Expanding Scope and Mandate and Granting Standing and Authority to Commence Certain Avoidance Actions on Behalf of Debtors' Estates, *In re* Enron Corp., No. 01-16034, (Bankr. S.D.N.Y. May 16, 2003) (asserting preference claims to recover \$53 million in accelerated distributions from Enron's nonqualified deferred compensation arrangements).

30. This assumes, of course, that these participants would have had the good sense to not invest all or most of the current compensation in Enron stock.

31. See I.R.C. § 409A(a)(4) (2012).

32. See *id.* § 409A(a)(2)–(3).

33. See *id.* § 409A(b).

2012]

FIXING SECTION 409A

643

these technical conditions resulted in immediate taxation (and corresponding immediate deduction for the service recipient) and the imposition of an additional twenty percent income tax and interest charges.³⁴

To be section 409A compliant, deferred compensation plans must restrict the timing of distributions to fixed dates or upon certain specified events³⁵ and cannot permit accelerated distributions (i.e., distributions that occur before the designated date or payment event).³⁶ Distributions may be made upon the service provider's separation from service, disability, or death, or upon the occurrence of an unforeseeable emergency (such as a medical emergency) or of a change of control of the service recipient. Distributions may be made at a specified time or pursuant to a fixed schedule. The purpose of the permissible distribution rules was to ensure that, once compensation is deferred, it may not be easily accessed by the service provider earlier than the normal distribution date or deferred beyond that date. In other words, the permissible distribution rules ensured that deferral elections were more or less irrevocable. Thus, a plan like Enron's that allowed for early distributions at the election of the participants with a ten percent haircut would not be compliant.

Section 409A also provides detailed rules for the timing of initial and subsequent deferral elections.³⁷ Again, the purpose of these rules is to restrict the flexibility of participants in deferred compensation plans.

III. THE PROBLEMS WITH SECTION 409A

A. *Section 409A Did Not Solve the Deferred Compensation Tax Problem*

It is still very easy to obtain the tax benefits from deferred compensation in those circumstances in which such benefits are available. Section 409A explicitly provides the roadmap to do so. To be sure, section 409A does reduce the flexibility of plan participants. But in cases where deferred compensation is tax-advantaged the reduced flexibility is often not a significant impediment. This is consistent with anecdotal evidence that the response to section 409A among tax planners was to make deferred compensation plans 409A compliant and not to do away with deferred compensation plans. Thus, the result is that section 409A simply provided more hoops to jump through to get the tax benefit of deferred compensation, and everyone is jumping through them rather than opting out.

The theoretically optimal solution would be to neutralize the taxation of deferred compensation with that of current compensation. This would remove any tax advantage, while leaving the parties free to construct the deferred compensation arrangement that best suits their non-tax business needs. As noted before, however, neutralization would be somewhat complex—but at least that complexity would solve the tax problem. Section

34. *See id.* § 409A(a)(1)(B), (b)(5).

35. *See id.* § 409A(a)(2).

36. *See id.* § 409A(a)(3).

37. *See id.* § 409A(a)(4).

409A introduces extraordinary complexity (as described below) without solving the tax problem.

B. *Section 409A Introduced an Immense Amount of Complexity*

Despite not solving the basic tax problem, section 409A managed to introduce a tremendous amount of complexity into the Code. Section 409A and its regulations provide extremely detailed rules outlining the permissible distribution dates and events.³⁸ They define, with inordinate specificity, “separation from service,” “disability,” “change in the ownership or effective control of the corporation,” “unforeseeable emergency,” and “specified time or fixed schedule.” There are also very complex rules defining deferred compensation³⁹ and outlining permissible initial and subsequent deferral election procedures.⁴⁰

C. *Being Section 409A Compliant Is Costly*

After the enactment of section 409A, all deferred compensation plans had to be reformed to comply with its technical conditions.⁴¹ And, given the inordinate complexity of the rules, full compliance is not an easy task.

D. *It Is Possible for Even Diligent Plan Drafters and Administrators to Commit Technical Violations*

Even diligent deferred compensation plan drafters and administrators can accidentally commit technical “foot-fault” violations. The rules are extremely intricate, complex, and lengthy. In addition, the subject matter of most of the rules appears totally benign, which can cause people to become lackadaisical in drafting or complying with them. For example, the definitions of “separation from service” or “disability” seem benign, yet failure to comply with section 409A’s extremely precise definitions⁴² will have disastrous tax consequences.

E. *Section 409A’s Federalization of Deferred Compensation Plans Can Undermine Legitimate Non-Tax Business Goals*

Section 409A also effectively federalized all deferred compensation plans. The additional twenty percent income tax is so significant—relative to the limited tax benefit of deferred compensation—that the only options are either to be 409A compliant or to not pay deferred compensation. Thus, after the enactment of section 409A, all deferred compensation plans have effectively been designed by federal tax regula-

38. See generally Treas. Reg. § 1.409A-3 (2007).

39. See generally *id.* § 1.409A-1.

40. See generally *id.* § 1.409A-2.

41. As noted above, plans could in theory instead be jettisoned in favor of additional current compensation, but this seems not to have been the reaction by tax planners.

42. See Treas. Reg. § 1.409A-3(i)(2), (4) (2007).

2012]

FIXING SECTION 409A

645

tors. This limits the flexibility of companies to design plans that best suit their business objectives, even in cases where the tax advantage of deferred compensation is minimal or non-existent.

For example, the section 409A regulations generally apply to non-qualified stock options because the service recipient's income realization occurs when the options are exercised, which can occur in taxable years after the year of receipt of the option.⁴³ However, the regulations exclude from the definition of deferred compensation stock options that have an exercise price at least equal to the value of the underlying stock at the time of grant.⁴⁴ Thus, the only stock options that are subject to section 409A are "in-the-money" stock options or "indexed" options (options whose exercise price is indexed to a particular benchmark like the Dow Jones Industrial Average). And because stock options may generally be exercised at any time (i.e., exercise is not limited to the specified permissible distribution dates or events), in-the-money or floating stock options per se violate section 409A and trigger the additional twenty percent tax. As a result, in-the-money or indexed stock options are never issued. Yet, as David Walker has explained, there may be very good non-tax business reasons to issuing in-the-money stock options,⁴⁵ and many have advocated indexed options as a more precise instrument with which to compensate employees.⁴⁶ The federalization of deferred compensation has nevertheless outlawed them.

F. *The Scope of Section 409A Is So Expansive that It Captures Arrangements that Are Not Tax-Motivated*

Section 409A applies to any deferred compensation arrangements. Many deferred compensation arrangements are obvious, such as salary or bonus deferral plans. But other deferred compensation arrangements are less obvious. For example, consider a small business owner who promises to give a loyal employee a share of the sales proceeds if and when he eventually sells his business. This is a deferred compensation plan that violates section 409A because the eventual payment date is not a permissible distribution date or event.⁴⁷ Or consider a schoolteacher who has the option to receive her ten-month salary over twelve months. This would be a deferred compensation arrangement that violates section 409A unless the arrangement complies with the deferral election rules.

43. See *id.* § 1.409A-1(b)(5)(i)(A).

44. See *id.*

45. See generally David I. Walker, *The Non-Option: Understanding the Dearth of Discounted Employee Stock Options*, 89 B.U. L. REV. 1505 (2009).

46. See Polsky, *supra* note 17, at 921.

47. It is possible that the sale of the company is a condition that rises to the level of a substantial risk of forfeiture, but this is by no means clear. See Treas. Reg. § 1.409A-1(d)(1) (2007). If it does, then the arrangement would not violate section 409A.

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Subjecting “accidental deferred compensation” plans to section 409A is problematic for two reasons. First, because these arrangements are not typically thought of as deferred compensation plans, they are a trap for the unwary. If a taxpayer wants to set up a formal deferred compensation plan, she would go to a lawyer who would (hopefully) know about section 409A. But if the taxpayer simply wants to promise to pay a future bonus to her employee, she might do that without legal advice or without consulting a lawyer who is sufficiently aware of the details of section 409A. Second, accidental deferred compensation arrangements are by definition not tax-motivated. The parties do not consider the arrangement deferred compensation, and it is not paid in lieu of current compensation. It is a bona fide business arrangement that happens to fall within section 409A’s expansive definition of deferred compensation.

IV. FIXING SECTION 409A

The previous part described the major deficiencies of Section 409A. Its beneficial effect—tightening up the conditions for deferred taxation—is small relative to these problems. This part discusses options for reforming section 409A, starting with legislative reforms that would require congressional action followed by regulatory changes that could be adopted by the Treasury without congressional involvement.

A. *Legislative Options*

Congress has two main options in fixing section 409A. It could go for full-fledged reform by attempting to neutralize the tax treatment of deferred and current compensation. It could do this by imposing accrual taxation on the service providers who receive deferred compensation or by imposing a special tax on the service recipients who pay deferred compensation. Once neutralized, there would be no need to distinguish between “good” deferred compensation plans and “bad” ones and no need to penalize the bad ones. Conceptually, this is clearly the best approach; the issue is whether the administrative burdens of neutralization are worth the benefits.

Congress could instead decide to tighten the doctrines of constructive receipt and economic benefit, which is what it attempted to do in enacting section 409A, without imposing significant unnecessary costs. One option would be to keep section 409A as it is, but limit its application to compensation paid by public companies.⁴⁸ Such a refocusing of section 409A would make sense. Smaller businesses are far less likely to have substantial

48. At the same time, Congress should limit the application of section 409A to compensation paid to employees or directors, as the current regulations largely provide. However, the statutory basis for this approach under current section 409A is questionable, as section 409A seems to apply, by its terms, to all compensation regardless of employee or independent contractor status. If Congress amends section 409A, it should codify the current regulation’s approach of limiting its scope to employee and director compensation.

2012]

FIXING SECTION 409A

647

formal deferred compensation for a number of reasons.⁴⁹ Smaller businesses are at the same time more likely to have “accidental” deferred compensation plans that run into section 409A problems because they lack the sophistication and controls of a large company. Further, the marginal compliance burden of section 409A on public firms will be relatively small because they have accounting, legal, and tax departments that already must review deferred compensation arrangements. In addition, because small businesses are often organized as flow-through tax entities, the effective marginal tax rates of employees and employers (i.e., the owners of small businesses) are likely to be similar, thereby reducing the tax advantage of deferred compensation. In short, refocusing section 409A on large employers better targets the companies that award large amounts of deferred compensation to exploit differing tax rates, while limiting the marginal section 409A compliance burden.

Congress should also remove the additional twenty percent income tax on non-compliant deferred compensation plans. Accrual taxation of “bad” deferred compensation plans is sufficient to take away any tax advantage from deferred compensation; the twenty percent additional tax is nothing but overkill.

Legislative tweaking of section 409A, while a move in the right direction, is not ideal. Deferred compensation arrangements are too varied and fluid for section 409A’s unyielding and comprehensive technical rules. On the other hand, the pre-409A standards of constructive receipt and economic benefit are appropriately flexible. Accordingly, the best legislative approach (absent fundamental deferred compensation reform) would be for Congress to replace the comprehensive rules in section 409A with an explicit grant of authority to the Treasury Department and the IRS to issue rules and regulations to fulfill the purposes of the constructive receipt and economic benefit doctrines by requiring an appropriate level of irrevocability and inflexibility in deferred compensation arrangements. This grant of authority would allow the tax administrators the flexibility to devise new technical rules in problem areas or to simply leave in place the broad common law standards. The flexibility would also allow the tax administrators to choose whether to promulgate general prophylactic regulations or fact-specific rulings (to, for example, deal with specific abusive transactions that have been uncovered). Importantly, the failure to comply with the new rules and regulations would not trigger the additional twenty percent tax. Instead, it would result in immediate taxation (and, depending on the circumstances, the general negligence or substantial understatement penalties that apply to underreported income).

49. Here are a couple of reasons. Employees of small businesses may have less faith than employees of public companies that the company will be around long enough to satisfy their long-term promises. Small businesses are less likely to have the sophistication and legal advice necessary to draft and implement deferred compensation plans.

I would recommend that, if given this grant of authority, the Treasury promulgate prophylactic regulations governing the timing of initial deferral elections and subsequent deferrals. These could look much like the timing rules in section 409A as it currently exists (without the twenty percent additional tax). The Treasury should also promulgate regulations tightening up the economic benefit doctrine to ensure that assets in rabbi trusts are both legally and practically available to creditors of the service recipient in the event of insolvency. Instead of issuing detailed rules setting forth permissible distribution dates and events, I would suggest leaving the pre-409A constructive receipt standard in place. That standard—that amounts cannot be made available to taxpayers without substantial restriction or limitation—is generally sufficient. If the IRS wants to show taxpayers how it interprets the “substantial restriction or limitation” standard, it could do so in Revenue Rulings. For instance, if a ten percent haircut is believed to be a problem (recall that bankruptcy preference law seemed to have taken care of much of the perceived Enron problem), the IRS could issue a revenue ruling describing its view that a ten percent haircut is not substantial enough to prevent the application of the constructive receipt doctrine.

B. *Regulatory Options*

Congress has not done very well in the executive compensation tax arena.⁵⁰ Sections 162(m) and 280G are consensus failures, and section 409A surely fits that mold. Given this history, it is unlikely that Congress will take appropriate action with respect to section 409A. In the absence of legislation, the Treasury and IRS have three options. They can apply section 409A literally as written, disregarding the fact that it is awful policy. The faithful servant approach is the one they have taken in drafting section 409A guidance to date. The only benefit of that approach is that it tees up quite nicely for Congress and everyone else how much of a mess section 409A really is, which (optimistically) could stimulate Congress to enact one of the legislative fixes described above.

Alternatively, the tax administrators could announce that they will not enforce section 409A. The IRS could issue a notice announcing that it will not enforce section 409A until further notice, while expecting never to issue that further notice. Such an explicit contravention of statutory language by the tax administrators is not unprecedented. In 1997, the Treasury Department promulgated the check-the-box regulations allowing non-corporate business entities to elect their classification. This allows substantively identical entities to be classified differently, despite statutory language that precludes such a result.⁵¹ Much more recently, the IRS is-

50. See generally Joy Sabino Mullane, *Incidence and Accidents: Regulation of Executive Compensation Through the Tax Code*, 13 LEWIS & CLARK L. REV. 485 (2009).

51. See 1 WILLIAM S. MCKEE ET AL., *FEDERAL TAXATION OF PARTNERSHIPS AND PARTNERS* ¶ 3.08 at 3-102 (4th ed. 2007) (arguing that statutory language precludes check-the-box regulations' elective regime); Susan Pace Hamill, *A Case for Eliminat-*

2012]

FIXING SECTION 409A

649

sued a series of notices contravening the explicit text of section 382, which limits the availability of loss carry-forwards and built-in losses held by companies that undergo a change in ownership.⁵²

The taxpayer standing doctrine precludes legal challenges of counter-textual agency interpretations as long as the interpretations are favorable to the taxpayer. The taxpayer standing doctrine prevents anyone from litigating anyone else's tax liability, on the ground that general taxpayer status does not result in a cognizable injury for standing purposes. This doctrine effectively allows the Treasury and the IRS to issue whatever guidance they would like, regardless of what the relevant statute requires, so long as the departure from the statute results in a benefit to the taxpayer. If the departure is unfavorable to the taxpayer, then it would quickly be challenged in court by an affected taxpayer.

Even though a policy of section 409A non-enforcement would be immune from legal challenge, there are several potential problems with that approach. There would be political risk in publicly disavowing a very recently enacted statute that was stimulated by the Enron collapse. And, the disavowal could be viewed by unsophisticated observers as a giveaway to corporate executives, since they are the biggest beneficiaries of nonqualified deferred compensation benefits. In addition, there is the potential for serious whipsaw of the IRS. While the application of section 409A is generally adverse to the taxpayer, this will not always be the case. Government disavowal of section 409A would allow taxpayers to selectively apply the provision whenever it suited them. Service recipients could assert the application of section 409A to claim deductions earlier than they would otherwise be allowed, and service providers could assert the application of section 409A to claim income realization in years that have been closed by the statute of limitations.

For example, consider a situation where an employee defers compensation in Year One which is payable in Year Ten. If the deferral arrangement is not section 409A compliant, then under the statute the compensation is included in the employee's income (and deductible by the employer) in Year One, rather than Year Ten when it is paid out. Absent section 409A enforcement, the income and deduction realization would occur in Year Ten (assuming that the traditional constructive receipt and economic benefit doctrines are satisfied). But the employer would argue that the statute entitles it to a deduction in Year One if that deduction is more beneficial than waiting until Year Ten. Similarly, in

ing the Partnership Classification Regulations, 68 TAX NOTES 335, 337 n.15 (1995); Philip F. Postlewaite & John S. Pennell, *JCT's Partnership Tax Proposals—'Houston, We Have a Problem'*, 76 TAX NOTES 527, 532 (1997).

52. For a full discussion of these notices and how they were inconsistent with section 382, see J. Mark Ramseyer & Eric B. Rasmusen, *Can the Treasury Exempt its Own Companies from Tax? The \$45 Billion GM NOL Carryforward*, in 1 CATO PAPERS ON PUBLIC POLICY (Jeffrey Miron ed. 2011), available at <http://rasmusen.org/papers/gm-ramseyer-rasmusen.doc>.

Year Ten, the employee could argue that section 409A required income inclusion in Year One (a year that is now closed by the statute of limitations), which would reduce the income inclusion in Year Ten. In those cases, the IRS would not be able to defend its position that section 409A does not apply because the statute requires its application.

To mitigate the whipsaw problem, the IRS could put conditions on its non-enforcement policy. The IRS could condition non-enforcement on consistency with that approach by the employer and, going forward, by the employee. It could do so by inviting taxpayers to check a box on their tax returns waiving the right to claim section 409A treatment. Failure to check the box would invite the IRS scrutiny to determine compliance with section 409A.

Besides political and whipsaw concerns, there is another drawback of an explicit non-enforcement policy. Such a policy would effectively leave the pre-409A doctrines of constructive receipt and economic benefit in place as they existed before section 409A was enacted, without any tightening up of the conditions for deferral. It would be awkward, to say the least, for the Treasury and the IRS to tinker around the edges of these doctrines while explicitly disregarding a statute designed to reinforce them.

A middle-ground approach, between literal interpretation and non-enforcement, would be for the Treasury and the IRS to recognize that section 409A is a legislative calamity when drafting guidance. Congress explicitly gave the Treasury specific authority to “prescribe such regulations as may be necessary or appropriate to carry out the purposes of this section [409A].” This specific delegation could be used to re-focus section 409A exclusively on the deferred compensation arrangements of extremely large employers, which were the types of arrangements that triggered its enactment.

For example, the Treasury could interpret “compensation” for purposes of section 409A to refer only to compensation earned by employees of publicly traded entities. As discussed above, such a refocusing of section 409A would make eminent sense for a number of reasons. One problem with this approach is that it is difficult to reconcile it with the statutory language, though it is obviously more faithful to the statutory language than a policy of non-enforcement. “Compensation” as used in the text of section 409A is not limited in any way, while the suggested interpretation limits the scope of compensation to that issued by public companies. But because the suggested interpretation is a taxpayer-favorable interpretation, it usually would be protected by the taxpayer standing doctrine. In addition, the current regulations effectively reinterpret “compensation” to refer only to employee compensation, thereby exempting independent contractor compensation from the scope of section 409A despite the absence of any statutory ground for making the distinction.⁵³ Thus, the current regulations reflect an awareness that the scope of section 409A is

53. See Treas. Reg. § 1.409A-1(f)(2) (2007).

2012]

FIXING SECTION 409A

651

overbroad, and they attempt to cabin its effect to arrangements that are problematic. The suggested interpretation merely extends this massaging of statutory text to the next logical place.

Whipsaw of the IRS would be a concern with this approach too. Non-public employers and their employees could assert section 409A in those cases where it suits them, while the IRS would be prevented from applying the provision to these taxpayers. However, the check-the-box procedure previously discussed could mitigate the whipsaw concern.

V. CONCLUSION

Section 409A is a failure. It fails to neutralize the tax treatment of deferred compensation with that of current compensation. At the same time, it imposes significant compliance costs on sophisticated taxpayers, and it is a dangerous trap for unwary taxpayers. It applies to a host of innocent transactions, while tax-advantaged deferred compensation plans persist as long as the “i’s” are dotted and the “t’s” are crossed.

Ideally, Congress should repeal section 409A and replace it with a system that taxes deferred compensation neutrally. Failing that, Congress should either replace section 409A with a broad grant of authority to the tax administrators to beef up the pre-409A constructive receipt and economic benefit doctrines or amend section 409A to limit its scope to employee compensation paid by public companies.

If Congress fails to act, the tax administrators should interpret “compensation” as used in section 409A to include only compensation paid by public companies to their employees or directors. This counter-textual interpretation of the statute creates the potential for whipsaw of the IRS by non-public companies and their employees, but this problem is outweighed by the benefits derived from cleaning up section 409A.

652

VILLANOVA LAW REVIEW

[Vol. 57: p. 635