The Puzzle of Non-Qualified Retirement Pay:
Optimal Contracting, Managerial Power, and Taxes

by
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University of Virginia School of Law
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Pay arrangements for managers of public corporations typically include substantial amounts of compensation deferred through non-qualified retirement plans. As a departure from the familiar baseline of current payment for current services, this presents a longstanding puzzle. The corporate-governance literature offers two explanations for the practice. The “optimal-contracting account” argues that non-qualified retirement pay represents “inside debt” that aligns the interests of managers with the interests of the corporation’s unsecured general creditors. The “managerial-power account” argues that non-qualified retirement pay represents “stealth compensation” that facilitates managers’ extraction of rents from corporate assets. In this paper, I set out a different explanation based on tax considerations. Specifically, I argue that corporations and managers use non-qualified retirement pay to supplement the benefits under tax-qualified retirement plans, to substitute lower corporate marginal tax rates for higher individual marginal tax rates on certain types of investment income, to avoid the $1 million limitation on corporate compensation deductions, and to avoid state income taxes. The tax account is at least as strong as the other two accounts in explaining the motivation for the basic decision to defer manager compensation and is superior to the other two accounts in explaining the contractual terms of non-qualified retirement plans.
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The University of Virginia pays my salary monthly, in arrears, over the academic year. Consequently, I receive my first paycheck on September 30, about five weeks after the start of classes. I like to point this out to my students as September draws to a close, adding that they will know I did not receive payment if I fail to show up for class the following week. I gladly accept a four- or five-week pay lag, but I doubt that I would be so patient if the delay lasted a year or more. Why, then, do corporate managers tolerate – and even prefer – the regular deferral of substantial portions of their compensation for long periods? The sums involved often run into the tens of millions of dollars, and the deferral periods sometimes last for decades. Why do compensation practices for managers deviate so much from the familiar baseline of current payment for current services?

Of course, I welcome the opportunity to defer part of my compensation through the University of Virginia’s retirement plan, but that is a very different matter. Federal tax and pension laws require that a tax-qualified retirement plan, such as a traditional pension plan or a section 401(k) plan, hold its assets in an exclusive-benefit trust that is fully secure from the creditors of both the employer and the employee. Most manager retirement pay, however, is deferred under a non-qualified retirement plan. Federal laws not only prohibit a non-qualified

1 Roy L. & Rosamond Woodruff Morgan Professor of Law, University of Virginia School of Law. For comments and criticisms, many thanks to Albert Choi, Quinn Curtis, Michael Graetz, Wojciech Kopczuk, Ruth Mason, Shu-Yi Oei, Gregg Polsky, Mildred Robinson, Alex Raskolnikov, Adam Rosenzweig, Michael Schler, Darien Shanske, David Walker, Bret Wells, Thomas White, Ethan Yale, George Yin, and Stephen Zeldes.


3 See Part I.A, infra.
retirement plan from holding its assets in an exclusive-benefit trust but affirmatively require that the assets remain fully exposed to the claims of the corporation’s general creditors. A manager who defers part of her compensation under a non-qualified plan thus bears a genuine and significant risk of never receiving payment. But more than 90 percent of large corporations provide managers with non-qualified retirement pay. What explains the willingness of managers to be paid far in the future for work performed in the present, particularly if part or all of the pay might be lost in the event of corporate insolvency? In short, why deferred rather than current compensation?

The corporate-governance literature to date has offered two principal explanations. The first attributes non-qualified retirement pay to optimal contracting between managers and corporate directors. On this “optimal-contracting account,” directors use deferred compensation to align the interests of managers with the interests of the corporation’s creditors. The account thus maintains that non-qualified retirement pay is a function of arm’s-length bargaining between directors and managers, with the advantage to the directors. The second explanation attributes non-qualified retirement pay to extraordinary managerial power. On this “managerial-power account,” managers use deferred compensation to obscure (“camouflage”) the rents that they extract from the corporation’s assets through their symbiotic relationships with the corporation’s directors. The account thus maintains that non-qualified retirement pay is a function of collusion between directors and managers, with the advantage to the managers.

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4 See Part I.A, infra.


Although both accounts suggest seemingly plausible solutions to the puzzle of non-qualified retirement pay, both accounts all but ignore fundamental tax considerations that lead managers and directors rationally to prefer deferred compensation over current compensation. These include the limitations on benefits payable from tax-qualified plans, the relationship between the manager’s marginal tax rates and the corporation’s marginal tax rates for certain types of investment income, the $1 million cap on the corporation’s compensation deduction, and state income taxes. These tax considerations provide a clean, straightforward explanation for the basic decision to defer manager compensation. Additionally, specific tax rules account for the contractual terms of non-qualified retirement plans – including the close coordination of non-qualified plans with tax-qualified plans, the wholesale exclusion of rank-and-file employees from non-qualified plans, the status of managers as unsecured general creditors under non-qualified plans, the heavy concentration of non-qualified retirement pay in the corporation’s own stock, and the sharp limitations on the time and form of distributions from non-qualified plans. By contrast, the optimal-contracting and managerial-power accounts have struggled to understand or have simply misunderstood these contractual terms.

In Part I of this paper, I set out a new explanation of non-qualified retirement pay, an explanation grounded in tax rules and tax considerations. I evaluate the tax account along two margins: the motivation for the basic decision to defer a manager’s compensation and the major contractual terms of non-qualified retirement plans. In Part II, I show that the tax account is at least as strong as the other two accounts on the first margin and is superior to the other two accounts on the second margin. Even so, I do not claim that the tax account refutes either the optimal-contracting account or the managerial-power account. It may well be that the solution to the puzzle lies in a combination of the three explanations. In Part III, I consider the policy implications of the tax account, including the implications for legislative reform of non-qualified retirement pay.
I. A Tax Account of Non-Qualified Retirement Pay

Non-qualified retirement pay has two defining characteristics: deferred payment of a manager’s compensation and deferred taxation of that compensation. It is remarkable, then, that the two main academic explanations of non-qualified retirement pay – the optimal-contracting account and the managerial-power account – largely ignore tax considerations. In this part, I introduce a new account of non-qualified retirement pay, one that draws heavily on tax rules and tax considerations. My thesis is straightforward: Both in the decision to defer compensation and in setting the contractual terms of non-qualified retirement plans, directors and managers respond to the incentives, restrictions, and opportunities provided by tax law. To set out the tax account, I first describe the basic tax rules for non-qualified retirement pay. I then identify four key tax considerations that provide powerful motivations for the deferral of manager compensation. Finally, I demonstrate how specific tax rules explain the most important contractual terms of non-qualified plans.

There is an important point about terminology here. The academic literature generally uses the term “executive pension” or “executive retirement plan” to denote non-qualified defined-benefit plans and the term “deferred compensation” to denote non-qualified defined-contribution plans. For obscure reasons, the literature stubbornly insists on treating the two plan types, which are explained in greater detail below, as though they were fundamentally different. But the distinction is largely inconsequential. Substantially the same tax and legal regime applies to all non-qualified plans, whether structured as defined-contribution or defined-benefit arrangements. In this paper, I use the term “non-qualified retirement plan” and

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9 See Part I.B.1, infra.
its cognates to reference any defined-contribution or defined-benefit arrangement that provides for the deferral of manager compensation.

A. Taxation of Non-Qualified Retirement Pay

The basic tax rules for non-qualified retirement pay are reasonably clear, although they are not intuitive. To avoid current taxation, a manager’s compensation must be deferred before it is earned.\(^\text{10}\) The decision to defer may be made unilaterally by the corporation (typically acting through the directors) or by agreement with the manager.\(^\text{11}\) The compensation, as adjusted for any investment gains or losses, generally must be distributed to the manager at a time and in a manner established before the compensation is deferred.\(^\text{12}\) Despite this general rule, the tax law permits subsequent changes to the time and manner of distribution under narrow conditions. Thus, a non-qualified retirement plan may (but need not) permit the manager to postpone distribution of her non-qualified retirement pay, although the manager must elect the postponement at least one year before the non-qualified retirement pay otherwise would be distributed and the postponement must push the payment starting date back by at least five years.\(^\text{13}\) In no event may the distribution of the non-qualified retirement pay be accelerated, either by the manager or by the corporation.\(^\text{14}\) The corporation may not set aside any assets for the exclusive benefit of the manager during the deferral period; instead, assets associated with the non-qualified plan must be held as general corporate assets subject to the

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\(^\text{10}\) Internal Revenue Code section 409A(a)(4)(B); Treasury Regulations section 1.451-2; Rev. Rul. 60-31, 1960-1 C.B. 174; Testimony of Pamela F. Olson, Assistant Secretary of the Treasury (Tax Policy), for the Committee on Finance, United States Senate (Apr. 8, 2003).


\(^\text{12}\) Internal Revenue Code section 409A(a)(2).

\(^\text{13}\) Internal Revenue Code section 409A(a)(4)(C).

\(^\text{14}\) Internal Revenue Code section 409A(a)(3).
claims of the corporation’s creditors.\textsuperscript{15} Failing any of these rules exposes the manager to immediate taxation on her vested non-qualified retirement pay and, in certain cases, a 20-percent penalty tax and an interest charge calculated from the time of the initial deferral.\textsuperscript{16}

Just as the manager defers tax on her non-qualified retirement pay, the corporation may not deduct the compensation until the manager includes it in her income.\textsuperscript{17} The tax law thus matches the timing of the manager’s inclusion with the timing of the corporation’s deduction. Furthermore, because the corporation remains the owner of any assets associated with the non-qualified retirement pay during the period of deferral, the corporation pays current tax on any investment income generated by those assets. As has long been understood in the tax literature, the deferral of the corporation’s deduction has the effect of substituting taxation of the corporation for taxation of the manager.\textsuperscript{18} That is, rather than tax the manager on the compensation when earned and on the investment income during the deferral period, the tax law, by deferring the corporation’s deduction, taxes the corporation during the deferral period. If individual marginal tax rates and corporate marginal tax rates line up exactly for all types of income, there is no revenue cost or benefit to the federal fisc from deferral under a non-qualified plan.\textsuperscript{19} To the extent that those rates diverge, however, the tax law effectively may either subsidize or penalize non-qualified retirement pay.\textsuperscript{20}

\begin{itemize}
\item \textsuperscript{15} Internal Revenue Code section 409A(b); Treasury Regulations section 1.83-3(e); Rev. Rul. 60-31, 1960-1 C.B. 174; Testimony of Pamela F. Olson, Assistant Secretary of the Treasury (Tax Policy), for the Committee on Finance, United States Senate (Apr. 8, 2003).
\item \textsuperscript{16} Internal Revenue Code sections 83(a), 409A(a) and (b), and 402(b); Rev. Rul. 60-31, 1960-1 C.B. 174.
\item \textsuperscript{17} Internal Revenue Code sections 83(h) and 404(a)(5); \textit{Albertson’s Inc. vs. Commissioner}, 42 F.3d 537 (9th Cir. 1994); Testimony of Pamela F. Olson, Assistant Secretary of the Treasury (Tax Policy), for the Committee on Finance, United States Senate (Apr. 8, 2003).
\item \textsuperscript{18} Halperin, “Interest in Disguise: Taxing the ‘Time Value of Money,’” 95 Yale L.J. 506 (1986).
\item \textsuperscript{20} Doran, “Executive Compensation Reform and the Limits of Tax Policy,” Urban-Brookings Tax Policy Center Discussion Paper No. 18, 8-9 (2004). Also, the tax law effectively may either subsidize or penalize non-qualified retirement pay if the individual marginal tax rate or the corporate marginal tax rate
These rules contrast sharply with the tax treatment of tax-qualified retirement plans and with the tax treatment of current compensation (that is, compensation paid and taxed when earned). Under a tax-qualified plan, the manager is taxed only when his retirement pay is distributed (just as with a non-qualified retirement plan),\textsuperscript{21} but the corporation nonetheless takes a current deduction when the compensation is paid into the plan.\textsuperscript{22} During the deferral period, the retirement pay is invested through a trust that is exempt from taxation.\textsuperscript{23} For current compensation, the manager is taxed immediately when he receives his compensation,\textsuperscript{24} the corporation takes a current deduction when the compensation is paid,\textsuperscript{25} and any investment income on the post-tax compensation is taxed to the manager (assuming that the manager does not invest the post-tax compensation through a tax-exempt or tax-deferred investment vehicle, such as an insurance or annuity contract).\textsuperscript{26}

To see the effects of these different tax regimes, consider the following examples. In each case, the applicable individual marginal income tax rate is 39.6 percent (currently the highest individual marginal tax rate for ordinary income), the applicable surtax on investment income for a middle- or high-income individual is 3.8 percent, the applicable corporate marginal income tax rate is 35 percent (currently the highest corporate marginal tax rate for ordinary income), the deferral period is 20 years, the sole investment is an interest-bearing bond, and the annual pre-tax rate of return on that bond is 5 percent.

\textsuperscript{21} Internal Revenue Code section 402(a).

\textsuperscript{22} Internal Revenue Code section 404(a)(1)-(3).

\textsuperscript{23} Internal Revenue Code sections 401(a)(1) and 501(a).

\textsuperscript{24} Internal Revenue Code section 61(a).

\textsuperscript{25} Internal Revenue Code section 162(a).

\textsuperscript{26} Internal Revenue Code section 61(a).
Example 1: Deferral under Tax-Qualified Retirement Plan. At the start of Year 1, Corporation defers $20,000 of Manager’s compensation under a tax-qualified retirement plan. Manager excludes the $20,000 from gross income in Year 1, yielding a Year 1 tax saving for Manager of $7,920. Corporation deducts $20,000 in Year 1, yielding a Year 1 tax saving for Corporation of $7,000. Corporation’s Year 1 post-tax cost of $13,000 has a Year 20 value of $24,646. Over the next 20 years, the $20,000 deferral accumulates at the pre-tax rate of 5 percent to $53,066. At the end of Year 20, the tax-qualified plan distributes $53,066 to Manager. Manager includes the $53,066 in her Year 20 income, paying $21,014 in tax. Manager nets $32,052.

Example 2: Deferral under Non-Qualified Retirement Plan. At the start of Year 1, Corporation defers $20,000 of Manager’s compensation under a non-qualified retirement plan. Manager excludes the $20,000 from gross income in Year 1, yielding a Year 1 tax saving for Manager of $7,920. Corporation does not deduct the $20,000 in Year 1. Over the next 20 years, the $20,000 deferral accumulates at Corporation’s post-tax rate of 3.25 percent to $37,917. At the end of Year 20, the non-qualified plan distributes $37,917 to Manager. Manager includes the $37,917 in her Year 20 income, paying $15,015 in tax. Manager nets $22,902. Corporation deducts the $37,917 from its Year 20 income, yielding a Year 20 tax saving of $13,271.

Example 3: No Deferral. At the start of Year 1, Corporation pays Manager $20,000 in compensation. Manager includes the $20,000 in gross income in Year 1, paying $7,920 in tax and netting $12,080. Manager’s Year 1 post-tax compensation of $12,080 has a Year 20 value of $21,109. Corporation deducts $20,000 in Year 1, yielding a Year 1 tax saving for Corporation of $7,000. Corporation’s Year 1 post-tax cost of $13,000 has a Year 20 value of $24,646.

As shown in Table 1, deferral of Manager’s compensation under the tax-qualified plan is more valuable than deferral under the non-qualified plan, which in turn is more valuable than current taxation of Manager’s compensation:

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27 This is determined using Corporation’s 3.25-percent post-tax rate of return.

28 This is determined using Manager’s 2.83-percent post-tax rate of return. The 2.83-percent post-tax rate of return reflects the imposition of ordinary income tax (at a rate of 39.6 percent) and the surtax on investment income (at a rate of 3.8 percent).

29 This is determined using Corporation’s 3.25-percent post-tax rate of return.
Table 1
Summary of Manager Income and Corporate Expense

<table>
<thead>
<tr>
<th></th>
<th>Tax-Qualified Retirement Plan</th>
<th>Non-Qualified Retirement Plan</th>
<th>No Deferral</th>
</tr>
</thead>
<tbody>
<tr>
<td>Year 20 Post-Tax Cost of Corporation’s Compensation Expense</td>
<td>($24,646)</td>
<td>($24,646)</td>
<td>($24,646)</td>
</tr>
<tr>
<td>Year 20 Post-Tax Value of Manager’s Income</td>
<td>$32,052</td>
<td>$22,902</td>
<td>$21,109</td>
</tr>
</tbody>
</table>

In all three examples, the Year 20 post-tax cost to Corporation of the Year 1 $20,000 compensation expense is the same ($24,646). But the Year 20 post-tax value to Manager of the $20,000 compensation earned in Year 1 is greater under the tax-qualified plan ($32,052) than under the non-qualified plan ($22,902). This difference in outcomes derives from the different tax treatment of tax-qualified and non-qualified retirement plans. Under the tax-qualified plan, the retirement pay is not taxed during the deferral period, so it accumulates at a pre-tax rate of return. Under the non-qualified plan, deferral of Corporation’s deductions subjects the retirement pay to current taxation during the deferral period at Corporation’s marginal tax rate of 35 percent, thereby yielding a smaller accumulation and a smaller payment to Manager.

No less significantly, the Year 20 post-tax value to Manager of the $20,000 compensation earned in Year 1 is greater in the case of the non-qualified plan ($22,902) than in the case of no deferral ($21,109), although the difference here is smaller. The reason is simple. In both cases, investment earnings on the $20,000 compensation remain subject to current taxation throughout the period that begins with Year 1 and ends with Year 20. In the case of deferral through the non-qualified plan, the investment earnings are taxed to Corporation at its rate of 35 percent. In the case of no deferral, the investment earnings are taxed to Manager at her rate of 43.4 percent (reflecting both the individual income tax and the surtax on investment income). The small difference in tax rates yields a slightly larger post-tax accumulation in the first case.
As a first approximation, these examples show that managers and corporations should have a strong preference for deferral of manager compensation through tax-qualified plans both over deferral through non-qualified plans and over no deferral at all. But the tax law sharply limits the amounts that can be deferred through tax-qualified plans, effectively limiting the extent to which managers and corporations can satisfy that preference.30 The examples also show that managers and corporations should have a preference for deferral of manager compensation through non-qualified plans over no deferral at all. Although that preference may appear somewhat weak, the tax considerations that bear on non-qualified retirement pay extend well beyond the basic tax rules set forth above. As discussed below,31 closer analysis of the relevant rules shows that managers and corporations have compelling tax reasons to prefer non-qualified retirement pay over current taxation of compensation.

B. Taxes and the Motivation for Deferring Compensation

Several important tax rules provide powerful incentives for both the manager and the corporation to delay payment of the manager’s compensation until after the manager has retired or otherwise terminated employment. These include the tax limitations on benefits payable by tax-qualified retirement plans, the taxation of investment returns on non-qualified retirement pay at corporate marginal tax rates, the $1 million limitation on the corporation’s compensation deduction, and the federal prohibition on state taxation of non-qualified retirement pay received by non-residents. Together, these tax considerations offer strong reasons for managers and corporations to include non-qualified retirement pay in manager compensation arrangements.

1. Supplementing Benefits under Tax-Qualified Retirement Plans

Non-qualified retirement plans allow corporations to provide managers with retirement benefits that, because of limitations under the tax code, cannot be paid by tax-qualified

30 See Part I.B, infra.

31 See Part I.B.1, infra.
retirement plans. Most public corporations maintain tax-qualified plans for their employees. These plans fall into two broad categories: defined-benefit plans (which include traditional pension plans) and defined-contribution plans (which include section 401(k) plans).\(^{32}\) Under a defined-benefit plan, the corporation promises to pay the employee a specific amount at a specific time.\(^{33}\) Typically, the payment is expressed as a single-life annuity beginning at the employee’s retirement.\(^{34}\) And, typically, that single-life annuity can be converted by the employee into a different payment form of equivalent actuarial value, such as a joint-and-survivor annuity, an annuity with term-certain payments, or a lump sum.\(^{35}\) Under a defined-contribution plan, the corporation promises to pay the employee an amount equal to the compensation initially deferred, as adjusted for subsequent investment gains and losses.\(^{36}\) Typically, the payment is expressed as a lump sum once she has retired, although that lump sum may be convertible by the employee into installment or annuity payments.\(^{37}\)

Federal tax and pension laws have long subjected tax-qualified plans to extensive regulation concerning matters such as employee participation and vesting and employer prefunding. Federal tax law also restricts the benefits provided by these plans. Since 1974, section 415 of the Internal Revenue Code has limited both the amount that a tax-qualified defined-benefit plan may pay out to an employee and the amount that a corporation may pay into a tax-qualified defined-contribution plan on behalf of an employee. The section 415 limits (as adjusted for inflation) currently stand at $210,000 (or the amount of the employee’s compensation, if smaller) for annual payments from a defined-benefit plan\(^{38}\) and $53,000 (or the

\(^{32}\) ABA Section of Labor and Employment Law, Employee Benefits Law (3d. ed) at 5-6 to 5-7.

\(^{33}\) ABA Section of Labor and Employment Law, Employee Benefits Law (3d. ed) at 5-8.

\(^{34}\) ABA Section of Labor and Employment Law, Employee Benefits Law (3d. ed) at 5-8.

\(^{35}\) ABA Section of Labor and Employment Law, Employee Benefits Law (3d. ed) at 5-84 to 5-85.

\(^{36}\) ABA Section of Labor and Employment Law, Employee Benefits Law (3d. ed) at 5-7 to 5-8.

\(^{37}\) ABA Section of Labor and Employment Law, Employee Benefits Law (3d. ed) at 5-84 to 5-85.

\(^{38}\) Internal Revenue Code section 415(b); IR-2015-118.
amount of the employee’s compensation, if smaller) for annual contributions to a defined-contribution plan.\textsuperscript{39} Other limits apply as well. Under section 401(a)(17) of the Internal Revenue Code (as adjusted for inflation), a tax-qualified retirement plan must disregard an employee’s compensation over $265,000 in determining benefit distributions from a defined-benefit plan or contributions to a defined-contribution plan.\textsuperscript{40} Under section 402(g) of the Internal Revenue Code (as adjusted for inflation), an employee participating in a section 401(k) plan may contribute no more than $18,000 through salary reduction each year (although the limit is raised to $24,000 in the case of an employee who has reached age 50).\textsuperscript{41} Under section 401(a)(4) of the Internal Revenue Code, a tax-qualified plan may not discriminate in favor of highly compensated employees.\textsuperscript{42} That non-discrimination rule bars practices such as providing managers and other high-paid employees benefits that are disproportionate, relative to salary and years of service, to the benefits provided to rank-and-file workers and crediting managers and other high-paid employees with benefit-accrual service under a method more favorable than that used for rank-and-file employees.\textsuperscript{43} And sections 401(k)(3) and 401(m) of the Internal Revenue Code set out specialized non-discrimination rules for tax-qualified plans that provide for employee pre-tax salary-reduction contributions, employee post-tax salary-reduction contributions, and employer matching contributions.\textsuperscript{44}

These limitations significantly reduce the benefits that otherwise would be paid to a manager by a corporation’s tax-qualified plan. Consider a tax-qualified defined-benefit plan. A typical defined-benefit plan might promise each employee a single-life annuity at retirement

\textsuperscript{39} Internal Revenue Code section 415(c); IR-2015-118.

\textsuperscript{40} Internal Revenue Code section 401(a)(17); IR-2015-118.

\textsuperscript{41} Internal Revenue Code section 402(g); IR-2015-118.

\textsuperscript{42} Internal Revenue Code section 401(a)(4).

\textsuperscript{43} See generally Treasury Regulations sections 1.401(a)(4)-1 through 1.401(a)(4)-13; Finston and Bodron, Plan Qualification – Pension and Profit-Sharing Plans A-109 through A-139 (2015); ABA Section of Labor and Employment Law, Employee Benefits Law (3d. ed) at 5-37 through 5-40.

\textsuperscript{44} Internal Revenue Code sections 401(k)(3) and 401(m).
equal to the product of two percent of the employee’s compensation (averaged over her five years of highest pay) and the employee’s number of years of employment with the corporation, up to 25 years. The intended effect of the formula is to provide any employee who works for the corporation for 25 years or more with an annual pension equal to 50 percent of the employee’s pay. But under the compensation limit of section 401(a)(17), the plan could not pay out a single-life annuity of more than $132,500 to any employee. A rank-and-file employee who works for the corporation for 25 years and whose applicable compensation amount is $80,000 would be entitled to a single-life annuity of $40,000 – an amount well within the section 401(a)(17) limit. By contrast, a manager who works for the corporation for 25 years and whose applicable compensation amount is $20 million would be entitled to a single-life annuity of $10 million – an amount well in excess of the section 401(a)(17) limit. The limit therefore reduces the single-life annuity payable to the manager from $10 million to $132,500 – a very substantial reduction in the manager’s retirement payments. The tax limitations have similar effects under tax-qualified defined-contribution plans.

For this reason, it is commonplace among public corporations to use non-qualified plans to supplement the benefits provided under tax-qualified plans. The standard use of a non-qualified defined-benefit plan is to restore the benefits lost under the tax-qualified defined-benefit plan by reason of the section 415, section 401(a)(17), and section 401(a)(4) limitations. Thus, in the case described above, the manager would be entitled to a single-life annuity from the corporation’s tax-qualified plan of $132,500 and a single-life annuity from the corporation’s non-qualified plan of $9,867,500, for a total equal to the $10 million annual payments that the manager would have received from the tax-qualified plan in the absence of sections 415 and section 401(a)(17). Similarly, a non-qualified defined-contribution plan often supplements a corporation’s tax-qualified defined-contribution plan, restoring the benefits lost by reason of the


46 Calculated as follows: 0.02 x $265,000 x 25. Although the section 415 limit would allow a single-life annuity of up to $210,000, the combined effect of the compensation limit under section 401(a)(17) and the plan’s benefit formula produces a maximum benefit of only $132,500.
limitations under sections 415, 401(a)(17), 402(g), 401(a)(4), 401(k)(3), and 401(m). Non-qualified defined-contribution plans also may function as stand-alone arrangements, allowing or even requiring a manager to defer salary, bonus, stock-option gains, and other compensation. But much of what is provided to managers under non-qualified plans constitutes benefits that, but for the limitations under the tax laws, would be provided to them under tax-qualified plans.

2. Reducing Taxation of Investment Returns

The deferral of compensation under a non-qualified retirement plan also permits the substitution of a corporation’s lower marginal tax rates for a manager’s higher marginal tax rates on particular types of investment income. As discussed above, federal tax law requires that any non-qualified retirement pay be held as general corporate assets, subject at all times to the claims of the corporation’s creditors. For this reason, the investment returns on those assets are taxed to the corporation, not the manager. This provides a tax advantage if the corporate marginal tax rate is lower than the individual marginal tax rate or if the corporation has unused net operating losses to offset current investment income. Compared to an investment of current compensation made by the manager, an investment made through a non-qualified retirement plan at the corporation’s lower marginal tax rate plan yields a larger accumulation at the end of the deferral period, ceteris paribus.

Although individual and corporate marginal tax rates have changed over time, the highest corporate income tax rate for ordinary income and short-term capital gains (35 percent) is currently 4.6 percentage points below the highest individual income tax rate for

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47 See Part I.A, supra.

48 Scholes et al., Taxes and Business Strategy: A Planning Approach 204-205 (5th ed. 2015).


50 A better post-tax rate of return does not directly benefit the manager in a defined-benefit arrangement because, under the terms of the plan, the corporation is obligated to pay the manager a specified amount regardless of investment performance.

51 Internal Revenue Code section 11(b).
ordinary income and short-term capital gains (39.6 percent).\textsuperscript{52} Interest earned on non-qualified retirement pay, therefore, is taxed at a lower income tax rate if the interest-bearing investment is owned by the corporation rather than by the manager. For dividends, the highest corporate income tax rate (10.5 percent) is 9.5 percentage points below the highest individual income tax rate (20 percent).\textsuperscript{53} The situation generally is reversed for long-term capital gains. The highest corporate income tax rate for long-term capital gains (35 percent)\textsuperscript{54} is 15 percentage points higher than the corresponding highest individual income tax rate (20 percent).\textsuperscript{55} However, long-term capital gains and dividends attributable to the corporation’s own stock are not taxed \textit{at all} if the stock is held by the corporation.\textsuperscript{56} Table 2 summarizes these rate differentials:

\textsuperscript{52} Internal Revenue Code sections 1(a) through (d).

\textsuperscript{53} Although the marginal income tax rate on dividend income received by a corporation is 35 percent, the dividends-received deduction effectively reduces the income tax rate to no more than 10.5 percent. Internal Revenue Code section 243(a).

\textsuperscript{54} Internal Revenue Code section 11(b).

\textsuperscript{55} Internal Revenue Code section 1(h).

Table 2
Tax-Rate Differentials for Designated Investment Income
(Income Tax Only)

<table>
<thead>
<tr>
<th>Investment Income</th>
<th>Corporate Tax Rate</th>
<th>Individual Tax Rate</th>
<th>Rate Differential</th>
</tr>
</thead>
<tbody>
<tr>
<td>Interest</td>
<td>35</td>
<td>39.6</td>
<td>(4.6)</td>
</tr>
<tr>
<td>Short-Term Capital Gain</td>
<td>35</td>
<td>39.6</td>
<td>(4.6)</td>
</tr>
<tr>
<td>Long-Term Capital Gain (other than corporation’s own stock)</td>
<td>35</td>
<td>20</td>
<td>15</td>
</tr>
<tr>
<td>Dividend (other than corporation’s own stock)</td>
<td>10.5</td>
<td>20</td>
<td>(9.5)</td>
</tr>
<tr>
<td>Long-Term Capital Gain (corporation’s own stock)</td>
<td>0</td>
<td>20</td>
<td>(20)</td>
</tr>
<tr>
<td>Dividend (corporation’s own stock)</td>
<td>0</td>
<td>20</td>
<td>(20)</td>
</tr>
</tbody>
</table>

Non-qualified retirement pay thus provides a distinct tax advantage. Most types of investment income bear income tax at modestly or substantially lower rates if the underlying investments are held by the corporation, as the tax rules for non-qualified retirement pay require. For long-term capital gains and dividends attributable to an investment in the corporation’s own stock, the difference is stark. The manager would pay income tax at a maximum rate of 20 percent on those income types; the corporation pays no tax at all on them.

Beginning in 2013, there is a further tax-rate differential attributable to the surtax imposed on net investment income. Enacted in the 2010 federal health-care reform law and formally part of the Medicare system, this tax is a 3.8-percent levy on the net investment income of moderate- and high-income taxpayers. Thus, any interest, short-term capital gains, long-term capital gains, and dividends received directly by a manager are subject to a 3.8-percent surtax.

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57 Internal Revenue Code section 1411(a).
surtax. But interest, short-term capital gains, long-term capital gains, and dividends received by a corporation do not incur the surtax. Incorporating this surtax into Table 2 gives the following results:

**Table 3**
Tax-Rate Differentials for Designated Investment Income
(Income Tax and Investment-Income Surtax)

<table>
<thead>
<tr>
<th>Investment Income</th>
<th>Corporate Tax Rate</th>
<th>Individual Tax Rate</th>
<th>Rate Differential</th>
</tr>
</thead>
<tbody>
<tr>
<td>Interest</td>
<td>35</td>
<td>43.4</td>
<td>(8.4)</td>
</tr>
<tr>
<td>Short-Term Capital Gain</td>
<td>35</td>
<td>43.4</td>
<td>(8.4)</td>
</tr>
<tr>
<td>Long-Term Capital Gain (other than corporation’s own stock)</td>
<td>35</td>
<td>23.8</td>
<td>11.2</td>
</tr>
<tr>
<td>Dividend (other than corporation’s own stock)</td>
<td>10.5</td>
<td>23.8</td>
<td>(13.3)</td>
</tr>
<tr>
<td>Long-Term Capital Gain (corporation’s own stock)</td>
<td>0</td>
<td>23.8</td>
<td>(23.8)</td>
</tr>
<tr>
<td>Dividend (corporation’s own stock)</td>
<td>0</td>
<td>23.8</td>
<td>(23.8)</td>
</tr>
</tbody>
</table>

Again, by deferring compensation and substituting the corporation’s marginal tax rates for the manager’s marginal tax rates, the corporation and the manager can substantially reduce the tax burden on the investment of that compensation.

In short, the differences in corporate and individual tax rates matter for purposes of determining whether to compensate a manager with current or deferred pay. Non-qualified retirement pay is taxed at the corporate marginal tax rate throughout the deferral period. In most cases, that rate is lower than the individual marginal tax rate, giving the corporation and

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58 Internal Revenue Code section 1411(c).
the manager good reason to prefer deferral over current compensation. In particular cases, as with investments in the corporation’s own stock, the corporate marginal tax rate is much lower than the individual marginal tax rate, giving the corporation and the manager good reason to prefer that the deferred amount be invested in a specific way.\(^59\)

3. Avoiding the $1 Million Deduction Limitation

Under section 162(m) of the Internal Revenue Code, a public corporation generally may not deduct compensation in excess of $1 million paid in any year to one of its most senior managers.\(^60\) This deduction limitation favors deferral of the manager’s pay because it applies only for the period of the manager’s employment. Once the manager has retired or otherwise ended her employment, the corporation may deduct all compensation paid to her, including compensation earned while her pay was subject to the section 162(m) limitation.\(^61\) This easy avoidance of the $1 million deduction cap – both obvious and familiar to those who have written executive-compensation agreements or studied their tax implications\(^62\) – induces a rational preference on the corporate side for deferring manager pay.

\(^{59}\) For a contrary argument, see Chason, Deferred Compensation Reform: Taxing the Fruit of the Tree in Its Proper Season, 57 Ohio St. L. J. 347, 378-382 (2006).

\(^{60}\) Internal Revenue Code section 162(m)(1).

\(^{61}\) Internal Revenue Code section 162(a), which permits the corporation to deduct compensation paid to its managers and other employees, limits the deduction to amounts that are “reasonable.” But that limitation has proven very soft, and disallowances of the deduction for unreasonable compensation are rare.

Congress enacted section 162(m) in 1993 to protect shareholders from what legislators considered aggressive pay practices. The underlying idea was simple, if misguided: The federal fisc should not subsidize excessive manager compensation by allowing the corporation to deduct payments over $1 million to certain senior managers. But Congress considered compensation tied to a manager’s performance benign and so included a categorical exception for performance-based compensation. Under that widely used provision, bonuses, stock-option gains, and other compensatory payments to a manager escape the $1 million deduction limitation if they are contingent on the manager satisfying a pre-determined performance benchmark, such as an increase in the corporation’s share price or an increase in the corporation’s revenues or profits. Although the exception for performance-based compensation has attracted significant attention as a likely trigger for the heavy use of stock options in manager-pay arrangements, it ordinarily does not directly affect the decision to defer manager compensation.

By contrast, the exception from section 162(m) for post-employment payments does affect that decision. Section 162(m) disallows the corporation’s deduction only for compensation paid to a “covered employee.” The statute defines the term “covered employee” as the chief executive officer of the corporation and the four highest-paid officers of the corporation (other than the chief executive officer) whose compensation must be reported to

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64 Internal Revenue Code section 162(m)(4)(C).

65 Treasury Regulations section 1.162-27(e).


67 Internal Revenue Code section 162(m)(3).
shareholders under the Securities Exchange Act of 1934. A corporation’s covered employees, then, are the senior managers whose pay must be reported on what the Securities and Exchange Commission calls the “summary compensation table.” Importantly, this includes only current employees of the corporation; it does not include former employees. Furthermore, section 162(m) only reaches amounts that otherwise would be deductible by the corporation during a year in which a manager is a covered employee. Under the tax code, non-qualified retirement pay is deductible by the corporation when it is paid out to a manager, not when it is earned by the manager. In other words, non-qualified retirement pay distributed after the manager has retired or otherwise terminated employment simply escapes the deduction limitation of section 162(m) even though it was earned while the manager was a current employee.

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68 Internal Revenue Code section 162(m)(3). Because of a regulatory change made by the Securities and Exchange Commission in 2006, the Internal Revenue Service now interprets section 162(m)(3) as reaching only four managers, rather than five. See Internal Revenue Service Notice 2007-49.

69 Treasury Regulations section 1.162-27(b)(2); SEC Regulation S-K, Item 402.

70 The Treasury Regulations are perfectly clear on this point. Under Treasury Regulations section 1.162-27(b)(2)(i), a “covered employee” of a corporation is “any individual who, on the last day of the taxable year, is . . . [t]he chief executive officer of the corporation or is acting in such capacity; or . . . [a]mong the four highest compensated officers (other than the chief executive officer)” (emphasis added). Internal Revenue Service 2007-49, which takes account of a later regulatory change by the Securities and Exchange Commission, is also clear on this point. It provides as follows: “The IRS will interpret the term ‘covered employee’ for purposes of § 162(m) to mean any employee of the taxpayer if, as of the close of the taxable year, such employee is the principal executive officer . . . of the taxpayer or an individual acting in such a capacity, or if the total compensation of such employee for that taxable year is required to be reported to shareholders under the Exchange Act by reason of such employee being among the 3 highest compensated officers for the taxable year (other than the principal executive officer or the principal financial officer)” (emphasis added). The SEC Regulations are also clear on this point. Under SEC Regulation S-K, Item 402(a)(3), the individuals for whom securities disclosure must be made are limited to those who were employees “during” or “at the end of” the corporation’s “last completed fiscal year.”

71 Treasury Regulations section 1.162-27(b)(3).

72 Internal Revenue Code sections 83(h) and 404(a)(5); Albertson’s Inc. vs. Commissioner, 42 F.3d 537 (9th Cir. 1994).

73 The requirement that the manager’s accrual of non-qualified retirement pay while still employed by the corporation be disclosed on the corporation’s summary compensation table has no bearing on this result.
This point is absolutely critical in understanding the incentives on the corporate side for deferring manager pay. Assume, for example, that a corporation intends to pay its chief executive officer $21 million in compensation during the corporation’s 2016 taxable year. Outright payment of $21 million as salary would trigger section 162(m), and the corporation would lose a $20 million deduction. At a corporate marginal tax rate of 35 percent, that $20 million deduction has an after-tax value to the corporation of $7 million. The corporation could avoid losing the deduction by making $20 million of the chief executive officer’s pay contingent on a pre-determined performance benchmark. Alternatively, the corporation could pay all or part of the otherwise non-deductible compensation after the chief executive officer is no longer employed by the corporation. Specifically, the corporation could pay him $1 million of current salary in 2016 and credit the remaining $20 million to a non-qualified retirement plan under which payment will be made following his retirement or other termination of employment.74

From the corporation’s perspective, such deferral is an extremely important mechanism for avoiding the $1 million compensation limitation. A manager accrues non-qualified retirement pay while she is a covered employee and while her compensation is subject to section 162(m), but the manager receives the non-qualified retirement pay once she is no longer a covered employee and once her compensation is no longer subject to section 162(m). The company thereby pays the manager non-performance compensation in excess of $1 million and preserves its full tax deduction. Certainly the academic and policy literature has been right to attribute the widespread use of stock options, at least in part, to the exception under section 162(m) for performance-based compensation. But somehow, the literature has generally overlooked the parallel point that the widespread use of non-qualified retirement pay can be attributed, at least in part, to the exception under section 162(m) for compensation paid to former managers.

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74 Others have noted that non-qualified retirement pay resembles salary much more than it resembles performance-based compensation. See, e.g., Bebchuk and Jackson, “Executive Pensions,” 30 J. Corp. Law 823, 849 (2005).
4. Avoiding State Income Taxes

Section 162(m) provides the corporation with a strong incentive for deferring a manager’s pay; state income taxes provide the manager with a strong incentive for deferral as well. Deferring compensation under a non-qualified retirement plan allows the manager to discontinue her residency in a high-tax state where she works or lives while employed and to establish residency in a low-tax state. That has the effect, under federal law, of completely preempting the high-tax state’s taxation of her non-qualified retirement pay. As with section 162(m), the critical point is to push the compensation beyond the end of the manager’s employment.

Under Public Law 104-95,\textsuperscript{75} passed by Congress in late 1995 and approved by the president in early 1996, a state may not impose income tax on the “retirement income” of any individual who is not a resident or domiciliary of that state.\textsuperscript{76} The statute defines “retirement income” to include non-qualified retirement pay if the non-qualified retirement pay is distributed as an annuity or as long-term installments or if it supplements a tax-qualified retirement plan.\textsuperscript{77} The effect of Public Law 104-95 is to preclude taxation by the state (or states) that would have taxed the compensation if it had been paid when earned.\textsuperscript{78} For example, assume that a manager lives in New Jersey, works for 25 years at a corporation in New York, and accrues $50 million under a non-qualified plan that supplements the corporation’s tax-qualified plan. In 2015, she retires from the corporation and moves to Florida. In 2016, she receives a lump-sum distribution of her $50 million non-qualified retirement pay. Both New Jersey and New York have state income taxes. The highest marginal tax rate in New Jersey is


\textsuperscript{76} 4 U.S.C. § 114(a).

\textsuperscript{77} 4 U.S.C. § 114(b).

8.97 percent,79 and the highest marginal tax rate in New York is 8.82 percent.80 If New Jersey taxed the manager’s $50 million distribution, it would collect $4,485,000 from her. If New York taxed her $50 million distribution, it would collect $4,100,000 in tax from her.81 But Public Law 104-95 prevents both New Jersey and New York from taxing the payment at all. Instead, Florida has the sole power to tax the manager’s $50 million non-qualified retirement pay, but Florida has no state income tax. By deferring a substantial portion of her compensation, the manager can avoid all state income taxes on that compensation.

C. Taxes and the Contractual Terms of Non-Qualified Retirement Plans

Tax considerations account for more than the basic decision to defer compensation; they also account for the contractual terms under which the compensation is deferred, held, and ultimately paid out. Here, the academic literature exhibits general unfamiliarity with the terms of non-qualified retirement plans. Most academic studies focus primarily or even exclusively on the amounts of non-qualified retirement pay attributable to specific managers. Even when the literature does examine the contractual terms of non-qualified plans, critical concepts are misunderstood, misinterpreted, or missed altogether. A notable exception here is an excellent recent article by Robert J. Jackson and Colleen Honigsberg, which sets out an empirical study of the contractual terms of non-qualified plans but fails to consider the tax basis for those terms.82

1. The Benefit Formula

The centerpiece of any non-qualified retirement plan is the benefit formula. That formula determines the amount of compensation deferred and, in the case of a defined-
contribution arrangement, the amount of investment gains and losses credited to or debited from the non-qualified retirement pay. In many cases, the benefit formula in a corporation’s non-qualified plan simply tracks the benefit formula in the corporation’s tax-qualified plan. This follows straightforwardly from tax considerations. First, the non-qualified plan in many cases supplements payments under the tax-qualified plan. The non-qualified plan therefore uses the benefit formula of the tax-qualified plan but ignores the benefit limitations of sections 415, 401(a)(17), 402(g), 401(a)(4), section 401(k)(3), and 401(m) of the Internal Revenue Code. Second, Public Law 104-95, under which a manager may avoid state income taxes on distributions from a non-qualified plan, generally requires coordination of the benefit formula in the non-qualified plan with the benefit formula in the corporation’s tax-qualified plan. Specifically, one of the categories for exemption from source-state taxation under Public Law 104-95 requires that the non-qualified plan be “maintained solely for the purpose of providing retirement benefits for employees in excess of [the benefit limitations in the Internal Revenue Code].”

2. Participation

Corporations invariably restrict participation in non-qualified plans to a select group of managers and other high-paid employees – known as a “top-hat group” – thereby excluding rank-and-file employees. This practice is strictly a function of the tax law; it is not a matter of corporate choice. The principal federal pension law, the Employee Retirement Income Security Act of 1974 (“ERISA”), generally mandates that any plan deferring the compensation of rank-and-file employees satisfy minimum pre-funding requirements and hold its assets in a trust


85 ERISA sections 302 and 303. Under ERISA section 301(a)(3), a non-qualified retirement plan covering only “a select group of management or highly compensated employees” – that is, a top-hat group – is exempt from ERISA sections 302 and 303.
for the exclusive benefit of the employees. But the tax code provides that holding such assets in an exclusive-benefit trust triggers immediate taxation for the covered employees on all vested benefits. Thus, except for the very rare case in which retirement benefits for rank-and-file employees exceed the limitations under section 415 of the Internal Revenue Code, a non-qualified retirement plan cannot cover rank-and-file employees, and tax deferral through such a plan is simply not possible for those employees. Instead, corporations cover rank-and-file employees through tax-qualified plans. That said, corporations often define the top-hat group as broadly as possible, providing for participation in non-qualified retirement plans by employees below the level of the most senior managers. Substantially all corporations with non-qualified defined-contribution plans cover their chief executive officers, presidents, and vice presidents in those plans. But between one-fourth and one-third of such corporations also allow participation by highly compensated sales personnel and middle-level managers. And fully half of those corporations set the minimum compensation amount for participation between $115,000 and $150,000 – thereby opening plan eligibility to employees with comparatively modest earnings.

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86 ERISA section 403(a). Under ERISA section 401(a)(1), a non-qualified retirement plan covering only “a select group of management or highly compensated employees” – again, a top-hat group – is exempt from ERISA section 403(a).

87 Internal Revenue Code sections 83(a) and 402(b).

88 ERISA section 4(b)(5) exempts excess-benefit plans from the ERISA funding and trust requirements. Technically, an excess-benefit plan may cover rank-and-file employees. However, an excess-benefit plan is permitted only to provide benefits in excess of the limitations under section 415 of the Internal Revenue Code. As a practical matter, then, the exemption for excess-benefit plans has no application in providing retirement benefits to rank-and-file employees.


3. Deferral Elections and Vesting

Non-qualified defined-benefit plans normally provide for the deferral of compensation on a purely non-elective basis; that is, such plans neither permit nor require managers to elect how much, if any, compensation to defer. By contrast, non-qualified defined-contribution plans often (but not invariably) provide for managers to elect how much, if any, compensation to defer and to elect the time and manner of distribution for the deferred compensation. In almost all (if not all) cases, non-qualified plans require that such elections be made before the compensation is earned. For example, a plan would require that a manager who elects to defer base salary earned during 2016 make her deferral election during 2015. Again, the defining considerations here are the applicable tax rules. Under the tax code, the failure to require the manager’s election before the compensation is earned exposes the manager to immediate taxation, a 20-percent tax penalty, and an interest charge.93

Non-qualified plans vary considerably in their vesting provisions. It is not uncommon for those plans to provide that managers are fully vested at all times in their non-qualified retirement pay, but it also is not uncommon for them to impose a graded- or cliff-vesting schedule.94 A non-qualified defined-contribution plan holding salary, bonus, or stock-option gains that a manager has deferred by election typically provides for full vesting at all times. However, a non-qualified defined-contribution or defined-benefit plan that supplements a tax-qualified plan typically provides a vesting schedule that matches the vesting schedule under the tax-qualified plan. The considerations here parallel the considerations for the benefit formula. The point is to supplement the tax-qualified plan, so the vesting schedule in the non-qualified plan generally tracks the vesting schedule in the tax-qualified plan.

93 Internal Revenue Code section 409A(a)(4). Special rules in section 409(a)(4) slightly relax the election-timing rules for the manager’s initial deferral election and for any election applicable to performance-based compensation earned over a period of at least twelve months.

4. Funding and Investment

Amounts deferred under a non-qualified plan (including investment gains) remain subject at all times to the claims of the corporation’s general creditors.\(^95\) Thus, in the event of the corporation’s insolvency, the manager stands in line with the corporation’s other unsecured creditors, potentially receiving little or nothing of her non-qualified retirement pay. This feature also derives straightforwardly from tax considerations. Funding a non-qualified retirement plan – that is, setting assets beyond the reach of the corporation’s general creditors – triggers immediate taxation, tax penalties, and interest charges for the manager.\(^96\)

Although the non-qualified plan must remain unfunded, the corporation may invest general corporate assets to mark investment growth on the non-qualified retirement pay and to hedge the risk on its payment obligation. It is commonplace for non-qualified defined-contribution plans to make those investments in the corporation’s own stock.\(^97\) This practice has a solid foundation in the tax law. As shown above, any long-term capital gains and dividends attributable to investment in the corporation’s stock are effectively untaxed if the investment is made by the corporation. This contrasts to a tax rate of 35 percent for long-term capital gains.

\(^{95}\) Internal Revenue Code section 409A(b); Treasury Regulations section 1.83-3(e); Rev. Rul. 60-31, 1960-1 C.B. 174; Testimony of Pamela F. Olson, Assistant Secretary of the Treasury (Tax Policy), for the Committee on Finance, United States Senate (Apr. 8, 2003).

\(^{96}\) Internal Revenue Code sections 83(a), 409A(a) and (b), and 402(b); Rev. Rul. 60-31, 1960-1 C.B. 174. In some cases, a corporation places the assets of a non-qualified retirement plan in what is known as a “rabbi trust.” The assets in a rabbi trust may be subject to the control of a third-party trustee and often cannot be reached by the corporation; the manager is therefore protected against the risk that the corporation will repudiate the contractual obligation to pay the non-qualified retirement benefits to the manager (for example, following a change of control). However, the assets in a rabbi trust remain subject to the claims of the corporation’s general creditors; the manager is therefore not protected against the risk of the corporation’s insolvency. For tax purposes, a non-qualified retirement plan using a rabbi trust is treated as an unfunded plan. See generally McNeil, Nonqualified Deferred Compensation Plans 1083-1084 (2013); Brisendine, Drigotas, and Pevarnik, Deferred Compensation Arrangements A-97 through A-104 (2012).

and a tax rate of 10.5 percent for dividends if the corporation invests in the stock of other corporations. Thus, *ceteris paribus*, the corporation should prefer that any investments attributable to a manager’s non-qualified retirement pay be made in the corporation’s own stock.

5. Distributions

A non-qualified plan generally provides for distribution of the manager’s non-qualified retirement pay to begin only after the manager’s retirement or other termination of employment and ordinarily gives the manager very limited control over distribution terms. For a non-qualified defined-benefit plan, the time and form of distributions normally track the time and form of distributions from the corporation’s tax-qualified defined-benefit plan (although the non-qualified plan may allow the manager to elect different distribution terms). For a non-qualified defined-contribution plan, the time and form of distributions are more likely to be set without reference to the time and form of distributions from the corporation’s tax-qualified defined-contribution plan, and the non-qualified plan may even permit distributions while the manager is still employed. Most non-qualified plans also provide for immediate distribution of all benefits following a change of corporate ownership or control. Importantly, non-qualified plans set the time and form of distributions prior to the point at which the managers earn the underlying compensation. A plan that permits a manager to elect a different time or form for distributions invariably requires that the manager make the election at least one year before the distributions otherwise would begin and that the manager’s election push the distribution starting date back by at least five years. Non-qualified retirement plans do not permit managers to accelerate distributions.

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Once again, there are strong tax reasons for these contractual terms. As shown above, avoiding the $1 million deduction limitation under section 162(m) and avoiding state income taxes require that the manager’s compensation be deferred until retirement or other termination of employment. It thus makes sense, from a tax perspective, to push the deferral period just beyond the point at which the manager leaves the corporation. Additionally, all the standard contractual terms setting distribution times and forms, regulating whether and how the manager may elect different distribution times and forms, and banning the acceleration of distributions derive directly from section 409A of the Internal Revenue Code. Those limitations on the manager’s control over the time and form of distributions of non-qualified retirement pay are strictly necessary to avoid immediate taxation, tax penalties, and interest charges for the manager. Given the very high tax stakes, it would be startling for a non-qualified plan not to conform to the distribution rules of section 409A.

II. Competing Accounts of Non-Qualified Retirement Pay

Both the optimal-contracting account and the managerial-power account attribute non-qualified retirement pay directly to the relationship between directors and managers, but they differ considerably in their understanding of that relationship. The optimal-contracting account characterizes manager compensation as a function of arm’s-length bargaining. On this account, the point of manager-pay arrangements generally and non-qualified retirement plans specifically is to align the interests of managers with the interests of corporate investors. In setting the amount and the terms of a manager’s compensation, the directors try to reward performance that enhances the value of the corporate enterprise. By contrast, the managerial-power account characterizes manager compensation as a vehicle for extracting rents from corporate assets with the complicity of pliable directors. On this account, the point of manager-pay arrangements generally and non-qualified plans specifically is to ensure outsized rewards for occupying managerial positions and to insulate those rewards from underlying business risks.

102 Internal Revenue Code sections 409A(a)(2) through (4).
Both the optimal-contracting and the managerial-power accounts are seemingly plausible explanations of manager-pay arrangements, but both are at best only partial explanations of non-qualified retirement pay. Although they initially appear to capture certain features of non-qualified plans, closer examination reveals that they either leave important aspects of those plans unexplained or simply misunderstand important contractual terms. Here, the explanatory power of the tax account emerges still more forcefully. The tax account explains non-qualified retirement pay at least as well as – and in many cases better than – either of the two competing accounts. This does not necessarily imply that the tax account should displace the optimal-contracting and managerial-power accounts, but it does establish that the tax account is essential to understanding non-qualified retirement pay.

A. Optimal Contracting

The optimal-contracting account is reasonably straightforward. Non-qualified retirement pay, as an obligation of the corporation for which no assets may be set beyond the reach of the corporation’s general creditors, is a form of unsecured corporate debt, and a manager to whom the corporation owes non-qualified retirement pay is one of the corporation’s unsecured creditors. By including non-qualified retirement pay in the manager’s compensation, the corporation’s directors align the manager’s interests with the interests of the corporation’s other unsecured general creditors. This strand of the academic literature therefore characterizes non-qualified retirement pay as “inside debt” (as opposed to the “outside debt” that the corporation owes to non-manager investors, such as banks and bondholders).

The optimal-contracting account considers non-qualified retirement pay to be part of the solution to the familiar agency problem in the management of publicly held corporations.103

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Compensating managers with equity instruments, such as stock options and restricted stock, mitigates the managerial agency problem with respect to the corporation’s equity investors (known as the “agency costs of equity”);\(^{104}\) similarly, compensating managers with debt instruments, such as non-qualified retirement pay, mitigates the problem with respect to the corporation’s lenders (known as the “agency costs of debt”).\(^{105}\) Under certain conditions, then, the use of non-qualified retirement pay to compensate the corporation’s managers can be highly desirable from the perspective of the corporation’s investors, particularly in moderating the managers’ inclination to expose the corporation to excessive risk.\(^{106}\) Unlike other components of manager compensation (including salary and cash bonuses), non-qualified retirement pay encourages managers to consider “not only the probability of [the corporation’s] default, but

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\(^{104}\) Edmans and Liu, Inside Debt, 15 Rev. of Fin. 75, 75-76 (2011); Tung and Wang, Bank CEOs, Inside Debt Compensation, and the Global Financial Crisis, Boston Univ. School of Law Working Paper No. 11-49 (2011).


also recovery values in default.”

That is, the manager’s non-qualified retirement pay, as an unsecured corporate obligation, may retain value in the event of the corporation’s insolvency, depending on the assets available to satisfy the corporation’s other unsecured creditors. Including non-qualified retirement pay in the manager’s compensation thus makes “the manager sensitive to the firm’s value in bankruptcy, and not just [to the likelihood of the firm’s] bankruptcy.”

Empirical studies generally suggest that including non-qualified retirement pay in the compensation of corporate managers aligns the interests of managers with the interests of other corporate creditors.

This account ostensibly explains several aspects of non-qualified retirement pay. Most fundamentally, it appears to offer a clear justification for the basic decision to defer part of the manager’s compensation. The point of deferral, the account argues, is to provide the manager with a substantial stake in the corporation’s debt. This certainly coheres with the unfunded and unsecured status of non-qualified retirement pay. By placing a manager’s deferred pay at risk in the event of corporate insolvency, a non-qualified retirement plan aligns the manager’s interests with those of the corporation’s unsecured general creditors, rather than with those of secured creditors who hold superior claims in bankruptcy. The optimal-contracting account also apparently explains the potentially long maturity associated with non-qualified retirement pay. The deferral of a manager’s compensation may last for years or even decades – just as the period for repayment of principal on a corporation’s bonds may last for a decade or more.

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However, tax considerations, which the optimal-contracting account sets to the side, explain these and other aspects of non-qualified retirement pay at least as well as – or better than – the optimal-contracting account. The basic decision to defer a manager’s compensation may be consistent with the object of creating a creditor-debtor relationship between the manager and the corporation, but it plainly implicates substantial tax considerations on both sides. Non-qualified plans typically give back what the tax laws take away from tax-qualified plans. Also, deferral of the manager’s pay substitutes the corporation’s lower marginal tax rates for the manager’s higher marginal tax rates on certain types of investment income, allows the corporation to avoid the $1 million deduction limitation of section 162(m), and permits the manager to avoid state income taxes. Even if the corporation’s directors were not otherwise inclined to put the manager in a creditor-debtor relationship with the corporation, these tax considerations independently would provide a sufficient reason for deferring part of the manager’s pay.

Moreover, tax rules dominate the contractual terms under which non-qualified retirement pay is funded and invested. The tax law flatly requires that non-qualified retirement pay remain an unfunded and unsecured general obligation of the corporation. Setting assets aside from the claims of the corporation’s general creditors to pay a manager’s non-qualified retirement pay would trigger immediate taxation, penalties, and interest charges for the manager and would trigger the application of the $1 million deduction limitation under section 162(m). In other words, setting aside assets to pay non-qualified retirement pay would unravel the tax benefits of deferring the compensation in the first place. Thus, the optimal-contracting account may have the matter exactly backwards: It may not be that a corporation defers a manager’s compensation because the directors want to make the manager an unsecured general creditor; rather, it may be that the manager is an unsecured general creditor because her compensation is deferred.

Additionally, tax considerations better explain the apparently anomalous maturities associated with non-qualified retirement pay. Although deferral periods of years or even

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110 See, e.g., Edmans and Liu, Inside Debt, 15 Rev. of Fin. 75, 76 n.4 (2011).
decades are broadly consistent with the characterization of non-qualified retirement pay as inside debt, the optimal-contracting account does not explain why the corporation’s obligation to distribute a manager’s non-qualified retirement pay ordinarily matures shortly after the manager’s retirement or other termination of employment. Rather than setting fixed maturity dates – so that, for example, compensation deferred in 2016 becomes payable in 2026, and compensation deferred in 2020 becomes payable in 2030 – most non-qualified plans distribute or begin distributing a manager’s non-qualified retirement pay soon after the manager leaves the corporation’s employment. Corporate bonds and corporate bank debt generally do not mature in that manner.

Again, tax considerations appear dispositive. To avoid the $1 million deduction limitation under section 162(m), the corporation must delay payment until the manager is no longer an employee of the corporation. Similarly, to avoid state income taxation under Public Law 104-95, the manager must delay receipt of her non-qualified retirement pay until the manager has established residency in a state that does not tax individual income. And the close link between a corporation’s non-qualified plan and its tax-qualified plan, a link driven by the benefit limitations set out in the tax code, encourages the distribution of non-qualified retirement pay at the same time that tax-qualified retirement payments begin – which, again, typically occurs just after retirement or other termination of employment.

On the whole, then, the optimal-contracting account appears plausible as an explanation for why corporations defer manager pay under non-qualified plans. But the account cannot explain several important contractual terms of those plans. The tax account, by contrast, also provides a cogent explanation of the basic decision to defer manager pay, and it provides a superior explanation for the contractual terms of deferral. In fact, the tax account suggests that the optimal-contracting account may well misconstrue the relationship between the decision to defer manager pay and the manager’s creditor status: The manager’s position as an unsecured general creditor may be better understood as a consequence of the decision to defer, rather than a cause of it.
B. Managerial Power

Like the optimal-contracting account, the managerial-power account is reasonably straightforward. On this explanation, non-qualified retirement pay represents “stealth compensation” – that is, compensation not readily understood by shareholders and other corporate stakeholders.111 By providing a manager with non-qualified retirement pay, directors can “camouflage” part of the manager’s pay package, thereby minimizing or even avoiding shareholder criticism of excessive compensation.112 The critical feature of non-qualified retirement pay, from the perspective of the managerial-power account, is that such pay may be difficult to understand and to quantify. By comparison to the flat dollar amounts associated with a manager’s salary, bonus, stock grants, and gains from the exercise of stock options, a manager’s annual non-qualified retirement accruals can appear entirely obscure. That, in turn, may lead shareholders to underestimate the value of the manager’s total compensation.

In contrast to the optimal-contracting account, which understands non-qualified retirement pay as a solution to the agency problem of managers in public corporations, the managerial-power account understands non-qualified retirement pay to be a manifestation of that agency problem. Managers, so the explanation runs, exercise outsized influence in setting their own pay.113 Rather than bargain at arm’s length with directors for compensation

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arrangements that encourage them to perform in the interests of investors, managers conspire with directors to extract rents from corporate assets. However, too much rent extraction – or, at least, too much perceptible rent extraction – invites shareholder backlash (“outrage” in the language of the managerial-power account). It thus becomes important for rapacious managers and complicit directors to cover their tracks – to camouflage manager rents. The general opacity of non-qualified retirement pay facilitates that because, for many years, non-qualified retirement pay simply was not subject to meaningful disclosure under federal securities laws. Empirical studies find at least some support for the association of non-qualified retirement pay with managerial power and rent extraction.


The managerial-power account plausibly explains several aspects of non-qualified retirement pay. Specifically, the basic decision to defer part of a manager’s compensation, the formula for determining the amount deferred (particularly in the case of a defined-benefit arrangement), and the end of the deferral period shortly after the manager’s retirement or other termination of employment all seemingly advance the objective of providing the manager with stealth compensation. If the directors and the manager believe that the value of the manager’s aggregate compensation – including salary, bonus, stock grants, and stock-option gains – will anger shareholders, deferring part of that compensation may be very attractive. Rather than pay the manager a current cash salary of $10 million, for example, the directors and the manager may agree to pay the manager a current cash salary of $1 million and to defer the other $9 million. The manager, of course, will expect that the deferred payment be adjusted for the time value of money for the risk of corporate insolvency during the deferral period. But shareholders may not adequately grasp that a current payment of $1 million and a $9 million present value of an unfunded and unsecured promise to make a larger payment in the future together have the same value as a current payment of $10 million.

The general obscurity of many plan benefit formulae no doubt helps on this point. The formula under a defined-contribution arrangement ordinarily is not difficult to understand. Typically, the corporation promises to make a single-sum payment equal to the amount initially deferred, as adjusted for investment gains and losses during the deferral period. Any camouflage value there is limited to the fact of moving a specific sum – the amount of the initial deferral – out of the manager’s current compensation. But matters are different with the benefit formula under a defined-benefit arrangement. Because a non-qualified defined-benefit plan typically supplements the corporation’s tax-qualified defined-benefit plan, the benefit formula under the non-qualified plan often incorporates the manager’s years of service, average compensation, and a designated multiplier. Furthermore, the non-qualified plan ordinarily promises an annuity stream for the manager’s life that begins just after the manager’s retirement. Thus, to determine the present value of the manager’s non-qualified retirement pay under a defined-benefit formula, a shareholder may need to know the manager’s age, the manager’s average compensation, the manager’s number of years of service, the designated
multiplier, the applicable actuarial factor, and the applicable discount factor. Although those values are not unknowable, they can be difficult to ascertain.\(^{119}\)

Furthermore, the deferral of non-qualified retirement pay until the manager’s retirement appears at least broadly consistent with the managerial-power account. Longstanding regulatory policy under the securities laws generally required disclosure only of the compensation paid to a manager during the current year. That policy made it attractive to directors and managers, so the argument runs, to defer part of the manager’s current compensation until just beyond the point at which the corporation’s disclosure obligation ended – that is, until the point at which the manager retired or otherwise left the corporation’s employment.\(^{120}\) On the managerial-power account, then, the government’s regulatory policy made non-qualified retirement pay an easy end run around the corporation’s disclosure obligations and helped to establish such pay as a form of stealth compensation.

Again, however, the tax account offers an explanation that is at least as good as – and, in many respects, better than – the managerial-power account. Consider first the basic decision to defer the manager’s compensation, which the managerial-power account attributes to a desire to camouflage part of the manager’s pay. That argument has weakened considerably with the Securities and Exchange Commission’s 2006 change in regulatory position requiring disclosure of all non-qualified retirement pay.\(^{121}\) If non-disclosure was the reason for deferring manager


\(^{121}\) The disclosures are made through the “summary compensation” table, a “pension benefits” table, and a “nonqualified deferred compensation” table. SEC Regulations sections 229.402(c) (summary compensation table), (h) (pension benefits table) and (i) (nonqualified deferred compensation table). Cf. Walker, The Challenge of Improving the Long-Term Focus of Executive Pay, 51 B.C. L. Rev. 435, 454 (2010) (arguing both that SEC’s 2006 regulatory change makes “subterfuge” of executive pensions “less
pay, why do corporations and managers continue to defer manager pay now that the
government mandates disclosure? Heroic efforts by Jackson and Honigsberg
notwithstanding, the managerial-power account offers no adequate explanation for the
persistence of non-qualified plans under a full-disclosure regime. By contrast, the tax account
imputes motivations for non-qualified retirement pay that remain valid even with disclosure.

effective” and that “it is probably too early to determine whether the revised rules have had any salutary
effect on the overall amount of executive compensation”).

A recent study that otherwise claimed empirical support for the managerial-power account found
scant evidence that corporations froze participation or benefit accruals for their non-qualified defined-
benefit plans after the change in SEC disclosure requirements. Cadman and Vincent, The Role of Defined
that, out of 284 corporations in the S&P 500 that they reviewed for the period 2005 through 2010, only five
froze participation or benefit accruals in their non-qualified defined-benefit plans without taking parallel
action under their tax-qualified defined-benefit plans. Id.

Jackson and Honigsberg argue that the SEC disclosure rules on non-qualified retirement pay continue
to offer two camouflage opportunities to corporations and managers. First, they say, the disclosure rules
do not require corporations to reveal the cost of shifting the taxation of investment income from the
manager to the corporation during the deferral period. Jackson and Honigsberg, “The Hidden Nature of
Executive Retirement Pay,” 100 Va. L. Rev. 479, 504-506. (2014). Second, they say, the disclosure rules do
not require corporations to reveal the distribution method used for a manager’s non-qualified retirement
pay and so do not permit investors to determine whether the non-qualified pay aligns the interests of the
manager with those of the corporation’s creditors. Id. at 504 and 506. Neither argument does the work
intended for it. On the first, Jackson and Honigsberg incorrectly assume that shifting taxation from the
manager to the corporation invariably increases the corporation’s tax liability. Id. at 505 (“The executive’s
tax savings from receiving this treatment . . . are equal to the gains the company [forges] through deferral
of its deduction” (emphasis added)). But, as shown above in Table 3, the corporation’s marginal tax rate
for investment income ordinarily is lower than the manager’s marginal tax rate for investment income. In
fact, for investments in the corporation’s own stock (which Jackson and Honigsberg find commonplace),
the corporation’s marginal tax rate is zero. On the second, Jackson and Honigsberg conflate the
distribution period, which may be very short, with the total deferral period, which may be very long.
Even non-qualified retirement pay that is distributed in a lump sum immediately on a manager’s
retirement may have been deferred for a lengthy period. In all likelihood, such non-qualified pay
represents a mix of long-term, medium-term, and short-term deferrals, corresponding respectively to
compensation that was deferred in the manager’s early, middle, and late career. The length of the payout
period itself is all but irrelevant. It is the length of the total deferral period that matters, and the payout
period is only one piece of the total deferral period. Jackson and Honigsberg are thus not justified in
concluding that “many executives receive their payments before long-term creditors do.” Id. at 512. A
manager who defers compensation under a non-qualified retirement plan over twenty years and receives
immediate payout after retirement effectively will have lent money to the corporation for periods that are
shorter than, the same as, and longer than periods for which a long-term creditor will have lent money to
the corporation.
On the tax account, the deferral decision turns on supplementing the benefits under the corporation’s tax-qualified plan, avoiding the $1 million limitation on the corporation’s compensation deduction, avoiding state income taxes, and substituting the corporation’s lower marginal tax rates for the manager’s higher marginal tax rates on certain types of investment income.124

Similarly, the managerial-power account’s characterization of the benefit formulae in non-qualified plans as an exercise in camouflage appears less plausible on closer examination. First, the formula for a non-qualified defined-contribution plan typically is very simple – far too simple to support the weight of the camouflage argument. The manager normally is entitled to a single-sum payment equal to the amount initially deferred, as adjusted for investment gains and losses. This offers no effective camouflage at all, particularly under the new disclosure rules. It does, however, serve the objectives posited by the tax account. Second, even though the formula for a non-qualified defined-benefit plan might be complex, that formula often matches up closely with the formula under the corporation’s tax-qualified defined-benefit plan. The point of using the same formula under both plans is that the non-qualified plan supplements the tax-qualified plan by restoring the benefits lost to the tax-qualified plan under

124 Bebchuk and Fried acknowledge that the use of non-qualified retirement pay allows a corporation to avoid the $1 million deduction limitation, but they regard this as, at most, a supplement to the camouflage explanation for non-qualified pay rather than a competing explanation. Bebchuk and Fried, Pay without Performance: The Unfulfilled Promise of Executive Compensation 110-111 (2004). Specifically, they say: “Everything else being equal, shareholders might . . . prefer much of the executive’s non-performance-based compensation to be paid after retirement, when Section 162(m) no longer limits deductibility. But the important question is whether executives should receive so much pay that is decoupled from performance. Because of the camouflaging of retirement benefits, not only [is] managers’ total compensation . . . higher than it appears from the compensation tables but also the fraction of total compensation that is decoupled from performance is larger than an examination of these tables would suggest.” Id. at 111. This argument gives up more ground than the managerial-power account can afford to surrender. The core position of the managerial-power account on non-qualified retirement pay is that the corporation uses non-qualified pay to compensate its managers because non-qualified pay is not fully disclosed, thereby permitting the corporation to camouflage part of the manager’s compensation. When confronted with the $1 million deduction limitation – which suggests an independently valid motivating cause for using non-qualified retirement pay – Bebchuk and Fried shift their stance, arguing that camouflage is simply an effect of using non-qualified pay. But if camouflage is simply an effect rather than the motivating cause, the use of non-qualified pay no longer provides sound evidence of rent extraction.
the tax code. Obscurity may be an effect of tracking the benefit formula under the tax-qualified plan, but that does not establish that it is the cause of doing so.

Perhaps the weakest argument made for the managerial-power account is that non-qualified plans cover only the corporation’s managers and other highly paid employees. Surely, the argument runs, non-qualified plans must be inefficient; otherwise, the corporation would provide non-qualified retirement pay to all its employees rather than just those who, by hypothesis, have outsized influence over the corporation’s compensation practices.125 This argument is badly misinformed. And, here again, the tax account explains the situation. Corporations do not cover rank-and-file employees under their non-qualified plans because they can provide full retirement benefits to those employees under tax-qualified plans and, more importantly, they cannot provide retirement benefits to those employees under non-qualified plans.126 As shown above,127 tax-qualified plans are superior to non-qualified plans because they provide for the accumulation of retirement benefits at a pre-tax rate of return. Ceteris paribus, corporations rationally prefer to provide retirement benefits through tax-qualified plans. Although, as shown above,128 the tax laws limit the benefits that may be provided under tax-qualified retirement plans, those limits generally do not bind for rank-and-file employees.129 In other words, the availability of tax-qualified plans almost always foreclose

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126 Chason, Deferred Compensation Reform: Taxing the Fruit of the Tree in Its Proper Season, 57 Ohio St. L. J. 347, 388 (2006).

127 See Part I.A, supra.

128 See Part I.B.1, supra.

129 Consider just the limitations under section 415 of the Internal Revenue Code, described above in Part I.B.1. For a defined benefit plan, the section 415 limitation on annual benefit payments is $210,000 (or the employee’s compensation, if less); for a defined contribution plan, the section 415 limitation on annual contributions is $53,000 (or the employee’s compensation, if less).
the need to provide rank-and-file employees with retirement benefits under non-qualified plans.

Moreover, as explained above,\(^{130}\) ERISA specifically mandates that a retirement plan covering rank-and-file workers satisfy minimum pre-funding requirements and hold its assets in a trust for the exclusive benefit of the employees. But under the tax code, holding assets in an exclusive-benefit trust triggers immediate taxation to employees on all vested retirement pay. Therefore, except for the very rare cases in which retirement benefits for rank-and-file employees exceed the limitations under section 415 of the Internal Revenue Code,\(^{131}\) it is legally impossible to provide such employees with non-qualified retirement pay. The managerial-power account misses this basic but crucial point. Non-qualified plans cover only managers and other highly paid employees because ERISA, working on the assumption that such employees do not require as much protection against corporate over-reaching as rank-and-file employees, does not require advance funding of their retirement pay.\(^{132}\) Efficiency, camouflage, and rent extraction are completely irrelevant in determining that rank-and-file workers may not participate in a non-qualified plan.

The managerial-power account also appears dubious in its understanding of the funding status of non-qualified retirement pay. If the objective of providing a manager with non-qualified retirement pay is simply to camouflage part of the manager’s compensation, why is

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\(^{130}\) See Part I.C.2, supra.

\(^{131}\) ERISA section 4(b)(5) exempts excess-benefit plans from the ERISA funding and trust requirements. Technically, an excess-benefit plan may cover rank-and-file employees. However, an excess-benefit plan is permitted only to provide benefits in excess of the limitations under section 415 of the Internal Revenue Code. As a practical matter, then, the exemption for excess-benefit plans has no application in providing retirement benefits to rank-and-file employees.

\(^{132}\) Consistent with that position, the Department of Labor interprets the top-hat exemption as applicable only when the non-qualified retirement plan limits coverage to employees having “the ability to affect or substantially influence, through negotiation or otherwise, the design and operation of their deferred compensation plan.” DOL Adv. Op. 90-14A (May 8, 1990). Nonetheless, as explained above, corporations often define plan participation broadly, covering employees below the level of the most senior managers. See Part I.C.2, supra. In other words, many employees who participate in non-qualified plans are in no position to collude with directors for the extraction of rents. Cf. Murphy, Explaining Executive Compensation: Managerial Power versus the Perceived Cost of Stock Options, 69 U. Chi. L. Rev. 847, 857-858 (2002).
that pay always exposed to the claims of the corporation’s general creditors? Surely every manager who does not receive current payment for current services would strongly prefer that the deferred pay be made as secure and as certain as possible. But the contractual undertaking for non-qualified retirement pay remains at all times a general, unsecured obligation of the corporation. That strongly implies that something more than – or different from – rent extraction is at work. But, again, this feature of non-qualified retirement pay is straightforward on the tax account. Longstanding tax rules prohibit the corporation from securing non-qualified retirement pay against the claims of its general creditors. Placing non-qualified retirement pay beyond the reach of the corporation’s creditors triggers immediate taxation, tax penalties, and an interest charge to the manager. What appears completely counter-intuitive on the managerial-power account is easily explained by the tax account. Managers driven by rent seeking should want full security for their non-qualified retirement pay, but managers driven by tax considerations should want to protect their tax deferral.

The managerial-power account points to the investment of non-qualified retirement pay as a further indicator of rent extraction. Substantial amounts under non-qualified defined-contribution retirement plans are notionally invested in the corporation’s own stock. That implies, according to the managerial-power account, that non-qualified retirement pay functions more like an investment in the corporation’s equity than an investment in the corporation’s debt – and, correspondingly, that non-qualified retirement pay is more about seeking rents than about aligning the interests of managers with the interests of corporate

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134 See Part I.A, supra.

135 This is a non-issue for defined-benefit plans. Under those arrangements, the corporation promises to pay the manager a specific amount at a specific time. Gains and losses on notional investments thus have no effect on the amount ultimately received by the manager.

creditors. But this argument overlooks two points. First, there are strong tax incentives to invest in the corporation’s stock through a non-qualified retirement plan. Setting the corporation up as the investor on behalf of the manager – precisely the effect of using a non-qualified plan – reduces the marginal tax rate on dividends and capital gains from 23.8 percent to zero. Second, the unfunded status of non-qualified retirement pay still leaves the manager in the position of an unsecured general creditor, even if the non-qualified retirement pay is notionally invested in the corporation’s stock. In terms of the manager’s legal rights and remedies against the corporation, the manager is unlike an actual shareholder who holds an equity position.

Finally, the tax account explains the distribution features of non-qualified plans better than the managerial-power account does. As Jackson and Honigsberg show, managers generally receive their non-qualified retirement pay shortly after retirement or other termination of employment.\textsuperscript{137} That practice makes perfect sense on the tax account. By deferring compensation until the manager’s employment has ended, the corporation avoids the $1 million limitation on deductible compensation, and the manager has an opportunity to avoid state income taxes. Additionally, the tax-qualified plans that non-qualified plans often supplement ordinarily begin the distribution of benefits at retirement or other termination of employment. And, to boot, termination of employment is one of the few distribution triggers permitted by the section 409A for non-qualified retirement pay.\textsuperscript{138}

By contrast, the timing of distributions is harder to explain on the managerial-power account now that the Securities and Exchange Commission has rewritten its disclosure regulations. In the past, deferral of a manager’s pay beyond the end of the manager’s employment allowed the corporation to avoid disclosure of that pay. But in 2006 the government changed the rule to require annual disclosure of all non-qualified retirement pay.


\textsuperscript{138} See Part I.C.5, supra.
for the corporation’s most senior managers.\textsuperscript{139} There is thus no continuing camouflage benefit in deferring a manager’s pay to the point of retirement or other termination of employment. Why not, then, provide for the manager’s non-qualified retirement pay to be distributed while the manager is still employed? Why provide for a potentially lengthy deferral, particularly in light of the risk that the corporation may become insolvent and unable to meet its commitment? Again, the managerial-power account offers no adequate answers here.

Jackson and Honigsberg argue that the distribution terms in non-qualified plans are not necessarily what they appear to be. They repeatedly claim that a manager may accelerate payments from a non-qualified plan in order to sidestep the risk of losing his non-qualified retirement pay in the event of corporate insolvency. Thus, they say: “[E]ven those executives who plan to receive their retirement pay over time often can accelerate their payouts.”\textsuperscript{140} Then: “In practice, executives have considerable freedom to withdraw from both defined contribution and defined benefit arrangements immediately in the event that the firm faces insolvency.”\textsuperscript{141} And, finally: “[E]ven executives who choose to retain their pay over time often retain the option to accelerate their payouts if bankruptcy looms.”\textsuperscript{142} That misstates the applicable tax rule. Section 409A not only prohibits a non-qualified retirement plan from accelerating the payment of a manager’s non-qualified retirement pay; it also prohibits a plan from even providing for the acceleration of a manager’s non-qualified retirement pay.\textsuperscript{143} Any non-qualified plan that gives the manager “freedom” on this point or the provides the manager an

\textsuperscript{139} The disclosures are made through the “summary compensation” table, a “pension benefits” table, and a “nonqualified deferred compensation” table. SEC Regulations sections 229.402(c) (summary compensation table), (h) (pension benefits table) and (i) (nonqualified deferred compensation table).


\textsuperscript{143} Internal Revenue Code section 409A(a)(3); Treasury Regulations section 1.409A-3(j).
“option” to accelerate payments triggers immediate taxation for the manager, with a penalty tax and interest charge, \textit{ab initio}. 144

C. Assessing the Tax, Optimal-Contracting, and Managerial-Power Accounts

Although the optimal-contracting and managerial-power accounts stand in tension, they are not mutually exclusive. 145 Each provides an ostensibly plausible explanation both for the basic decision to defer manager compensation through non-qualified retirement plans and for particular contractual terms of those plans. The tax account provides a different, competing explanation that is superior to the other two on many points. Plan terms concerning benefit formulae, eligibility for participation, funding, investments, and distributions conform closely

\footnote{144}{Internal Revenue Code section 409A(a). In a footnote, Jackson and Honigsberg cite the section 409A anti-acceleration rule but then immediately dismiss it, saying that, “[i]n practice, directors can and do amend these agreements to permit executives to accelerate retirement payments when the firm faces insolvency.” Jackson and Honigsberg, “The Hidden Nature of Executive Retirement Pay,” 100 Va. L. Rev. 479, 502, n. 56 (2014). But they cite no source for that assertion. Even so, the assertion is worth close consideration. Jackson and Honigsberg are correct to say that the corporation retains the power to amend its non-qualified plan to permit the acceleration of a manager’s payments; indeed, the corporation almost always retains the power to amend its non-qualified plan in any manner. The existence of the amendment power, however, does not itself imply that the power is in fact exercised in the manner supposed by Jackson and Honigsberg. Moreover, the amendment power resides in the corporation, not in the manager. Unless one assumes \textit{ex ante} that the managerial-power account is correct, there is no reason to suppose that the corporation would exercise the amendment power in the manager’s interest to provide for an acceleration of payments. But making that assumption in order to prove the validity of the managerial-power account obviously would be an exercise in circular reasoning.}

to the underlying tax rules and tax considerations. It is tempting to conclude that the tax account must be the correct answer to the puzzle of non-qualified retirement pay.

That temptation should be resisted; it is important not to put more weight on the tax account than it can bear. Certainly the tax account identifies strong motivations for the basic decision to defer manager pay. Non-qualified plans supplement the benefits payable under tax-qualified plans, allow corporations to end run the $1 million deduction limitation, allow managers to end run state income taxes, and substitute lower marginal tax rates for higher marginal tax rates on certain investment returns. But positing these tax motivations does not in itself invalidate either the creditor-alignment motivation suggested by the optimal-contracting account or the rent-extraction motivation suggested by the managerial-power account. The motivation for non-qualified retirement pay may differ from one corporation or one manager to another; in some cases, the motivation may be mixed. As an explanation of why managers and corporations use non-qualified plans, the tax account challenges the optimal-contracting and managerial-power accounts, but it does not refute them.

The story is different with the contractual terms of non-qualified plans. Here, the tax account should displace the other two accounts. Most prior scholarship, whether written in the service of the optimal-contracting account or of the managerial-power account, focuses almost exclusively on the motivation for non-qualified retirement pay. Jackson and Honigsberg sensibly step beyond that narrow inquiry and examine actual plan terms to see what they reveal about the reason for deferral.146 Although Jackson and Honigsberg find some evidence supporting the optimal-contracting account, they see stronger indications of managerial power.147 Unfortunately, they consciously shunt tax considerations to the side,148 even though

146 Jackson and Honigsberg, the Hidden Nature of Executive Retirement Pay,” 100 Va. L. Rev. 479 (2014).


148 Jackson and Honigsberg, the Hidden Nature of Executive Retirement Pay,” 100 Va. L. Rev. 479, 484 n. 10 (2014).
the tax account ultimately explains plan terms far better than either the optimal-contracting account or the managerial-power account.

It is important, however, not to conflate the contractual terms of non-qualified plans with the underlying reason for including non-qualified retirement pay in manager compensation. Certainly, plan terms may be suggestive of manager and director motivations. As Jackson and Honigsberg argue, a non-qualified plan bearing few indicia of corporate debt may not, in the end, represent an effort to align the interests of the managers with those of the corporation’s unsecured general creditors. Thus, the close conformity of plan terms with the applicable tax rules and tax considerations no doubt points to the tax account as highly relevant to the underlying puzzle. But, still this is not dispositive. The tax account’s superior explanation of plan terms could be reconciled to the basic manager and director motivations posited by either the optimal-contracting or the managerial-power account. That is, even if a corporation and a manager agree to a non-qualified plan in order to facilitate rent extraction or to align the manager’s interests with those of the corporation’s unsecured creditors, both sides should still want the plan terms to satisfy the applicable tax rules for non-qualified retirement pay.

In short, the tax account provides a rival explanation for why corporations establish and maintain non-qualified plans and a superior explanation for the contractual terms of those plans. But neither of those two points compels the conclusion that the core claim of either the optimal-contracting account or the managerial-power accounts is wrong. At least as developed here, the tax account illuminates the problem, but it does not dispose of it. The puzzle of non-qualified retirement pay remains unsolved.

III. Policy Implications of the Tax Account

The tax account has two important implications for public policy on non-qualified retirement pay. First, the tax account suggests that there may be no clear normative imperative for policymakers either to encourage or to discourage the use of non-qualified retirement pay in manager pay arrangements. Second, the tax account suggests that any undertaking by policymakers to limit or to reform non-qualified retirement pay must address the relevant tax
considerations. The best mechanism for doing so would be the imposition of accrual-based taxation.

A. The Ambiguous Normative Status of Non-Qualified Retirement Pay

The optimal-contracting account and the managerial-power account, which have dominated the academic debate about non-qualified retirement pay, respectively imply optimistic and pessimistic normative judgments. On the optimal-contracting account, non-qualified retirement pay aligns the manager’s interests with those of the corporation’s unsecured general creditors; that, in turn, encourages the manager to preserve firm value in the event of corporate insolvency. In the absence of non-qualified retirement pay, the manager – who may hold a substantial equity stake in the firm – likely would steer the firm toward higher-risk ventures, thereby potentially benefitting shareholders but potentially harming unsecured creditors. From this perspective, non-qualified retirement pay usefully tempers the manager’s appetite for risk. The important lesson of the optimal-contracting account is that directors should find the right combination of inside debt and equity in the manager’s compensation package so that the manager directs the corporation to take on neither too much nor too little risk. Policymakers, if they intervene at all, should do so only with the aim of facilitating the appropriate level of non-qualified retirement pay.

By contrast, the managerial-power account finds little or nothing of value in non-qualified retirement pay. On this account, non-qualified retirement pay simply offers a vehicle for a corporation’s manager and directors to disguise the manager’s performance-insensitive compensation. The lesson of the managerial-power account is that directors probably should not maintain non-qualified retirement plans at all; instead, they should compensate managers with currently taxable and easily quantifiable cash and equity interests. Eliminating non-qualified retirement pay from manager pay arrangements would facilitate shareholder understanding and monitoring of executive compensation, thereby forcing managers and directors to agree pay packages that transparently serve shareholder interests. Policymakers, at a minimum, should require full and understandable disclosure of all aspects of non-qualified plans; at the extreme, they should consider measures to curb or eliminate such plans.
The tax account has more ambiguous normative implications. The use of non-qualified retirement pay to avoid state income taxes certainly seems objectionable, for all the familiar reasons. A manager who lives in New Jersey, a high-tax state, while working in New York, also a high-tax state, enjoys the benefits and amenities provided by the governments of those states. But by deferring part of her compensation until she has retired and established residency in Florida, which does not tax income, the manager avoids paying in full for the costs of government in New Jersey and New York during her working years. The avoidance of state income tax seems particularly objectionable if the manager establishes Florida residency only as long as necessary to obtain the benefit of Florida’s non-taxation of income. If the manager works in New York while living in New Jersey, retires to Florida, and then returns to re-establish residency in New Jersey or New York after the receipt of her non-qualified retirement pay, she continues to enjoy the benefits and amenities provided by the government of New Jersey or New York during her retirement years – but, again, without paying in full for them.

By contrast, a corporation’s use of non-qualified retirement pay to avoid the $1 million deduction limitation under section 162(m) seems much less troubling because the limitation itself represents bad tax policy. The premises underlying section 162(m) are deeply flawed. Congress enacted the limitation in 1993 on a mistaken economic assumption and a contestable policy judgment: that permitting a corporation to deduct the costs of compensating its employees represents a tax subsidy (the economic assumption) and that the federal fisc should not provide such a subsidy for compensation paid to any senior manager in excess of $1 million unless that compensation depends on the manager’s job performance (the policy judgment). But compensation paid by a corporation to its managers is part of the corporation’s cost of producing taxable income and, under an income tax, must be deductible along with the corporation’s other ordinary and necessary business expenses. Denying a deduction for compensation expenses turns away from an income tax and toward a gross-receipts tax. Additionally, denying the deduction for compensation expenses has the effect of increasing the
corporate tax burden, the incidence of which remains highly uncertain. 149 Whether the corporate income tax is borne by shareholders or by rank-and-file employees, it makes no sense to punish either group for compensation decisions made by the corporation’s directors. It would seem all to the good, then, if the use of non-qualified retirement pay allows corporations to end run section 162(m).

The other tax motivations for non-qualified retirement pay have less definite normative implications. Many non-qualified plans supplement the retirement benefits under tax-qualified plans that are limited by sections 415, 401(a)(17), 402(g), 401(a)(4), 401(k)(3), and 401(m) of the Internal Revenue Code. It is hard to see a strong policy concern about that practice. Congress has sound reasons to limit the extensive tax subsidies provided through tax-qualified plans. Those subsidies present an enormous drain on federal revenues, 150 and the managers whose benefits under tax-qualified plans are limited by the Internal Revenue Code generally have the resources and the disposition to save for retirement in the absence of federal tax incentives. Infra-marginal subsidies are seldom attractive as a policy matter; expensive infra-marginal subsidies are still more objectionable. But once appropriate limitations on subsidies for tax-qualified plans are in place, there seems to be little basis in tax policy either to encourage or to discourage private contractual arrangements for non-subsidized retirement benefits above those limitations.

The use of non-qualified plans to provide managers with lower marginal tax rates on certain investment returns is a somewhat closer call. At first pass, it may seem objectionable as a matter of tax policy to permit a manager to lower the applicable marginal tax rate by 23.8 percentage points for investments in the corporation’s stock, by 13.3 percentage points for dividends paid on other stock, and by 8.4 percentage points for interest and short-term capital gains. But it is critical here to pay close attention to the nature of the manager’s interest. The


manager whose non-qualified retirement pay is invested in the corporation’s stock (or any other financial instrument) does not actually own shares in the corporation (or such other financial instrument), and he does not have the rights and remedies available to an actual shareholder (or an actual owner of such other financial instrument). Instead, the manager holds an unsecured contractual claim against the corporation for payment in the future, and the manager faces the risk of non-payment either because of corporate insolvency or because of the corporation’s repudiation of the obligation.\footnote{Of course, as explained above, use of a rabbi trust protects the manager against the risk of repudiation by the corporation.} There is, then, a genuine economic cost for the manager of substituting the corporation’s lower marginal tax rate for his own higher marginal tax rate.

Between the manager and the underlying investment stands an entirely separate entity – the corporation as the actual owner of the investment. The interposition of that entity exposes the manager to additional and qualitatively different risk that the investment will become worthless.

The tax account introduces new questions and new possibilities about both the motivations and the effects of non-qualified retirement pay, and it consequently raises doubt about whether there is any policy imperative to addressing non-qualified retirement pay through legislative or regulatory action. In the end, non-qualified retirement pay may be less harmful than the managerial-power account maintains, or it may be less beneficial than the optimal-contracting account maintains. Certain tax considerations – particularly the avoidance of state income taxes – suggest a case for reforming the rules applicable to non-qualified retirement pay; other tax considerations – particularly the avoidance of the $1 million deduction limitation under section 162(m) and the supplementing of benefits under tax-qualified retirement plans – imply that corporations and managers should be left alone to work out whatever non-qualified plans they deem best.

B. Pursuing Reform through Accrual-Based Taxation

In any event, policymakers in recent years seem unable not to reform the rules for manager compensation. Assuming that Congress decides again to change the laws applicable
to non-qualified retirement pay, any such policy initiative should reflect the considerations identified in the tax account. Earlier efforts to regulate manager compensation are paradoxically informative here. In the past, Congress has attempted to reform non-qualified retirement pay through the tax code, but it has done so in a bumbling manner, likely exacerbating any underlying policy problems that it wanted to address. A much better approach would be to impose accrual-based taxation on managers covered by non-qualified plans.

Prior changes to the tax rules for non-qualified retirement pay have followed the misguided approach of imposing tax penalties on pay practices that legislators consider objectionable. Most prominently, Congress in 2004 enacted section 409A of the Internal Revenue Code primarily to standardize the constructive-receipt rules for non-qualified plans and to prohibit certain aggressive funding practices. Innocuous as that general purpose may have been, Congress foolishly imposed a 20-percent penalty tax on any manager whose non-qualified retirement pay fails the section 409A rules.152 The punitive consequences under section 409A no doubt have encouraged conformity to the statutory constructive-receipt and funding rules. But they have also increased the cost of providing non-qualified retirement pay as managers understandably have demanded indemnification agreements from their corporate employers to cover any adverse outcomes under section 409A.

Other manager-pay reforms have made the same mistake. The tax rules on golden parachutes, for example, impose penalties on both the manager and the corporation for certain payments made to managers as part of a corporate change in control.153 Such penalty-based reforms rest on the flawed assumption that managers and corporations either will ensure that their pay practices conform to the new rules or will abandon the targeted pay practice altogether. But in many cases, a third option may be the most attractive: fail the applicable rules and pay the tax penalty, ensuring that any penalty nominally imposed on the manager is


153 Internal Revenue Code sections 280G and 4999.
actually borne by the corporation. As with the 20-percent penalty under section 409A, this has the effect of increasing the cost of compensation. It does not, however, further the policy objectives that led Congress to enact the reform in the first place.

Halperin and Yale have suggested a different approach to reforming non-qualified retirement pay. They argue for a corporate-level tax to be imposed at the highest marginal tax rate for individuals on the investment earnings attributable to the corporation’s obligations under its non-qualified plans. Chason also proposes a corporate-level tax on investment earnings (with several differences in detail from the tax proposed by Halperin and Yale). This approach gets directly at the substitution of the corporation’s lower marginal tax rate for the manager’s higher marginal tax rate and eliminates a significant tax rationale for non-qualified retirement pay. But the approach does not work if the corporation itself is not subject to U.S. tax, it does little to address the use of non-qualified retirement pay to avoid state income taxes, and it does nothing to address the use of non-qualified retirement pay to avoid the $1 million deduction limitation of section 162(m) (assuming that the latter is deemed objectionable).

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158 Internal Revenue Code section 457(f) imposes accrual-based taxation on employees of tax-exempt and governmental employers, and Internal Revenue Code section 457A imposes accrual-based taxation on employees of employers not subject to U.S. taxation.

159 At most, the separate tax (if implemented by the states) would apply only to investment earnings but not to the underlying compensation deferred by managers.
As I first argued in 2004, shortly after the enactment of section 409A, the best approach to reform, if reform must be had, is to impose accrual-based taxation on managers for their non-qualified retirement pay. Under accrual-based taxation, the manager includes non-qualified retirement pay in her gross income as soon as her rights to that pay become vested, and the corporation deducts such pay at the time of the manager’s inclusion. Accrual-based taxation is the correct approach as a matter of basic income-tax policy. It also directly addresses most of the tax considerations behind the deferral of manager compensation. It eliminates the avoidance of state income taxes by taxing non-qualified retirement pay when that pay is earned (assuming, as seems almost certain, that the states follow the federal tax code in imposing accrual-based taxation). Similarly, it eliminates the avoidance of the $1 million limitation on deductible compensation under section 162(m) by bringing the manager’s non-qualified retirement pay forward into current compensation. And it subjects annual investment returns to taxation at the manager’s marginal tax rate rather than the corporation’s marginal tax rate. Only the use of non-qualified retirement pay as a supplement to the benefits payable under tax-qualified plans is not directly picked up by accrual-based taxation.

The mechanism for implementation of accrual-based taxation is straightforward: Every year, the manager includes in gross income (and the corporation deducts from gross income) the change in the vested single-sum payout value of the manager’s non-qualified retirement pay. For both the manager and the corporation, the annual change in the vested single-sum payout value is treated as compensation income and is therefore taxed (or deducted) at the applicable tax rate for ordinary income. The “single-sum payout value” is the amount that would be distributed to the manager from the non-qualified plan if immediate payment were made as a lump sum. Thus, the change in the single-sum payout value for any year is the difference between the amount that would be distributed to the manager if payment were made as a lump sum at the close of the taxable year (typically, December 31) and the amount that

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would be distributed to the manager if payment were made as a lump sum at the beginning of the taxable year (typically, January 1).

In the simple case of a non-qualified defined-contribution plan, the change in a manager’s single-sum payout value for a year typically would be the manager’s account balance as of the end of the taxable year less the manager’s account balance as of the start of the taxable year. In the more complicated case of a non-qualified defined-benefit plan, the change in a manager’s single-sum payout value for a year would be the present value of the manager’s benefit stream as of the end of the taxable year less the present value of the manager’s benefit stream as of the start of the taxable year. In both cases, the amount included in the manager’s gross income (and deducted from the corporation’s gross income) for the year would incorporate both compensation deferred during that year and any investment earnings, whether or not realized, on compensation deferred during that year and prior years.\footnote{This point bears some emphasis. Under accrual-based taxation, any unrealized appreciation in the value of an actual or notional investment – for example, in the corporation’s own stock – would be subject to immediate taxation. Cf. Halperin and Yale, “Deferred Compensation Revisited,” 114 Tax Notes 939, 943 (2007).}

Accrual-based taxation of non-qualified retirement pay raises three principal administrative issues: determining when a manager’s non-qualified retirement pay is vested, valuing a manager’s non-qualified retirement pay, and providing for the payment of tax on amounts not receivable until a later taxable year.\footnote{For any year, the change in the single-sum payout value of a manager’s non-qualified retirement pay could be either positive or negative. The manager would include any positive value in her gross income under section 61(a)(1) of the Internal Revenue Code and would deduct any negative value from her gross income under section 165(a) of the Internal Revenue Code. Per section 165(c)(1) of the Internal Revenue Code, the manager’s section 165(a) deduction would not be limited. See also Chason, Deferred Compensation Reform: Taxing the Fruit of the Tree in Its Proper Season, 57 Ohio St. L. J. 347, 391 (2006).} Of the three, the vesting issue is the simplest. Longstanding tax regulations on the compensatory transfer of restricted stock or other property provide that an employee’s rights in the restricted stock or other property are unvested as long as those rights are conditioned on the employee performing “substantial

services” or on “the occurrence of a condition related to a purpose of the transfer.” Thus, a provision in a non-qualified retirement plan that a manager forfeits her benefits if she does not remain with the corporation for five years delays vesting – and, under accrual-based taxation, the corresponding income inclusion – until the end of those five years. Insubstantial or unlikely forfeiture conditions – such as a sham requirement to provide consulting services or a requirement to refrain from criminal activity or other wrongdoing – do not defer vesting. These rules have broad application (subject to greater or lesser modifications) throughout the rules for the taxation of non-qualified retirement pay. As such, they are familiar and generally not problematic.

Valuing a manager’s non-qualified retirement pay is only somewhat more complex. For any non-qualified retirement plan that denominates the manager’s benefit as an account balance (which includes most non-qualified defined-contribution plans), the value of the manager’s non-qualified retirement pay is simply the account balance. Thus, determining the change for any taxable year in the manager’s payout value requires nothing more than subtracting the account balance at the start of the year from the account balance at the end of the year. For any non-qualified retirement plan that denominates the manager’s benefit as a stream of payments

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165 Treasury Regulations section 1.83-3(c)(1).
166 Treasury Regulations section 1.83-3(c)(2).
167 See, e.g., Treasury Regulations section 1.402(b)-1(a)(1) (taxation of manager’s interest in non-qualified retirement plan using an exclusive-benefit trust); Treasury Regulations section 1.409A-1(d)(1) (taxation of manager’s interest in non-qualified retirement plan failing substantive requirements of Internal Revenue Code section 409A); Treasury Regulations section 1.457-11(a)(1) (taxation of employee’s interest in non-qualified retirement plan maintained by tax-exempt organization or by state or local government that fails requirements of Internal Revenue Code section 457(b)); Treasury Regulations section 31.3121(v)(2)-1(e)(3) (FICA taxation of manager’s interest in non-qualified retirement plan). Chason suggests that accrual-based taxation of non-qualified retirement pay likely would lead managers and executives to greater use of “irrevocably funded arrangements.” Chason, Deferred Compensation Reform: Taxing the Fruit of the Tree in Its Proper Season, 57 Ohio St. L. J. 347, 395 (2006). The reasoning here, apparently, is that because Internal Revenue Code section 402(b) already applies accrual-based taxation to funded non-qualified retirement plans, the application of accrual-based taxation to unfunded non-qualified retirement plans would remove the tax disadvantage to using a funded arrangement. However, funding a non-qualified retirement plan would cause the plan to lose the top-hat exemption from the ERISA participation, vesting, funding, and fiduciary rules. That likely would weigh heavily against the use of a funding arrangement, even in the event of accrual-based taxation for an unfunded plan.
(which includes most non-qualified defined-benefit plans), the value of the manager’s non-qualified retirement pay is the present value of that stream of benefits. Determining that present value requires standardized assumptions about interest rates and mortality, which the government could provide through regulations.\(^\text{168}\) For example, assume that a 53-year-old manager has a vested right to annual non-qualified retirement pay of $10 million for life, beginning at age 65. Application of standardized actuarial assumptions would yield a lump-sum value for purposes of determining how much the manager must include in gross income for the current taxable year.\(^\text{169}\) Any over- or under-inclusions resulting from the use of standardized assumptions can be corrected (with adjustment for the time value of money) as actual payments are made.\(^\text{170}\)

The liquidity issues associated with requiring managers to pay tax currently on amounts on amounts not receivable until a later taxable year are less significant than they might appear. There are at least three feasible approaches here. First, a manager could be required simply to pay tax as his non-qualified retirement pay is earned and vested. For example, if in 2016 a manager defers $10 million under her employer’s non-qualified retirement plan, she would owe a 2016 tax liability of $3,960,000 on that deferral (assuming a 39.6-percent marginal tax rate and assuming that the manager is vested in the $10 million deferral). Under this approach, the


\(^{169}\) To avoid systematic over-inclusions, an early retirement subsidy in a defined-benefit arrangement should be ignored until the manager actually retires under conditions entitling him to the subsidy.

\(^{170}\) The accrual-based rules used in current law for specific aspects of non-qualified retirement pay generally botch the treatment of benefits that are difficult to value when earned. Internal Revenue Code section 457A provides that, if the amount of a payment is not “determinable” at the time the right to payment vests, the payment is subject to a 20-percent penalty tax and interest charge. Internal Revenue Code section 457A(c); Internal Revenue Service Notice 2009-8, Q&A-19 through Q&A-21, 2009-4 I.R.B. 347, 352-353. The imposition of the penalty tax and interest charge has no defensible basis in sound tax policy. The regulation under Internal Revenue Code section 3121(v)(2), which subjects non-qualified retirement pay to accrual-based taxation, err in the other direction. Those regulations provide delay taxation of any under a non-qualified defined-benefit plan that is not “reasonably ascertainable.” Treasury Regulations section 31.3121(v)(2)-1(e)(4). See also Chason, Executive Compensation and Tax Neutrality: Taxing the Investment Component of Deferred Compensation, 31 Cardozo L. Rev. 1667, 1688-1689 (2010).
manager would simply pay the government $3,960,000 with her 2016 tax return. Such undiluted accrual-based taxation of non-qualified retirement pay is hardly unprecedented: The law generally follows this approach for employment taxes on non-qualified retirement plans\(^\text{171}\) and for income taxes on split-dollar life-insurance arrangements,\(^\text{172}\) non-qualified retirement plans failing certain statutory requirements,\(^\text{173}\) non-qualified retirement plans funded through exclusive-benefit trusts,\(^\text{174}\) and non-qualified retirement plans maintained by tax-exempt organizations,\(^\text{175}\) state or local governments,\(^\text{176}\) or certain foreign corporations and partnerships.\(^\text{177}\) Many senior managers no doubt have substantial liquid assets (including base salary) to cover the taxes imposed on their non-qualified retirement pay, although certain managers may not.

Second, the corporation could pay the tax on behalf of the manager and subtract the same amount from the manager’s non-qualified retirement pay.\(^\text{178}\) Under this approach, the corporation would act as the withholding agent, just as the corporation does with respect to the manager’s base salary and other currently taxable compensation, and the manager would claim a credit on her income tax return for the amount paid to the government by the corporation. To continue the example from above, the manager would not pay tax on her non-qualified retirement pay to the government with her 2016 tax return. Instead, the corporation in 2016 would pay $3,960,000 to the government on the manager’s behalf and would reduce the manager’s benefit under the non-qualified retirement plan by $3,960,000. On her 2016 tax

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\(^{171}\) Internal Revenue Code section 3121(v)(2).

\(^{172}\) Treasury Regulations section 1.61-22(d).

\(^{173}\) Internal Revenue Code section 409A.

\(^{174}\) Internal Revenue Code section 402(b).

\(^{175}\) Internal Revenue Code section 457(f).

\(^{176}\) Internal Revenue Code section 457(f).

\(^{177}\) Internal Revenue Code section 457A.

return, the manager would claim as a tax credit of $3,960,000, representing the amount already paid by the corporation on her behalf and subtracted from her non-qualified retirement pay. This approach shifts the liquidity burden from the manager to the corporation; it therefore could present problems for cash-constrained and otherwise distressed businesses.

Third, the manager’s payment of the current tax liability on her non-qualified retirement pay could be deferred, with an interest adjustment, until she actually receives her non-qualified retirement pay. Under this approach, the manager would accrue a tax liability of $3,960,000 in 2016, but she would not pay that tax liability until she actually receives the distribution of her non-qualified retirement pay. If her non-qualified retirement pay were distributed to her in 2026, she would pay a total of $6,450,423 with her 2026 tax return. That amount represents the original $3,960,000 tax liability as adjusted for interest during the intervening ten years (with an assumed rate here of 5 percent). This approach minimizes liquidity problems for both the manager and the corporation.

Other tax academics raise objections to accrual-based taxation of managers, but their concerns do not present serious obstacles. Halperin argues that “full accrual would tax employees on benefits that they might never receive.” This objection has both a strong version and a weak version. The strong version of the objection – which is the one advanced by Halperin – is that accrual-based taxation might trigger a current tax liability with respect to a benefit that the manager forfeits before receipt. As an example, he points to benefits that “are forfeited if death occurs before normal retirement age.” But such non-qualified retirement pay is not vested and, thus, would not be subject to accrual-based taxation until the manager

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180 This approach also helps to address valuation problems because the tax imposed when the non-qualified retirement pay first vests can be adjusted to reflect the tax that would have been imposed had the actual amount ultimately payable been known at the time of vesting. In other words, it allows a “true-up” of the correct tax liability at the time the tax is first paid to the government.


reaches normal retirement age. Even in the case of non-qualified retirement pay that is vested for tax purposes but is later forfeited (by reason, for example, of the manager’s commission of a felony or another act injurious to the corporation), the manager under accrual-based taxation would be permitted a loss deduction for the amount of the forfeiture. The weak version of the objection is that present value of a manager’s non-qualified retirement pay, determined under actual assumptions, may turn out to be more than the actual amount of the manager’s non-qualified retirement pay (if, for example, a manager receiving benefits in annuity form dies before the end of his predicted life expectancy). Again, however, final tax liability can be adjusted at the time of actual receipt and any over-inclusions in past years can be addressed through loss deductions in later years.

Halperin also criticizes accrual-based taxation because of the “potential bunching of income which could cause higher than normal rates to apply.” Of course, when Halperin published his article in 1986, the Internal Revenue Code provided for many more tax brackets than it does now. There were fifteen different tax brackets for individuals in 1986; there are only seven in 2016. Additionally, the highest marginal tax rate applies to all income over amounts ($400,000 to $450,000) that are really modest by the standards of senior corporate managers. It is hard to imagine that taxation of non-qualified retirement pay on an accrual basis or on a cash basis would move a manager into or out of the top marginal tax rate.

Halperin and Yale criticize accrual-based taxation for its treatment of investment earnings on a manager’s deferred compensation. They assume that accrual-based taxation either would defer tax on investment earnings until non-qualified retirement pay is distributed or would tax investment earnings currently – in which case, they say, accrual-based taxation “does not alleviate the need to develop a proposal to impose a special tax on the

183 See also Chason, Deferred Compensation Reform: Taxing the Fruit of the Tree in Its Proper Season, 57 Ohio St. L. J. 347, 391-392 (2006).

184 Halperin and Yale, “Deferred Compensation Revisited,” 114 Tax Notes 939, 940 (2007). As they note, this is the approach followed by Internal Revenue Code section 457(f) for certain non-qualified plans maintained by state or local governments or by tax-exempt organizations.
investment return.” But that last point does not follow. By taxing a manager on each year’s change in the payout value of his non-qualified retirement pay, accrual-based taxation imposes tax on both deferred compensation and on investment earnings, without any need to differentiate between the two or to devise a separate tax on the latter.

Finally, Halperin and Yale object to accrual-based taxation on that ground that it “would inhibit deferred compensation arrangements, which would be said to serve an important business purpose.” I tend to agree with the point, which is why I remain skeptical that any reform of the tax rules for non-qualified retirement pay is appropriate. That said, the effect of accrual-based taxation – if implemented with sound actuarial assumptions and current deductions for losses – closely tracks a manager’s actual economic income. If accurately taxing a manager’s income inhibits a particular manager-pay practice, the pay practice may have no redeeming value apart from the tax play associated with inaccurate taxation under the current rules.

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