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Time to Start Over on Deferred Compensation

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A law school dean once asked me to suggest a restaurant for a dinner meeting. I named a place, but told him that we could go somewhere else if he objected to northern Italian cuisine. “In my book,” he replied, “anyone who objects to northern Italian should start over.” That struck me as surely right: Not liking northern Italian food must be as good an indication as any that you have made too many wrong turns and that you might as well put all your efforts down as a failure.

Government regulators would do well to follow simple heuristics like that. Writing good regulations — “good” in the sense of promoting the public interest — always presents challenges. Regulators must hit a small but important target where private conduct is brought within appropriate government control, but unnecessary compliance burdens and other deadweight costs are minimized. Even if they see the government’s objectives clearly, regulators often have only a limited understanding of the underlying private activities. Moreover, regulators may be unaware of how their rules disrupt or distort those activities in socially harmful ways.

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Regulators occasionally hit the target exactly. More often, they miss — though not by an intolerably wide margin (good enough for government work, as the saying goes). However, sometimes regulators miss the mark so badly that the only responsible next step is to acknowledge the failure. That is the case with the final regulations under Internal Revenue Code (Code) section 409A.¹ Those regulations are irreparably flawed — so flawed that the best members of the practicing bar cannot make sense of them for basic transactions. When the government issues rules that even experts cannot understand, the government should start over.

I. A BAD BEGINNING

In fairness to the regulators who wrote the section 409A regulations, the statute itself is fundamentally unsound. I had all too close a look at the legislative problems when I was part of the Treasury team that provided technical advice to the Congressional staff who drafted section 409A. Although staffers added the worst feature — the 20% penalty tax on “bad” deferred compensation — after I left government, the wheels came off early in the process. Without question, I share responsibility for the poor legislative product.

Section 409A was originally intended to serve two objectives. First, members of Congress wanted to eliminate “haircut” distributions under corporate deferred compensation plans. Those members objected to the constructive-receipt rule that allowed a corporate manager to take a premature distribution of deferred compensation as long as the manager forfeited part of the total deferral. The mandate to Ways and Means staff was to draft legislation that would ban haircuts. Second, Treasury wanted to bring order to the general constructive-receipt rules.² A quarter-century moratorium on rulemaking in the area prevented Treasury from narrowing the application of the constructive-receipt doctrine for deferred compensation,³ and we saw the haircut legislation as a vehicle for setting boundaries around what was permissible. For this reason, we encouraged Congressional staff to include rules about

deferral and distribution elections.

However, there are always those at the table with other objectives. In this case, certain staffers wanted to add a strong punitive element to the draft legislation. In their view, a corporate manager who exercised too much control over when her compensation would become taxable should be treated more harshly than a corporate manager who had chosen not to defer her compensation in the first instance. By contrast, Treasury argued that taxing "bad" deferred compensation more heavily than current compensation was not sensible tax policy. As a compromise, the draft legislation included an interest charge on deferred compensation that failed the new rules. The theory was that the interest charge would treat "bad" deferred compensation the same as current compensation (allowing for a little too much here and a little too little there).

As enacted in October of 2004, section 409A fell far short of sound reform. Most importantly, section 409A failed to impose accrual-based taxation on all corporate managers who earn compensation in one year and receive it in a later year. Accrual-based taxation, which follows directly from the Haig-Simons definition of income, presents the correct result as a matter of tax policy. That approach treats deferred compensation — regardless of whether it is "good" or "bad" (in the sense of satisfying or not satisfying an arbitrary set of statutory requirements) — just like current compensation. In other words, accrual-based taxation eliminates the possibility of a tax preference for deferred compensation. It may be

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5 The statute does impose accrual-based taxation on managers with "bad" deferred compensation.


7 Daniel Halperin and Ethan Yale argue cogently for a special tax on the investment income of deferred compensation rather than accrual-based taxation of the manager. Daniel Halperin & Ethan Yale, "Deferred Compensation Revisited," 114 TAX NOTES 939 (Mar. 5, 2007). If the special tax is to be collected from the corporation, however, it may not reach situations in which the corporation is not subject to U.S. tax. This would be a significant omission. The deferral of the corporation's deduction under Code section 404(a)(5) would have no effect in such a case, and the manager would continue to enjoy an unwarranted tax preference. If instead the special tax is to be collected from the manager, it is not clear how it would
that the Congressional staffers who sought penalty taxes for "bad" deferred compensation would have preferred accrual-based taxation in all cases, but that sensible starting point cannot justify the fallback they ultimately pursued.

In their misguided eagerness to tax "bad" deferred compensation more heavily than current compensation, the staffers responsible for adding the 20% penalty tax ensured nonsense outcomes. Before section 409A, the tax law set up a defensible hierarchy for deferred compensation. Unfunded, unsecured deferred compensation would result in tax deferral if the manager was not in constructive receipt of the deferrals and current taxation if the manager was in constructive receipt of the deferrals. Funded or secured deferred compensation would result in current taxation of all vested deferrals, whether or not those amounts were constructively received by the manager. The tax results were harsher — current taxation of vested deferrals and current taxation of investment earnings on those deferrals — if the manager's deferred compensation was secured through a trust set up as part of a discriminatory plan.

Today, a manager covered by an unfunded, unsecured deferred compensation plan that fails section 409A is taxed more heavily than a manager covered by a funded or secured deferred compensation plan, even if that funded or secured plan is discriminatory. This stunning result calls for emphasis: A manager whose deferred compensation is protected fully from the corporation's creditors incurs a smaller tax than a manager whose deferred compensation, although not

present any administrative or political advantage over accrual-based taxation. It is presumably for this reason that new Code section 457A, enacted as part of the Emergency Economic Stabilization Act of 2008, imposes accrual-based taxation on deferred compensation for managers of offshore hedge funds.

See Staff of Joint Comm. on Taxation, 108th Cong., Written Testimony of the Staff of the Joint Committee on Taxation on Executive Compensation and Company-Owned Life Insurance Arrangements of Enron Corporation and Related Entities, at 20 (Joint Comm. Print 2003) ("The Joint Committee staff believes that [deferred] compensation should be includible in income no later than the time it is earned unless there is a substantial risk of forfeiture of the rights to the compensation.").

9 Halperin and Yale wryly observe that "[t]he rationale for the special penalty under section 409A . . . hasn't been completely developed." Halperin & Yale, supra note 7, at 944.

10 I.R.C. § 451(a).
11 I.R.C. §§ 83(a), 402(b).
13 I.R.C. § 409A(a)(1).
compliant with section 409A, remains exposed to the corporation's creditors.

Consider the point from another angle. Congress applied section 409A to offshore rabbi trusts because such arrangements may protect deferred compensation from a corporation's creditors. However, it did not apply section 409A to secular trusts even though such arrangements in fact protect deferred compensation from a corporation's creditors. Thus, the manager whose deferred compensation potentially avoids the claims of creditors incurs a higher tax than a manager whose deferred compensation actually avoids the claims of creditors. These glaring policy mistakes cannot be justified.

Finally, section 409A substantially increases risk-bearing costs for corporate shareholders. By taxing a manager with “bad” deferred compensation more heavily than a manager who receives current compensation, section 409A inevitably increases the costs to shareholders of compensating the manager with deferred compensation. Rent-seeking managers insist on indemnification and gross-up agreements to cover the 20% penalty tax, and those agreements shift the downside risk of section 409A from the manager to the owners of the corporation. The phenomenon is no different from what occurred in response to tax sanctions for golden parachutes and compensation in excess of $1 million. Imposing a tax penalty on corporate managers for reaching their hands too deeply into shareholder pockets only encourages them to reach deeper still — so that shareholders cover both the manager's greed and the statutory penalty on that greed.

II. A TURN FOR THE WORSE

To tell the story of the Oxford English Dictionary, Simon Winchester used the charming title The Meaning of Everything. In writing rules under section 409A, the government appears to have seen its job as the regulation of everything. Even by the standard of tax regulations, the final section 409A regulations are very detailed and very complicated. However, there is little cause for the government to take pride in its effort. After defining an ambitious scope for the project, the government failed to supply the judgment

15 See Doran, supra note 6.
16 I.R.C. §§ 280G (disallowing a deduction for golden parachutes), 4999 (imposing an excise tax on golden parachutes), 162(m) (disallowing a deduction for compensation in excess of $1 million).
and craftsmanship needed to make such a complex system work. The result is a tangled set of regulations that experienced, thoughtful, compliance-minded practitioners cannot understand.

One important point should be made up front. The overriding problem with these regulations is not that they are too tough on taxpayers; indeed, on many issues, the regulators give more ground than they should. Rather, the overriding problem is that the regulations fail to provide effective guidance. The government tried to address all conceivable issues that could arise under the statute with detailed rules specifying outcomes to the last possible degree of particularity. Then, recognizing that many of those outcomes would be indefensible on policy or political grounds, the government made up numerous ad hoc exceptions (with outcomes under the exceptions also specified to the last possible degree of particularity). Although the government intended to squeeze any possible ambiguity out of the regulations, the approach had the opposite effect: Ambiguity is the one reliable constant as the rules, exceptions, counter-rules, and counter-exceptions pile up, trip over each other, and pull in different directions.

Consider the deceptively simple question of whether an employee has separated from service. Under the statute, an employee's separation from service permits a distribution of her deferred compensation. 17 One might have thought that, given the great diversity of the terms and conditions of employment, the government would have seen the wisdom in using a flexible standard here rather than trying to specify outcomes for every possible situation involving every employee subject to section 409A. And, in fact, the regulations give us a general statement that an employee has separated from service if the employee has died, retired, or otherwise terminated employment. 18 That seems sensible enough, and many of us — after adding an example or two indicating that sham separations do not count — might have left the matter at that and moved on to the next issue.

Instead, we are told that employment is not necessarily terminated just because the employee is no longer working for the employer. The regulations say that employment “is treated as continuing” while the individual who had been an employee is on military leave, sick leave, or other bona fide leave of absence. 19 This

treatment lasts for six months or, if longer, for so long as the individual retains a statutory or contractual right of reemployment with the employer. The regulators do not trust us to determine whether a leave of absence is bona fide, so they specify that a leave of absence is bona fide only if there is a "reasonable expectation" that the individual will return to work for the employer. We are not told, however, who must have this expectation (the employer? the individual? either? both?), nor are we told at what point one determines whether the appropriate party does or does not have the expectation (at the start of the leave? during the leave? at the end of the leave?).

Next, the regulations tell us that, if the leave period exceeds six months and the individual does not have a statutory or contractual right to reemployment, employment is deemed to terminate on the first day immediately following the end of the six months. This has the trappings of a hard-and-fast rule, although the general proposition about treating employment as lasting throughout a leave period suggests that the employer and the individual may contract around it by agreeing that the individual would have a right of reemployment. The regulations make clear that the six-month default rule can be extended to twenty-nine months, if the leave is because of a medically determinable physical or mental impairment that can be expected to result in death or to last for a continuous period of not less than six months and if that medically determinable physical or mental impairment causes the individual to be unable to perform the duties of the individual's job or of a substantially similar job.

You might be glad that, if nothing else, at least you have slogged through the separation-from-service issue. But, at this point, you in fact have barely begun. All we have, so far, is a general rule defining separation from service and a quirky set of rules about leaves of absence. What about the myriad other ways that employment might terminate? Now, you get the general rule about "termination of employment," which is worth quoting in full, if only because it is characteristic of the muddled prose that runs throughout the regulations:

Whether a termination of employment has occurred is determined based on whether the facts and circumstances indicate that the employer and employee reasonably anticipated that no further services would be performed after a certain date or that the level of bona fide services the

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20 Id.
employee would perform after such date (whether as an employee or as an independent contractor) would permanently decrease to no more than 20 percent of the average level of bona fide services performed (whether as an employee or an independent contractor) over the immediately preceding 36-month period (or the full period of services to the employer if the employee has been providing services to the employer less than 36 months).\footnote{Treas. Reg. § 1.409A-1(h)(1)(ii)(2007).}

Even that not-so-pithy sentence will not get you past the finish line. There is still more work to do. First come the facts and circumstances that feed into the determination. These include whether the employee is treated as an employee for other purposes (such as salary continuation and benefit plans), whether there has been consistent treatment of others who are similarly situated, and whether the employee is permitted and available to perform services for other employers in the same line of business. The regulations are careful to note that other (but unspecified) facts and circumstances may also bear on the determination.

Next come the presumptions and the nonpresumptions, which, incidentally, are not properly coordinated with the general facts-and-circumstances standard. These are built around the very dubious notion that employers can make precise determinations about how much any particular employee, no matter how high or low in an organization, works from year to year. If the employee’s services for the employer drop to 20% or less of the average services performed by the employee during the immediately preceding thirty-six months, the employee is presumed to have separated from service. If the employee’s services for the employer remain at or above 50% of the average services performed by the employee during the immediately preceding thirty-six months, the employee is presumed not to have separated from service. Furthermore, if the employee’s services for the employer fall between the 20% mark and the 50% mark, there is no presumption for or against separation from service. (I am not making this up.) Whether anyone can actually implement these rules — I believe that even the government will find them impossible to apply on audit — appears not to have occurred to the regulators.

You are still not done with this issue, of course. The regulations state that the 20% mark is not fixed; instead, an employer can treat another level of "reasonably anticipated permanent reduction in the
level of bona fide services” as a separation from employment.\textsuperscript{22} If the employer chooses this option, it must set out in writing a level of services greater than 20% but less than 50% that will serve as the threshold for presuming a separation from service.\textsuperscript{23} Apparently, the no-presumption zone would then fall between the percentage chosen by the employer and the 50% mark. Thus, assuming that an employer could actually administer these percentage-based presumptions and nonpresumptions, the employer could make limited adjustments to the scheme.

No presumption is really a presumption unless it can be overcome, so the regulations have rules for that as well. We are told that the presumption against separation from service (that is, if the employee's services are at or above the 50% mark) is rebuttable by showing that the employer and the employee reasonably anticipated that the employee's services would fall to 20% or less of the average services during the immediately preceding thirty-six months (or full period of employment, if the employee has not been employed for thirty-six months). Similarly, the presumption in favor of termination of employment (where the employee's services are at or below the 20% mark or any higher mark set by the employer) is rebuttable by showing that the employer and the employee reasonably anticipated that the employee's services would not fall to 20% or less of the average services during the immediately preceding thirty-six months (or full period of employment, if the employee has not been employed for thirty-six months). Apparently, the nonpresumption that applies when the employee's services fall between the 20% and the 50% marks does not need a rebutting rule; in any event, none is given.

There are still more rules on this topic, including rules that tell you how to treat paid and unpaid leaves of absence for purposes of the presumption in favor of termination and the presumption against termination. On top of that, there are rules for determining whether independent contractors have separated from service, for determining whether individuals who are both independent contractors and employees have separated from service, for figuring out who the employer is, for dealing with asset sales involving the employer, and for handling collective bargaining situations in which employees work for more than one employer. Of all the verbiage on separation from service, my favorite passage is the requirement — buried about halfway through these pages and pages of rules and stated without the

\textsuperscript{22} Id.
\textsuperscript{23} Id.
slightest hint of self-consciousness — that a deferred compensation plan must “specify” the definition of separation from service. How could anyone even hope to do that?

In their current form, the regulations on separation from service provide a numbing amount of detail but very little payoff in actual guidance. Once one looks beyond the superficial determinacy, the regulations actually give nothing more than a verbose facts-and-circumstances test. I cannot help but think that the regulators, if they had thought about what their rules actually say, would have concluded that they are unable to state categorically when an employee has separated from service. The permutations of possibilities in how employment is conducted and how it is terminated are too great to set forth a single rule, and it is naïve or arrogant to try. In the end, the government might as well have given taxpayers the same advice that a cranky federal judge gave as he sentenced an eighty-year-old defendant to a thirty-year prison sentence. When the defendant objected that he was an old man and could not serve thirty years, the judge replied, “Do the best you can.”

If the tortured-but-vacuous definition of “separation from service” stood alone in these regulations, one could chuckle and move on. However, there are two hundred pages of still more byzantine rules. The result of all this hyper-specificity is, of course, exactly the opposite of what the government intended. Rather than remove ambiguities and uncertainties, the regulators have multiplied them; rather than answer every question, they have raised many additional and unnecessary issues; rather than translate legislative language into a workable and administrable set of regulations, they have rendered a provision with very serious consequences into an unworkable mess.

The best members of the practicing bar are at a loss to make sense of these rules for many commonplace transactions. The regulations do not give the coherent and sensible guidance that regulations must provide. Rather than own up to the shortcoming, the government has retreated into a “no-rule” position on the regulations. In effect, after failing in its responsibility to provide usable guidance through the rulemaking process, the government now refuses to address the many questions, ambiguities, and outright inconsistencies that it has created in any forum other than audit and litigation. With exquisite irony, the regulators urge taxpayers to accommodate the convoluted regulations

24 Id.
by avoiding "complicated" deferral arrangements. They have missed the point altogether: The regulations do not give effective guidance even for simple deferral arrangements.

The regulators should understand these problems by now. After the final regulations were issued in April 2007, the practicing bar responded twice that its clients simply could not comply with the rules by the January 1, 2008 effective date. The government first postponed the date by which amendments to deferred compensation plans were required from December 31, 2007 to December 31, 2008, but held the effective date of the regulations at January 1, 2008. That action, of course, was pointless. Difficulties in amending plan documents are not nearly as serious as the difficulties in complying with these problematic rules. The government finally relented and postponed the effective date of the regulations until January 1, 2009.

In the meantime, the sensible standard of "reasonable, good faith" compliance applies.

III. A FRESH START

Congress shows absolutely no inclination to undertake a thoughtful revision of section 409A. At a minimum, that would require repealing the 20% penalty tax, which ultimately amounts to nothing more than a transfer of wealth from shareholders to the government with substantial deadweight costs along the way. Still better would be the outright repeal of cash-method tax accounting for corporate managers so that tax is paid as compensation is earned and vested. But those actions surely lie beyond the capacity of legislators. The responsibility for a second-best solution, then, falls on the regulators — the same regulators who so far have done just about all they can to make a bad law worse.

By deferring the effective date of the final regulations, the

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27 See Letter from Ninety-Two Law Firms to Kevin Brown, Acting Commissioner, Internal Revenue Service (Aug. 21, 2007) (on file with author); see also Letter from Ninety-Six Law Firms to Donald L. Korb, Chief Counsel, Internal Revenue Service, and Eric Solomon, Assistant Sec'y, Tax Pol'y, Dep't of the Treasury (Sept. 21, 2007) (on file with author). At the time those letters were submitted, I was (but no longer am) affiliated with one of the signatory firms.
30 Id.
government gave both taxpayers and itself an important reprieve. The
government should use this time to consider very seriously its next steps. It would be a mistake to push forward with the current regulations; they are not a credit to the government and cannot be salvaged in their current form. The responsible approach — the good government approach — would be to acknowledge that the regulations have been poorly conceived and poorly executed, to withdraw them in their entirety, and to begin again.

There are many ways to improve the regulations in the next round. I will suggest three. First, the government should limit the scope of the regulations to the group of taxpayers of greatest (and possibly exclusive) concern to Congress: corporate managers who form “top hat” groups within their companies and corporate directors. The statute on its face reaches more broadly, no doubt. But the government can continue the reasonable, good-faith standard for union members, public school teachers, clergy, and everyone else outside the target group while it writes regulations tailored to the specific concerns presented by corporate managers and directors. Among other benefits, that approach would spare the government the awkwardness of penalizing elementary school teachers who want to stretch their school-year salaries out over twelve months.31 More importantly, it would simplify the range of situations that the regulations would have to cover in the short run.

The regulators might protest that they lack the authority to limit the reach of section 409A. That argument is transparently false. The statute plainly provides that the government can prescribe regulations “necessary or appropriate” to effect the purposes of section 409A.32 All the government needs to do is determine that the necessary or

31 The Service magnanimously stated that, at least for the short term, it would not sanction school teachers under section 409A for failing to make deferral elections by the dates required under the final regulations. See Frequently Asked Questions: Sec. 409A and Deferred Compensation, (Aug. 7, 2007), available at http://www.irs.gov/newsroom/article/0, id=172883,00.html. The deferrals involved are simply the pushing of income from one calendar year to the next when teachers choose to receive their school-year pay over twelve months rather than nine or ten. Left unexplained, of course, is why the Service did not exempt school teachers from section 409A in the first instance. School teachers electing to take their salaries over twelve months bear little resemblance to the corporate bandits who prompted the enactment of section 409A. A small measure of common sense here would have saved teachers needless confusion and the government needless embarrassment. But common sense remains in short supply. See I.R.S. Notice 2008-62, 2008-29 I.R.B. 118 (describing expanded exemption from section 409A for teachers).

appropriate rules for corporate managers and directors consist of regulations but that, for the time being, the necessary or appropriate rules for everyone else consist of the reasonable, good faith standard. Such exercises of reasoned judgment by the government may be infrequent, but they are not unprecedented: With considerably less statutory authority than it has under section 409A, the government for three decades took the position that it would not apply the qualified-plan nondiscrimination rules to governmental employers.\(^{33}\) If the government redirects its focus under section 409A to corporate managers and directors, no one in Congress will complain that the government has shirked its duty by not taking down everyone else in the first round.

Second, in writing new regulations, the government should make sensible use of broad and flexible standards. The over-reliance on rules in the current regulations is misguided. It introduces unnecessary complexity and sets up nearly endless ad hoc exceptions to accommodate specific situations. The definition of separation from service could have — and should have — been handled in one or two sentences with a handful of examples. The regulators' baffling desire to specify in advance the outcome for every conceivable case — which does not succeed in any event — increases the level of indeterminacy.

Third, the government should simplify the regulations. The statute is not sufficiently complex to justify four hundred pages of regulations and preamble. Twenty-five or thirty double-spaced pages should have been more than sufficient to write coherent, administrable guidance. Rules of this length and intricacy do not promote compliance; they undermine it. Certainly, the statutory language of section 409A raises important interpretive points, and without any doubt, the government must discharge its obligation to interpret and enforce the law. However, that requires clarity of guidance, and the approach taken in the current regulations has failed to provide that clarity. The responsible next step for the government is to start over.