The Puzzle of Nonqualified Retirement Pay

MICHAEL DORAN*

I. Introduction

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 managers of public companies 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.[1] 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 401(k) plan, hold its assets in an exclusive-benefit trust that is fully

* University of Virginia School of Law. For comments and criticisms, thanks to Albert Choi, Quinn Curtis, Elizabeth Drigotas, Austin Frerick, Brian Galle, Michael Graetz, Peter Gulia, Daniel Halperin, David Hasen, Wojciech Kopczuk, Ruth Mason, Shu-Yi Oei, Gregg Polsky, Alex Raskolnikov, Mildred Robinson, Adam Rosenzweig, Chris Sanchirico, Michael Schler, Darien Shanske, Reed Shuldiner, Sloan Speck, Andrew Stumpff, David Walker, Bret Wells, Thomas White, Peter Wiedenbeck, Ethan Yale, George Yin, and Stephen Zeldes. Clayton Bailey provided outstanding research assistance.

1 See, e.g., Brian Cadman & Linda Vincent, The Role of Defined Benefit Pension Plans in Executive Compensation, 24 Eur. Acct. Rev. 779, 779-800 (2015); Alex Edmans & Qi Liu, Inside Debt, 15 Rev. Fin. 75, 76 n.3 (2011); Alex Edmans & Xavier Gabaix, Is CEO Pay Really Inefficient? A Survey of New Optimal Contracting Theories, 15 Eur. Fin. Mgmt. 486, 492 n.8 (2009); Rangarajan K. Sundaram & David L. Yermack, Pay Me Later: Inside Debt and Its Role in Managerial Compensation, 62 J. Fin. 1551, 1552-54 (2007); see also Peter Loftus, J&J Chief to Receive $143 Million Farewell, Wall St. J. (Mar. 15, 2012), http://www.wsj.com/articles/SB10001424052702304459804577281560545538288; Dan Fitzpatrick, Retirement Benefits for BofA's Lewis: $83 Million, Wall St. J. (Feb. 27, 2010), http://www.wsj.com/articles/SB10001424052748704625004575089742035330432.

secure from the creditors of both the employer and the employee.[2] Most manager retirement pay, however, is deferred under a *nonqualified* retirement plan. Federal laws not only prohibit a nonqualified retirement plan from holding its assets in an exclusive-benefit trust but affirmatively require that those assets remain fully exposed to the claims of the corporation's general creditors.[3] A manager who defers part of her compensation under a nonqualified plan thus bears a genuine risk of never receiving payment. Yet by some measures more than 90% of large corporations provide managers with nonqualified retirement pay.[4] What explains the willingness of managers to be paid in the future for work performed in the present, particularly if part or all of the pay might be lost to corporate insolvency? In short, why deferred rather than current compensation?

The corporate-governance literature offers two principal explanations. The first attributes nonqualified retirement pay to optimal contracting between managers and corporate directors.[5] On this "optimal-contracting account," directors use deferred compensation to align the interests of managers with the interests of the corporation's unsecured general creditors.[6] The account thus maintains that nonqualified retirement pay is a function of arm's-length bargaining between directors and managers, with the advantage to the directors.[7] The second explanation attributes nonqualified retirement pay to extraordinary managerial power.[8] On this "managerial-power account,"

[2] IRC § 401(a); ERISA § 403(c)(1), 29 U.S.C. § 1103(c)(1); see Section II.A.

[3] See Section II.A.

[4] Myron S. Scholes, Mark A. Wolfson, Merle M. Erickson, Michelle L. Hanlon, Edward L. Maydew & Terrence J. Shevlin, Taxes & Business Strategy: A Planning Approach 202 (5th ed. 2015) ("Roughly, 91% of *Fortune* 1000 companies and 92% of financial institutions offer [nonqualified deferred compensation] plans."). The focus throughout this Article is on the pay arrangements between managers and public companies. The Newport Group reports that 72% of Fortune 1000 companies offer a defined contribution nonqualified retirement plan and that 20% of those companies offer a defined benefit nonqualified retirement plan. The Newport Group, Executive Benefits: A Survey of Current Trends 13, 41 (2014-2015); see also MullinTBG, 2014 Executive Benefit Survey: Summary of Results 2-3 (Mar. 2015), http://www.retire.prudential.com/media/managed/documents/prs/2014_MullinTBGExecutiveBenefitsSurvey_FINAL.pdf ("Dipping down below 90% for the first time in many years, [nonqualified deferred compensation plans] were offered by 84.1% of survey respondents and were more likely to be sponsored by large, publicly traded companies.").

[5] See, e.g., Edmans & Liu, note 1; Sundaram & Yermack, note 1.

[6] Edmans & Liu, note 1, at 76; Robert J. Jackson Jr. & Colleen Honigsberg, The Hidden Nature of Executive Retirement Pay, 100 Va. L. Rev. 479, 483 (2014); Sundaram & Yermack, note 1, at 1558.

[7] See Jackson & Honigsberg, note 6, at 483-84.

[8] See, e.g., id. at 485; Lucian A. Bebchuk & Jesse M. Fried, Stealth Compensation Via Retirement Benefits, 1 Berkeley Bus. L.J. 291, 296-300 (2004) [hereinafter Stealth Compensation]; Lucian A. Bebchuk & Jesse M. Fried, Pay Without Performance: The Unfulfilled Promise of Executive Compensation 61 (2004) [hereinafter Pay Without

managers use deferred compensation to obscure the rents that they extract from the corporation's assets through their symbiotic relationships with the corporation's directors.[9] The account thus maintains that nonqualified retirement pay is a function of collusion between directors and managers, with the advantage to the managers.[10]

Although both accounts suggest plausible solutions to the puzzle of nonqualified retirement pay, both accounts all but ignore fundamental tax considerations that may cause managers and directors rationally to prefer deferred compensation over current compensation. These include the relationship between the manager's tax rates and the corporation's tax rates, the $1 million cap on the corporation's compensation deduction, and state income taxes.[11] Such tax considerations provide a clean, straightforward explanation for the basic decision to defer manager compensation. Additionally, tax rules account for the specific contractual terms of nonqualified retirement plans—including the close coordination of nonqualified plans with tax-qualified plans, the wholesale exclusion of rank-and-file employees from nonqualified plans, the status of managers as unsecured general creditors under nonqualified plans, the concentration of nonqualified retirement pay in the corporation's own stock, and the sharp limitations on the time and form of distributions from nonqualified plans.[12] By contrast, the optimal-contracting and managerial-power accounts have struggled to understand or have simply misunderstood these contractual terms.

In Part II, I set out an explanation of nonqualified retirement pay 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 nonqualified retirement plans. In Part III, 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 IV, I consider the policy implications of the tax account, including the implications for legislative reform of nonqualified retirement pay.

Performance]; see also Lucian A. Bebchuk & Robert J. Jackson, Jr., Executive Pensions, 30 J. Corp. Law 823, 828-31 (2005) (dismissing other explanations of executive pensions).

[9] Jackson & Honigsberg, note 6, at 485; Bebchuk & Fried, Pay Without Performance, note 8, at 23-37, 61-62.

[10] Jackson & Honigsberg, note 6, at 485.

[11] See Section II.B.

[12] See Section II.C.

II. A Tax Account of Nonqualified Retirement Pay

Nonqualified 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 nonqualified retirement pay—the optimal-contracting account and the managerial-power account—largely ignore tax considerations. In this Part, I introduce a new account of nonqualified retirement pay, one that draws heavily on tax rules and tax considerations. My thesis is simple. Both in the decision to defer compensation and in setting the contractual terms of nonqualified retirement plans, directors and managers respond to the incentives, restrictions, and opportunities provided by the tax law. To set out the tax account, I first describe the basic tax rules for nonqualified retirement pay and explain the relationship between nonqualified retirement plans and tax-qualified retirement plans. I then identify three key tax considerations that provide motivating reasons for the deferral of manager compensation. Finally, I demonstrate how specific tax rules explain the most important contractual terms of nonqualified plans.

There is an important point about terminology here. The corporate-governance literature generally uses the term "executive pension" or "executive retirement plan" to denote nonqualified *defined benefit* plans and the term "deferred compensation" to denote nonqualified *defined contribution* plans.[13] For unknown reasons,[14] the literature stubbornly insists on treating the two plan types, which are explained in greater detail below,[15] as though they were fundamentally different. But the distinction is largely inconsequential. Substantially the same tax and legal regime applies to all nonqualified plans, whether structured as defined contribution or defined benefit arrangements. In this Article, I use the term "nonqualified retirement plan" and its cognates to reference any defined contribution or defined benefit arrangement (other than a tax-qualified plan) that provides for the deferral of manager compensation.

---

[13] See, e.g., Cory A. Cassell, Shawn X. Huang, Juan Manuel Sanchez & Michael D. Stuart, Seeking Safety: The Relation Between CEO Inside Debt Holdings and the Riskiness of Firm Investment and Financial Policies, 103 J. Fin. Econ. 588, 588 n.1 (2012); Edmans & Liu, note 1, at 76, 89; Sundaram & Yermack, note 1, at 1552, 1559-60, 1583; Bebchuk & Fried, Stealth Compensation, note 8, at 302, 309; Bebchuk & Fried, Pay Without Performance, note 8, at 96, 102.

[14] See Sundaram & Yermack, note 1, at 1559-60 (suggesting that "disclosure is extremely limited for deferred compensation," and they must "restrict the analysis in this paper to pension only.").

[15] See Section II.A.

A. *Taxation of Nonqualified Retirement Pay*

The basic tax rules for nonqualified 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.[16] The decision to defer may be made unilaterally by the corporation or by agreement between the corporation and the manager.[17] The compensation, as adjusted for any investment gains or losses, generally must be distributed to the manager under a payment schedule established before the compensation is deferred.[18] Despite this general rule, the tax law permits subsequent changes to the time and manner of distribution under narrow conditions.[19] Thus, a nonqualified retirement plan may (but need not) permit the manager to postpone the scheduled distribution of her nonqualified retirement pay, although the manager must elect the postponement at least one year before the nonqualified retirement pay otherwise would be distributed and the postponement generally must push the payment starting date back by at least five years.[20] In no event may the distribution of the nonqualified retirement pay be accelerated either by the manager or by the corporation.[21] The corporation may not set aside any assets for the exclusive benefit of the manager during the deferral period; instead, any assets associated with the nonqualified plan must be subject to the claims of the corporation's general creditors.[22] Failing any of these rules exposes the manager to immediate taxation on her vested nonqualified retirement pay and, in certain cases, a 20% penalty tax and an interest charge calculated from the time of the initial deferral.[23]

Just as the manager defers tax on her nonqualified retirement pay, the corporation may not deduct the compensation until the manager includes it in her income.[24] The tax law thus matches the timing of the manager's inclusion with the timing of the corporation's deduction.

[16] IRC § 409A(a)(4)(B); Reg. § 1.451-2; Rev. Rul. 60-31, 1960-1 C.B. 174; see Enron: Joint Comm. on Tax'n Investigative Rep. on Compensation-Related Issues: Hearing Before the Comm. on Fin., 108th Cong. 72 (2003), http://www.finance.senate.gov/imo/media/doc/92222.pdf [hereinafter Olson Statement] (statement of Pamela F. Olson, Ass't Sec'y for Tax Pol'y, Treasury Dep't).

[17] IRC § 409A(a)(4)(B); Rev. Rul. 60-31, 1960-1 C.B. 174.

[18] IRC § 409A(a)(2).

[19] E.g., IRC § 409A(a)(4)(C).

[20] Id.; Reg. § 1.409A-2(b). The five-year rule does not apply in the event of a distribution payable by reason of disability, death, or unforeseeable emergency. IRC § 409A(a)(4)(C)(ii).

[21] IRC § 409A(a)(3).

[22] IRC § 409A(b); Reg. § 1.83-3(e); Rev. Rul. 60-31, 1960-1 C.B. 174; see Olson Statement, note 16, at 74.

[23] IRC §§ 83(a), 409A(a)-(b), 402(b); Rev. Rul. 2007-48, 2007-2 C.B. 129; Rev. Rul. 60-31, 1960-1 C.B. 174.

[24] IRC § 404(a)(5); see Olson Statement, note 16, at 72-73.

More importantly, because the corporation remains the owner of any assets associated with the nonqualified retirement pay during the deferral period, the corporation pays current tax on the investment earnings generated by those assets. As has long been noted in the tax literature, this has the effect of substituting taxation of the corporation for taxation of the manager on the investment earnings associated with nonqualified retirement pay.[25] The current taxation of investment earnings to the corporation is absolutely fundamental to the treatment of nonqualified retirement pay.

The significance of this point often is not appreciated. It is sometimes assumed that the deferral of the corporation's deduction for nonqualified retirement pay is irrelevant to ensuring proper tax treatment of the manager and the corporation. But that misses the subtle distinction between deferring the corporation's deduction for the principal amount of nonqualified retirement pay and deferring the corporation's deduction for both the principal amount and the investment earnings credited to the principal. Allowing the corporation a current deduction for investment earnings on nonqualified retirement pay would be the same as allowing the corporation to exclude those investment earnings from gross income.[26]

That, in turn, would permit nonqualified retirement pay to accumulate at a pretax rate of return rather than a post-tax rate of return—in effect, making the corporation a tax-exempt investment vehicle with respect to nonqualified retirement pay. For this reason, the courts have rejected theories under which a corporation could claim a current deduction for the investment earnings credited to nonqualified retirement pay.[27]

Rather than tax the manager on the investment earnings during the deferral period, then, the law taxes the investment earnings to the corporation. If individual tax rates and corporate 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 nonqualified plan.[28] To the extent that those rates diverge, however, the tax law effectively may either subsi-

[25] See generally Daniel I. Halperin, Interest in Disguise: Taxing the "Time Value of Money," 95 Yale L.J. 506 (1986); see also Daniel I. Halperin & Alvin C. Warren, Jr., Understanding Income Tax Deferral, 67 Tax L. Rev. 317 (2014).

[26] See Halperin & Warren, note 25, at 317-18; see generally E. Cary Brown, Business-Income Taxation and Investment Incentives, in Income, Employment and Public Policy: Essays in Honor of Alvin H. Hansen 300 (1948).

[27] See, e.g., Albertson's, Inc. v. Commissioner, 42 F.3d 537 (9th Cir. 1994).

[28] Michael Doran, Executive Compensation Reform and the Limits of Tax Policy 7-8 (Urban-Brookings Tax Pol'y Ctr., Discussion Paper No. 18, 2004), http://scholarship.law.georgetown.edu/cgi/viewcontent.cgi?article=2101&context=facpub.

dize or penalize nonqualified retirement pay.[29] Specifically, if the corporation pays tax on investment earnings at a rate that is lower than the rate at which the manager would pay tax on those investment earnings, the federal fisc loses tax revenue relative to the baseline of current compensation (that is, compensation paid and taxed when earned). At a minimum, this possibility raises a question about whether the rules for nonqualified retirement pay reach the right policy result.

The tax treatment of nonqualified retirement pay contrasts sharply with the tax treatment of tax-qualified retirement plans and with the tax treatment of current compensation. Under a tax-qualified plan, the manager is taxed only when his retirement pay is distributed (just as with a nonqualified retirement plan),[30] but the corporation nonetheless takes a current deduction when the compensation is paid into the plan.[31] More importantly, the retirement pay is invested during the deferral period through a trust that is exempt from taxation.[32] For current compensation, the manager is taxed immediately when he receives his compensation,[33] the corporation takes a current deduction when the compensation is paid,[34] and any investment income on the post-tax compensation is taxed to the manager (assuming that the manager does not invest through a tax-exempt or tax-deferred vehicle, such as an annuity contract).

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% (currently the highest individual marginal tax rate for ordinary income),[35] the applicable surtax on investment income for a middle- or high-income individual is 3.8%,[36] the applicable corporate marginal income tax rate is 35% (currently the highest corporate marginal tax rate for ordinary income),[37] the deferral period is

[29] Id. at 8-9. Also, the tax law effectively may either subsidize or penalize nonqualified retirement pay if the individual tax rate or the corporate tax rate changes between the time the deferred compensation is earned and the time the deferred compensation is paid. Eric D. Chason, Deferred Compensation Reform: Taxing the Fruit of the Tree in Its Proper Season, 67 Ohio St. L.J. 347, 366-68 (2006).

[30] IRC § 402(a).

[31] IRC § 404(a); see Doran, note 28, at 1-2.

[32] IRC §§ 401(a)(1), 501(a); see Doran, note 28, at 7.

[33] IRC § 61(a).

[34] IRC § 162(a).

[35] IRC § 1.

[36] IRC § 1411(a).

[37] IRC § 11(b)(1)(D).

twenty years, the sole investment is an interest-bearing bond,[38] and the annual pretax rate of return on that bond is 5%.[39]

Example 1: *Deferral Under Tax-Qualified Retirement Plan*

At the start of Year 1, *Corporation* defers $50,000 of *Manager*'s compensation under a tax-qualified retirement plan. *Manager* excludes the $50,000 from gross income in Year 1. *Corporation* deducts $50,000 in Year 1, yielding a Year 1 tax saving for *Corporation* of $17,500. *Corporation*'s Year 1 post-tax cost of $32,500 has a Year 20 value of $61,615.[40] Over the next twenty years, the $50,000 deferral accumulates at the pretax rate of 5% to $132,665. At the end of Year 20, the tax-qualified plan distributes $132,665 to *Manager*. *Manager* includes the $132,665 in her Year 20 income, paying $52,535 in tax. *Manager* nets $80,130.

Example 2: *Deferral Under Nonqualified Retirement Plan*

At the start of Year 1, *Corporation* defers $50,000 of *Manager*'s compensation under a nonqualified retirement plan. *Manager* excludes the $50,000 from gross income in Year 1. *Corporation* does not deduct the $50,000 in Year 1. Over the next twenty years, the $50,000 deferral accumulates at *Corporation*'s post-tax rate of 3.25% to $94,792.[41] At the end of Year 20, the nonqualified plan distributes $94,792 to *Manager*. *Manager* includes the $94,792 in her Year 20 income, paying $37,538 in tax. *Manager* nets $57,254. *Corporation* deducts the $94,792 from its Year 20 income, yielding a Year 20 tax saving of $33,177.

Example 3: *No Deferral*

At the start of Year 1, *Corporation* pays *Manager* $50,000 in compensation. *Manager* includes the $50,000 in gross income in Year 1, paying $19,800 in tax and netting $30,200. *Manager*'s Year 1 post-tax compensation of $30,200 has a

[38] That is, the investment produces income. IRC § 61(a)(4).

[39] For Example 1 and Example 3, the investment would be actual; for Example 2, the investment could be either actual or notional.

[40] This is determined using *Corporation*'s 3.25% post-tax rate of return (5% less the 35% corporate tax rate).

[41] It would not be uncommon, in the case of a nonqualified retirement plan, for *Corporation* to determine investment earnings on the basis of *Corporation*'s pretax rate of return. That effectively commits *Corporation* to pay *Manager* additional compensation equal to the difference between the pretax rate of return and the after-tax rate of return.

Year 20 value of $52,772.[42] *Corporation* deducts $50,000 in Year 1, yielding a Year 1 tax saving for *Corporation* of $17,500. *Corporation*'s Year 1 post-tax cost of $32,500 has a Year 20 value of $61,615.[43]

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

TABLE 1
Summary of *Manager* Income and *Corporate* Expense

	Tax-Qualified Retirement Plan	*Nonqualified Retirement Plan*	*No Deferral*
Year 20 Post-Tax Cost of *Corporation*'s Compensation Expense	($61,615)	($61,615)	($61,615)
Year 20 Post-Tax Value of *Manager*'s Income	$80,130	$57,254	$52,772

In all three examples, the Year 20 post-tax cost to *Corporation* of the Year 1 $50,000 compensation expense is the same ($61,615). But the Year 20 post-tax value to *Manager* of the $50,000 compensation earned in Year 1 is greater under the tax-qualified plan ($80,130) than under the nonqualified plan ($57,254). This difference in outcomes derives from the different tax treatment of investment returns under tax-qualified and nonqualified retirement plans. Under the tax-qualified plan, investment income on the retirement pay is not taxed during the deferral period, so it accumulates at a pretax rate of return. Under the nonqualified plan, deferral of *Corporation's* deductions subjects the investment income on the retirement pay to current taxation during the deferral period at *Corporation's* marginal tax rate of 35%, thereby yielding a smaller accumulation and a smaller payment to *Manager*.

No less significantly, the Year 20 post-tax value to *Manager* of the $50,000 compensation earned in Year 1 is greater in the case of the

[42] This is determined using *Manager*'s 2.83% post-tax rate of return. The 2.83% post-tax rate of return reflects the imposition of ordinary income tax (at a rate of 39.6%) and the surtax on investment income (at a rate of 3.8%).

[43] This is determined using *Corporation*'s 3.25% post-tax rate of return.

nonqualified plan ($57,254) than in the case of no deferral ($52,772), although the difference here is smaller. The reason is simple. In both cases, investment earnings on the $50,000 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 nonqualified plan, the investment earnings are taxed to *Corporation* at its rate of 35%. In the case of no deferral, the investment earnings are taxed to *Manager* at her rate of 43.4% (reflecting both the individual income tax and the surtax on investment income). The difference in tax rates yields a 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 over both deferral through nonqualified plans and no deferral at all. Most public corporations in fact maintain tax-qualified plans for their employees. But the tax law sharply limits the amounts that can be deferred through tax-qualified plans, effectively constraining the extent to which managers and corporations can satisfy that preference. Nonqualified retirement plans enable corporations to provide managers with retirement benefits that, because of limitations under the Code, cannot be paid from tax-qualified retirement plans.

Tax-qualified plans fall into two broad categories: defined benefit plans (which include traditional pension plans) and defined contribution plans (which include 401(k) plans).[44] Under a defined benefit plan, the corporation promises to pay the employee a specific amount at a specific time.[45] Typically, the payment is expressed as a single-life annuity beginning at the employee's retirement.[46] 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.[47] 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.[48] Typically, the payment is expressed as a lump sum payable at the employee's retirement, although that lump sum may be convertible by the employee into installment or annuity payments.[49]

---

[44] Am. Bar Ass'n, Sec. of Labor and Employment Law, Employee Benefits Law 5-5 to 5-7 (3d ed. 2012).

[45] Id. at 5-8.

[46] Id.

[47] Id. at 5-84 to 5-85.

[48] Id. at 5-7 to 5-8.

[49] Id. at 5-84 to 5-85.

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, § 415 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.[50] The inflation-adjusted § 415 limits currently stand at $215,000 (or the amount of the employee's compensation, if smaller) for annual payments from a defined benefit plan[51] and $54,000 (or the amount of the employee's compensation, if smaller) for annual contributions to a defined contribution plan.[52] Other limits apply as well. Under the inflation-adjusted limit of § 401(a)(17), a tax-qualified retirement plan must disregard an employee's compensation over $270,000 in determining benefits from a defined benefit plan or contributions to a defined contribution plan.[53] Under the inflation-adjusted limit of § 402(g), an employee participating in a 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).[54] Under § 401(a)(4), a tax-qualified plan may not discriminate in favor of highly compensated employees.[55] That nondiscrimination 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.[56] And §§ 401(k)(3) and 401(m) set out specialized nondiscrimination rules for tax-qualified plans that provide for employee pretax salary-reduction contributions, employee

---

[50] Congress enacted § 415 as part of the Employee Retirement Income Security Act of 1974, Pub. L. No. 93-406, 88 Stat. 829, 979. See generally H.R. Rep. No. 93-1280, at 343-48, reprinted in 1974-3 C.B. 415, 504-09; H.R. Rep. No. 93-807, at 35-37, 110-26, reprinted in 1974-3 Supp. C.B. 236, 270-72, 345-61; H.R. Rep. No. 93-779, at 34-37, 108-24, reprinted in 1974-3 C.B. 244, 277-80, 351-67; S. Rep. No. 93-383, at 118-29, reprinted in 1974-3 Supp. C.B. 80, 197-208 (1973); see also James A. Wooten, The Employee Retirement Income Security Act of 1974: A Political History 89, 100, 112, 260, 266-67 (2004). Prior to 1974, the IRS had asserted benefit limitations on tax-qualified retirement plans as an administrative matter. See, e.g., Rev. Rul. 72-3, 1972-1 C.B. 105 (obsoleted because the ruling position is covered by ERISA).

[51] IRC § 415(b); Notice 2016-62, 2016-46 I.R.B. 725.

[52] IRC § 415(c); Notice 2016-62, note 51.

[53] IRC § 401(a)(17); Notice 2016-62, note 51.

[54] IRC § 402(g); Notice 2016-62, 2016-46 I.R.B. 725.

[55] IRC § 401(a)(4).

[56] See generally Reg. §§ 1.401(a)(4)-1 to -13; Felicia A. Finston & Mark A. Bodron, Plan Qualification—Pension and Profit-Sharing Plans, 351-6th Tax Mgmt. Portfolio (BNA) § IX; Am. Bar Ass'n, note 44, at 5-37 to 5-40.

post-tax salary-reduction contributions, and employer matching contributions.[57]

These limitations significantly reduce the benefits that otherwise could 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 equal to the product of 2% 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 twenty-five years.[58] The intended effect of the formula is to provide any employee who works for the corporation for twenty-five years or more with an annual pension equal to 50% of the employee's pay. But under the compensation limit of § 401(a)(17), the plan could not pay out a single-life annuity of more than $135,000 to any employee.[59] A rank-and-file employee who works for the corporation for twenty-five years and whose compensation is $80,000 would be entitled to a single-life annuity of $40,000—an amount well within the § 401(a)(17) limit. By contrast, a manager who works for the corporation for twenty-five years and whose compensation is $4 million would be entitled to a single-life annuity of $2 million—an amount well in excess of the § 401(a)(17) limit. The limit therefore reduces the single-life annuity payable to the manager from $2 million to $135,000—a very substantial reduction. The tax limitations have similar effects under tax-qualified defined contribution plans.

For this reason, it is commonplace among public corporations to use nonqualified plans to supplement the benefits provided under tax-qualified plans. A standard use of a nonqualified defined benefit plan is to restore the benefits lost under the tax-qualified defined benefit plan by reason of the §§ 415, 401(a)(17), and 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 $135,000 and a single-life annuity from the corporation's nonqualified plan of $1,865,000, for a total equal to the $2 million annual payments that the manager would have received from the tax-qualified plan in the absence of §§ 415 and 401(a)(17). Similarly, a nonqualified defined contribution plan may supplement a corporation's tax-qualified defined contribution plan, restoring the benefits lost by reason of the limitations under §§ 415, 401(a)(17), 402(g), 401(a)(4), 401(k)(3), and

[57] IRC § 401(k)(3), (m).

[58] Cf. Sundaram & Yermack, note 1, at 1560-61.

[59] Calculated as follows: 0.02 x $270,000 x 25. Although the § 415 limit would allow a single-life annuity of up to $215,000, the combined effect of the compensation limit under IRC § 401(a)(17) and the plan's benefit formula produces a maximum benefit of only $135,000.

401(m). That said, nonqualified defined contribution plans also often function as stand-alone arrangements, allowing or even requiring a manager to defer salary, bonus, stock-option gains, and other compensation.

It is difficult to determine precisely the strength of the link between tax-qualified plans and nonqualified plans. It may be, for instance, that a corporation would provide nonqualified retirement pay to a manager in any event and that the corporation models its nonqualified retirement pay on its tax-qualified plan as a matter of convenience. But there are good reasons to conclude otherwise. First, as indicated above, both managers and corporations have strong tax reasons to prefer tax-qualified plans to nonqualified plans. It thus makes sense for a corporation to provide deferred compensation through a nonqualified retirement plan only to the extent that deferred compensation is unavailable through a tax-qualified plan. Second, as indicated below,[60] corporations often tether the benefit formulae under their nonqualified plans to the benefit formulae under their tax-qualified plans. For example, a corporation ordinarily computes benefits under a nonqualified plan as the difference between the benefits that would be payable under the tax-qualified plan in the absence of the benefit limitations and the benefits actually payable under the tax-qualified plan. Third, survey evidence indicates that corporations themselves identify the benefit limitations on tax-qualified plans as the most common justification for nonqualified retirement pay. In various surveys, between 75% and 90% of companies report that they provide their managers with nonqualified retirement pay for the purpose of supplementing the benefits payable under their tax-qualified plans.[61] Fourth, as corporations have curtailed sharply their use of tax-qualified defined benefit plans, they have also curtailed sharply their use of nonqualified defined benefit plans[62]—plainly implying that the rationale for the latter is to supplement the benefits provided under the former.

[60] See Subsection II.C.1.

[61] Principal Fin. Group, 2015 Trends in Nonqualified Deferred Compensation 3 (June 2016), https://secure02.principal.com/publicvsupply/GetFile?fm=BB10711&ty=VOP&EXT=.VOP; Principal Fin. Group, 2014 Nonqualified Deferred Compensation Survey Results: Plan Sponsor & Plan Participant Select Findings 4 (2015); MullinTBG, note 4, at 2-3; HayGroup, Executive Benefits Survey: Results of the 2011 Executive Retirement Benefits & Perquisites Survey 4 (2011), http://www.haygroup.com/downloads/us/2011_Hay_Group_Executive_Benefits_Survey_Findings_with_brand_cover_(2).pdf.

[62] See, e.g., The Newport Group, note 4, at 40-41; see also HayGroup, note 61, at 3.

B. *Taxes and the Motivation for Deferring Compensation*

Several tax rules provide motivating reasons for both the manager and the corporation to defer payment of the manager's compensation. As described below, these include the taxation of investment returns on nonqualified retirement pay at corporate tax rates, the $1 million limitation on the corporation's compensation deduction, and the federal prohibition on state taxation of nonqualified retirement pay received by nonresidents.

1. *Reducing Taxation of Investment Returns*

The deferral of compensation under a nonqualified retirement plan permits the substitution of a corporation's lower tax rates for a manager's higher tax rates. As discussed above, federal tax law requires that any nonqualified retirement pay be held as general corporate assets, subject at all times to the claims of the corporation's creditors.[63] For this reason, any investment returns on those assets are taxed to the corporation, not the manager. This provides a tax advantage if the corporate tax rate is lower than the individual tax rate[64] or if the corporation has operating losses to offset current income.[65] Compared to an investment of current compensation by the manager, an investment through a nonqualified plan at the corporation's lower tax rate yields a larger accumulation, ceteris paribus.[66]

Of course, individual and corporate marginal tax rates have changed over time. During the post-war years, the top corporate marginal tax rate has been as high as 52.8% (for 1968 and 1969) and as low as 34% (from 1987 to 1993), and the top individual marginal tax rate has been as high as 92% (for 1952 and 1953) and as low as 28% (from 1988 to 1990).[67] Table 2 shows the highest corporate marginal tax rates and the highest individual marginal tax rates over the last fifty years. With the exception of the years after the Tax Reform Act of 1986[68] and the decade following the tax cuts of the early 2000's, the

---

63 See note 22 and accompanying text.

64 Scholes et al., note 4, at 204-05.

65 Halperin, note 25, at 540.

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

67 Federal Corporate Income Tax Rates, Income Years 1909–2012, Tax Found. (July 6, 2012), http://taxfoundation.org/article/federal-corporate-income-tax-rates-income-years-1909-2012; IRC § 11(b)(1)(D); Federal Individual Income Tax Rates History: Nominal Dollars: Income Years 1913–2013, Tax Found. (Oct. 17, 2013), http://taxfoundation.org/sites/taxfoundation.org/files/docs/fed_individual_rate_history_nominal.pdf; IRC § 1(a)–(d).

68 Pub. L. No. 99–514, 100 Stat. 2085.

top corporate marginal tax rate has always been lower than the top individual marginal tax rate, although the difference between the two has been narrower in recent years than it was before the tax cuts of the early 1980's.

TABLE 2
Historical Differences in Corporate and Individual Marginal Tax Rates

Year	*Highest Corporate Marginal Tax Rate*	*Highest Individual Marginal Tax Rate*	*Difference*
1967	48	70	(22.0)
1968	52.8	70	(17.2)
1969	52.8	70	(17.2)
1970	49.2	70	(20.8)
1971	48	70	(22.0)
1972	48	70	(22.0)
1973	48	70	(22.0)
1974	48	70	(22.0)
1975	48	70	(22.0)
1976	48	70	(22.0)
1977	48	70	(22.0)
1978	48	70	(22.0)
1979	46	70	(24.0)
1980	46	70	(24.0)
1981	46	70	(24.0)
1982	46	50	(4.0)
1983	46	50	(4.0)
1984	46	50	(4.0)
1985	46	50	(4.0)
1986	46	50	(4.0)
1987	34	38.5	(4.5)
1988	34	28	6.0
1989	34	28	6.0
1990	34	28	6.0
1991	34	31	3.0
1992	34	31	3.0
1993	34	39.6	(5.6)
1994	35	39.6	(4.6)
1995	35	39.6	(4.6)
1996	35	39.6	(4.6)
1997	35	39.6	(4.6)
1998	35	39.6	(4.6)
1999	35	39.6	(4.6)
2000	35	39.6	(4.6)
2001	35	39.1	(4.1)
2002	35	38.6	(3.6)
2003	35	35	0
2004	35	35	0
2005	35	35	0
2006	35	35	0
2007	35	35	0
2008	35	35	0

2009	35	35	0
2010	35	35	0
2011	35	35	0
2012	35	35	0
2013	35	39.6	(4.6)
2014	35	39.6	(4.6)
2015	35	39.6	(4.6)
2016	35	39.6	(4.6)

The differences in tax rates also vary for different types of investment income. Currently, the highest corporate income tax rate for ordinary income and short-term capital gains (35%)[69] is 4.6 percentage points below the highest individual income tax rate for ordinary income and short-term capital gains (39.6%).[70] Interest earned on nonqualified 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%) is 9.5 percentage points below the highest individual income tax rate (20%).[71] The situation generally is reversed for long-term capital gains. The highest corporate income tax rate for long-term capital gains (35%)[72] is 15 percentage points higher than the corresponding highest individual income tax rate (20%).[73] But the corporation is not taxed at all on long-term capital gains and dividends attributable to the corporation's own stock if the stock is held by the corporation.[74] Table 3 summarizes these differences in marginal tax rates:

[69] IRC § 11(b).

[70] IRC § 1(a)-(d). This ignores the effect of the overall limit on itemized deductions under § 68; where applicable, that limit effectively increases the manager's tax rate.

[71] Although the marginal income tax rate on dividend income received by a corporation is 35%, a corporation can take a dividends received deduction of 70% of the dividend amount received from any corporation (thus, 10.5% = 35% * (1 - 70%)), and up to 100% if the recipient corporation has a larger ownership stake. IRC § 243; see also Chason, note 29, at 379.

[72] IRC § 11(d).

[73] IRC § 1(h)(1)(D).

[74] IRC § 1032; see Halperin, note 25, at 540 n.133; Eric D. Chason, Quantifying the Tax Advantage of Deferred Compensation, 1 N.Y.U. Rev. Emp. Benefits & Executive Compensation §§ 8.05-8.06 (2008).

TABLE 3
Differences in Marginal Tax Rates for Designated Investment Income (Income Tax Only)

Investment Income	*Corporate Tax Rate*	*Individual Tax Rate*	*Rate Difference*
Interest	35	39.6	(4.6)
Short-Term Capital Gain	35	39.6	(4.6)
Long-Term Capital Gain (other than corporation's own stock)	35	20	15
Dividend (other than corporation's own stock)	10.5	20	(9.5)
Long-Term Capital Gain (corporation's own stock)	0	20	(20)
Dividend (corporation's own stock)	0	20	(20)

Nonqualified retirement pay thus can provide 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 nonqualified 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% on those income types; the corporation pays no tax at all on them.

Beginning in 2013, there is a further rate difference attributable to the surtax imposed on net investment income. Enacted in the 2010 federal healthcare reform law[75] and formally part of the Medicare system, this tax is a 3.8% levy on the net investment income of moderate- and high-income taxpayers.[76] Thus, any interest, short-term capital gains, long-term capital gains, and dividends received directly by a manager are subject to a 3.8% surtax.[77] But interest, short-term capital gains, long-term capital gains, and dividends received by a corporation do not incur the surtax.[78] Incorporating this surtax into Table 3 gives the following results:

[75] Health Care and Education Reconciliation Act of 2010, Pub. L. No. 111–152, 124 Stat. 1029, 1061–62 (codified as amended at IRC § 1411).

[76] IRC § 1411(a).

[77] IRC § 1411(c).

[78] IRC § 1411(a).

TABLE 4
Differences in Marginal Tax Rates for Designated Investment Income (Income Tax and Investment-Income Surtax)

Investment Income	*Corporate Tax Rate*	*Individual Tax Rate*	*Rate Difference*
Interest	35	43.4	(8.4)
Short-Term Capital Gain	35	43.4	(8.4)
Long-Term Capital Gain (other than corporation's own stock)	35	23.8	11.2
Dividends (other than corporation's own stock)	10.5	23.8	(13.3)
Long-Term Capital Gain (corporation's own stock)	0	23.8	(23.8)
Dividends (corporation's own stock)	0	23.8	(23.8)

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.

Even so, a focus on marginal tax rates understates the potential tax advantage of nonqualified retirement pay. Many corporations have an effective tax rate of zero for specific years because of operating losses that offset all other income. A recent study by the Government Accountability Office determined that "at least two-thirds of active U.S. corporations had no federal income tax liability" for each of the seven years from 2006 to 2012.[79] Although the study found that the likelihood of having tax liability increases with corporate size, 42.3% of corporations with assets of at least $10 million paid no federal income tax in 2012, and 19.5% of large corporations that reported book profits in 2012 paid no federal income tax for that year.[80] Even some of the biggest corporations—including General Electric, Boeing, and Verizon—had no federal income tax liability for the five years from 2008 to 2012, and more than 100 of the Fortune 500 companies reporting book profits had no federal income tax liability in at least one of those five years.[81] Because operating losses reduce the corporation's effective tax rate to zero, the corporation effectively becomes a tax-

[79] Gov't Accountability Office, Corporate Income Tax: Most Large Profitable U.S. Corporations Paid Tax But Effective Tax Rates Differed Significantly from the Statutory Rate 10 (2016), http://www.gao.gov/assets/680/675844.pdf.

[80] Id.

[81] Fact Sheet: Corporate Tax Rates, Tax Fairness Briefing Booklet, Americans for Tax Fairness, Aug. 2014, at 18, http://americansfortaxfairness.org/files/Tax-Fairness-Briefing-Booklet.pdf.

exempt vehicle for the investment of nonqualified retirement pay during its loss years.[82] The manager's deferred compensation accumulates at a pretax rate of return, just as it would if held in a tax-qualified plan.

To see the effect of the corporation's operating losses on the manager's investment returns, consider Table 5, which reproduces the information from Table 1 with modifications. The second column still shows the corporation's expense ($61,615) and the manager's income ($80,130) in the case of a tax-qualified plan. The third column still shows the corporation's expense ($61,615) and the manager's income ($57,254) in the case of a nonqualified plan maintained by a corporation with positive tax liability for all investment income. But the fourth column now shows the corporation's expense ($61,615) and the manager's income ($80,130) in the case of a nonqualified plan maintained by a corporation that has operating losses throughout the deferral period (which could include net operating loss carrybacks and carryforwards). The use of the corporation's operating loss to offset all other income confers a substantial tax advantage for the corporation's nonqualified retirement pay.[83]

TABLE 5
Summary of Manager Income and Corporate Expense

	Tax-Qualified Retirement Plan	*Nonqualified Retirement Plan (No Operating Loss)*	*Nonqualified Retirement Plan (Operating Loss)*
Year 20 Post-Tax Cost of Corporation's Compensation Expense	($61,615)	($61,615)	($61,615)
Year 20 Post-Tax Value of Manager's Income	$80,130	$57,254	$80,130

[82] See Halperin, note 25, at 540.

[83] David Walker acknowledges this point but notes that "[f]urther work is needed to determine how widespread a problem this really is" and argues that, in any event, "[p]resumably, few firms expect to be in a sustained loss position." David I. Walker, The Practice and Tax Consequences of Nonqualified Deferred Compensation 35 (Bos. Univ. Sch. of Law, Working Paper No. 16–27, 2016), https://www.bu.edu/law/files/2016/08/NQDC-SSRN.pdf. But it is hardly necessary for a corporation to have an operating loss for every year of a manager's deferral period in order for the deferral to reduce the aggregate tax burden on the investment income. Even if the corporation and the manager had identical marginal tax rates for investment income, nonqualified retirement pay would present a meaningful tax advantage if the corporation paid no federal income tax on its investment income for just a few of the taxable years during the deferral period.

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. Nonqualified retirement pay is taxed at the corporate tax rate throughout the deferral period. In most cases, the corporate marginal tax rate is lower than the individual marginal tax rate, giving the corporation and the manager good reason to prefer deferral over current compensation.[84] 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.[85] And for any year in which the corporation has an operating loss—or to which the corporation can carry back or forward a net operating loss from another year—the corporation becomes a vehicle for the tax-exempt investment of the manager's nonqualified retirement pay. In such circumstances, the potential investment returns on nonqualified retirement pay can match the potential investment returns under tax-qualified plans.[86]

2. *Avoiding the $1 Million Deduction Limitation*

Under § 162(m), a public corporation generally may not deduct compensation in excess of $1 million paid in any year to one of its most senior managers.[87] This deduction limitation favors deferral of the manager's pay because it applies only for the period of the manager's employment.[88] 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

[84] Ethan Yale argues that the tax benefit attributable to the difference in manager and corporate marginal tax rates is smaller than ordinarily assumed. Specifically, he argues that the true tax benefit "is, at most, an incremental yield throughout the deferral period equal to the product of the after-tax risk-free rate of return and the employee's marginal tax rate." Ethan Yale, Investment Risk and the Tax Benefit of Deferred Compensation, 62 Tax L. Rev. 377 (2009). His argument relies on the assumptions applicable to the Domar-Musgrave model, including the symmetrical taxation of gains and losses. Id. at 391-94. See generally Evsey D. Domar & Richard A. Musgrave, Proportional Income Taxation and Risk-Taking, 58 Q.J. Econ. 388 (1944).

[85] For a contrary argument, see Chason, note 29, at 381, 378-82 (presenting "a prima facie case that corporations have no tax advantage in investing.").

[86] Walker correctly points out that, even if the corporation otherwise has federal tax liability, the corporation may earn a pretax rate of return on nonqualified retirement pay invested through corporate-owned life insurance. Walker, note 83, at 4. But the manager also could invest at a pretax rate of return under a life insurance contract (and, unlike a corporation, could also invest at a pretax rate of return under a deferred annuity contract). Of course, earning a pretax rate of return through an insurance product comes at a cost because the issuer will charge fees that offset some percentage of the tax savings.

[87] IRC § 162(m)(1). The compensation addressed by § 162(m) is limited to that of the chief executive officer and the three "highest compensated officers for the taxable year (other than the chief executive officer)." IRC § 162(m)(3).

[88] Id.

to the § 162(m) limitation.[89] 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[90]—induces a rational preference on the corporate side for deferring manager pay.

Congress enacted § 162(m) in 1993[91] to discourage what legislators considered aggressive pay practices.[92] 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.[93] 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 predetermined performance benchmark, such as an increase in the corporation's share price or an increase in the corporation's revenues or profits.[94] Although the exception for performance-based compensation has attracted significant attention as a possible trigger for the heavy use of stock options in manager-pay arrangements,[95] it would not directly affect the decision to defer manager compensation.

---

[89] See notes 96–99 and accompanying text. IRC § 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.

[90] See, e.g., Judith E. Alden & Murray S. Akresh, Using Equity to Compensate Executives, in Executive Compensation 67, 119 (Yale D. Tauber & Donald R. Levy eds., 2002); Eric D. Chason, Executive Compensation and Tax Neutrality: Taxing the Investment Component of Deferred Compensation, 31 Cardozo L. Rev. 1667, 1680 (2010) ("A significant attraction of deferred compensation is avoiding the § 162(m) limit."); Chason, note 29, at 370-71, 377-78, 388-90; Meredith R. Conway, Money for Nothing and the Stocks for Free: Taxing Executive Compensation, 17 Cornell J. L. & Pub. Pol'y 383, 411–14 (2008); Joy Sabino Mullane, The Unlearning Curve: Tax-Based Congressional Regulation of Executive Compensation, 60 Catholic U. L. Rev. 1045, 1061 (2011) (discussing how nonqualified deferred compensation plans "allow[ ] companies to avoid the § 162(m) deduction limit").

[91] Revenue Reconciliation Act of 1993, Pub. L. No. 103–66, § 13211, 107 Stat. 416, 469–71 (codified as amended at IRC § 162(m)).

[92] David M. Schizer, Tax Constraints on Indexed Options, 149 U. Pa. L. Rev. 1941, 1942 (2001); Olson Statement, note 16.

[93] IRC § 162(m)(4)(C); see Conway, note 90, at 397; Schizer, note 92, at 1942.

[94] Reg. § 1.162-27(e).

[95] See, e.g., Aspen Gorry, Kevin A. Hassett, R. Glenn Hubbard & Aparna Mathur, The Response of Deferred Executive Compensation to Changes in Tax Rates, J. Pub. Econ. (forthcoming 2017), http://www.sciencedirect.com/science/article/pii/S0047272715001383; Olson Statement, note 16; Lucian Arye Bebchuk, Jesse M. Fried & David I. Walker, Managerial Power and Rent Extraction in the Design of Executive Compensation, 69 U. Chi. L. Rev. 751, 791–92 (2002); Tod Perry & Marc Zenner, Pay for Performance? Government Regulation and the Structure of Compensation Contracts, 62 J. Fin. Econ. 453 (2001).

By contrast, the exception from § 162(m) for post-employment payments can affect that decision. Section 162(m) disallows the corporation's deduction only for compensation paid to a "covered employee."[96] 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 shareholders under the Securities Exchange Act of 1934.[97] A corporation's covered employees, then, are the senior managers whose pay must be reported on what the Securities and Exchange Commission (SEC) calls the "summary compensation table."[98] Importantly, this includes only current employees of the corporation; it does not include former employees.[99] Furthermore, § 162(m) only reaches amounts that otherwise would be deductible by the corporation during a year in which a manager is a covered employee.[100] Under the Code, nonqualified retirement pay is deductible by the corporation when it is paid out to a manager, not when it is earned by the manager.[101] In other words, nonqualified retirement pay distributed after the manager has retired or otherwise terminated employment simply escapes the deduction limitation of § 162(m) even though it was earned while the manager was a current employee.[102]

---

[96] IRC § 162(m)(3).

[97] Id. Because of a regulatory change made by the Securities and Exchange Commission in 2006, the IRS now interprets § 162(m)(3) as reaching only four managers, rather than five. See Notice 2007-49, note 97.

[98] SEC Reg. S-K, Item 402, 17 C.F.R. § 229.402 (2015); Reg. § 1.162-27(c)(2)(ii).

[99] The Treasury regulations, an IRS notice, and the SEC regulations all are perfectly clear on this point. The regulations provide that 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)." Reg. § 1.162-27(c)(2)(i) (emphasis added). Notice 2007-49, which takes account of a later regulatory change by the SEC, 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." Notice 2007-49, note 97 (emphasis added). Finally, under Item 402 of the SEC regulations, 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." SEC Reg. S-K, Item 402, 17 C.F.R. § 229.402(a)(3) (2015).

[100] Reg. § 1.162-27(c)(3).

[101] IRC § 404(a)(5); Albertson's, Inc. v. Commissioner, 42 F.3d 537, 546 (9th Cir. 1994).

[102] The requirement that the manager's accrual of nonqualified 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 important 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 2017 taxable year. Outright payment of $21 million as salary would trigger § 162(m), and the corporation would lose a $20 million deduction. At a corporate marginal tax rate of 35%, that $20 million deduction has an after-tax value to the corporation of $7 million. In many cases, the corporation may pay the $21 million salary and simply forfeit the $20 million deduction.[103] But the corporation could avoid losing the deduction by making $20 million of the CEO pay contingent on a predetermined performance benchmark. Or the corporation could pay all or part of the otherwise nondeductible compensation after the CEO is no longer employed by the corporation. Specifically, the corporation could pay him $1 million of current salary in 2017 and credit the remaining $20 million to a nonqualified retirement plan under which payment will be made following his retirement or other termination of employment.[104]

From the corporation's perspective, such deferral is an important mechanism for avoiding the $1 million compensation limitation. A manager *accrues* nonqualified retirement pay while she is a covered employee and while her compensation is subject to § 162(m), but the manager *receives* the nonqualified retirement pay once she is no longer a covered employee and once her compensation is no longer subject to § 162(m). The company thereby pays the manager nonperformance compensation in excess of $1 million and preserves its full tax deduction. Although the corporate-governance literature has attributed the widespread use of stock options, at least in part, to the exception under § 162(m) for performance-based compensation, the literature somehow generally has overlooked the parallel point that the widespread use of nonqualified retirement pay may be attributable, at least in part, to the exception under § 162(m) for compensation paid to former managers.[105]

3. *Avoiding State Income Taxes*

Section 162(m) provides the corporation with an incentive for deferring a manager's pay; state income taxes provide the manager with

---

[103] See generally Michael Doran, Uncapping Executive Pay, 90 S. Cal. L. Rev. (forthcoming 2017).

[104] Others have noted that nonqualified retirement pay resembles salary much more than it resembles performance-based compensation. See, e.g., Bebchuk & Jackson, note 8, at 849–51.

[105] But see Divya Anantharaman & Vivian W. Fang, Executive Debt-Like Compensation in Corporate Governance: Recent Developments and New Trends 139, 149 (Sabri Boubaker, Bang Dang Nguyen & Duc Khuong Nguyen eds., 2012).

a strong incentive for deferral as well. Deferring compensation under a nonqualified 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 after employment. That has the effect, under federal law, of completely pre-empting the high-tax state's taxation of her nonqualified retirement pay. As with § 162(m), the critical point is to push the compensation beyond the end of the manager's employment.

Under Public Law 104-95,[106] 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.[107] The statute defines "retirement income" to include nonqualified retirement pay if the nonqualified retirement pay supplements a tax-qualified retirement plan (or if it is distributed as an annuity or in long-term installments).[108] The effect of this provision is to preclude taxation by the state (or states) that would have taxed the compensation if it had been paid when earned.[109] For example, assume that a manager lives in New Jersey, works for twenty-five years at a corporation in New York, and accrues $50 million under a nonqualified plan that supplements the corporation's tax-qualified plan. In 2016, she retires from the corporation and moves to Florida. In 2017, she receives a lump-sum distribution of her $50 million nonqualified retirement pay. Both New Jersey and New York have state income taxes. The highest marginal tax rate in New Jersey is 10.75%,[110] and the highest marginal tax rate in New York is 8.82%.[111] If New Jersey taxed the manager's $50 million distribution, it would collect $5,375,000 from her. If New York taxed her $50 mil-

[106] Pub. L. No. 104-95, 109 Stat. 979 (1996) (codified as amended at 4 U.S.C. § 114 (1996)).

[107] 4 U.S.C. § 114(a).

[108] 4 U.S.C. § 114(b).

[109] See, e.g., N.Y. Dep't of Tax'n and Fin., Advisory Opinion Petition No. I120515A (Apr. 8, 2013), https://www.tax.ny.gov/pdf/advisory_opinions/income/a13_5i.pdf (treating lump sum payment of income earned out of state as "nontaxable retirement income"); Ill. Dep't of Revenue, Letter No. IT 06-0005-GIL (Apr. 6, 2006), http://www.revenue.state.il.us/LegalInformation/LetterRulings/it/2006/ig060005.pdf (finding that gain recognized on the exercise of options issued for services rendered in the state and subsequently exercised in the state was taxable in the state); Ill. Dep't of Revenue, Letter No. IT 06-0001-GIL (Jan. 3, 2006), http://www.revenue.state.il.us/LegalInformation/LetterRulings/it/2006/ig060001.pdf (excluding pension income earned by nonresident from state income); see also Commissioner of Revenue v. Oliver, 436 Mass. 467, 468 n.4 (2002) (noting that "taxpayer's nonqualified pension income is not taxable in Massachusetts after 1995 due to the enactment of [4 U.S.C. § 114].").

[110] N.J. Rev. Stat. § 54A:2-1a (West Supp. 2016).

[111] N.Y. Tax Law § 601(b)(1)(A) (McKinney 2014).

lion distribution, it would collect $4,100,000 in tax from her.[112] But Public Law 104-95 prevents New Jersey and New York from taxing the payment at all. Instead, Florida has the sole power to tax the manager's $50 million nonqualified 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.[113]

C. *Taxes and the Contractual Terms of Nonqualified Retirement Plans*

Tax considerations explain more than the basic decision to defer compensation; they also account for the contractual terms under which compensation is deferred, held, and ultimately paid out. Here, the corporate governance literature exhibits general unfamiliarity with the terms of nonqualified retirement plans.[114] Most studies focus primarily or even exclusively on the amounts of nonqualified retirement pay attributable to specific managers.[115] Even when the literature does examine the contractual terms of nonqualified plans, critical concepts are misunderstood, misinterpreted, or missed altogether.[116] A notable exception here is an excellent recent article by Robert Jackson and Colleen Honigsberg, which sets out an empirical study of the contractual terms of nonqualified plans but which nonetheless fails to consider the tax basis for those terms.[117]

1. *The Benefit Formula*

The centerpiece of any nonqualified retirement plan is the benefit formula. That formula determines the amount of compensation deferred and, in the case of a defined contribution arrangement, the

---

[112] Of course, if the manager had not deferred the $50 million in compensation, it would have been taxed to her at the marginal rates in effect during the years when she earned the compensation.

[113] Shortly after enactment of Public Law 104-95, the Congressional Research Service noted that "[s]tate tax administrators are troubled that the new law creates a loophole for individuals to avoid taxation by deferring large amounts of their compensation until retirement, and then moving to a state with no income tax." Nonna A. Noto, Cong. Research Serv., 96-167 E, Source Taxes: Congress Prohibits State Taxation of Nonresident Pension Income, at CRS-3 (1996).

[114] See, e.g., Lucian A. Bebchuk & Robert J. Jackson, Jr., Executive Pensions, 30 J. Corp. Law 823 (2005); Lucian A. Bebchuk & Jesse M. Fried, Stealth Compensation Via Retirement Benefits, 1 Berkeley Bus. L.J. 291 (2004).

[115] See, e.g., Lucian A. Bebchuk & Robert J. Jackson, Jr., Executive Pensions, 30 J. Corp. Law 823 (2005).

[116] See, e.g., notes 175-82 and accompanying text.

[117] Jackson & Honigsberg, note 6. The article is discussed in more detail in Sections III.B and III.C.

amount of actual or notional investment gains and losses credited to or debited from the nonqualified retirement pay.[118] In many cases, the benefit formula in a corporation's nonqualified plan simply tracks the benefit formula in the corporation's tax-qualified plan.[119] This follows straightforwardly from tax considerations. First, the nonqualified plan in many cases supplements payments under the tax-qualified plan. The nonqualified plan therefore uses the benefit formula of the tax-qualified plan but ignores the limitations of §§ 401(a)(4), 401(a)(17), 401(k)(3), 401(m), 402(g), and 415 of the Code. Second, Public Law 104-95, under which a manager may avoid state income taxes on distributions from a nonqualified plan, generally requires coordination of the benefit formula in the nonqualified plan with the benefit formula in the corporation's tax-qualified plan. Specifically, one of the categories exempted from source-state taxation under Public Law 104-95 requires that the nonqualified plan be "maintained *solely* for the purpose of providing retirement benefits for employees in excess of [the benefit limitations in the Code]."[120]

2. *Participation*

Corporations invariably restrict participation in nonqualified plans to a select group of managers and other high-paid employees—known as a "top-hat group"—thereby excluding rank-and-file employees.[121] This practice is strictly a function of the tax law; it is not a matter of corporate choice. The principal federal pension statute, the Employee Retirement Income Security Act of 1974 (ERISA),[122] generally mandates that any plan deferring the compensation of rank-and-file employees satisfy minimum prefunding requirements[123] and hold its assets in a trust for the exclusive benefit of the employees.[124] But the

[118] As explained in Section II.A, no assets may be set aside under a nonqualified retirement plan from the claims of the corporation's general unsecured creditors. See note 22 and accompanying text. For this reason, investment returns on nonqualified retirement pay may be determined purely by the outcomes of notional investments recorded on the corporation's books and records. Alternatively, the corporation may make actual investments of its assets in connection with its nonqualified retirement plan, but any such investments must remain within the reach of the corporation's general unsecured creditors.

[119] See, e.g., The Newport Group, note 4, at 42.

[120] 4 U.S.C. § 114(b)(1)(I)(ii) (emphasis added).

[121] See, e.g., The Newport Group, note 4, at 17-19.

[122] 29 U.S.C. §§ 1001-1461 (2012).

[123] ERISA § 302(a), 29 U.S.C. § 1082(a) (2012); ERISA § 303(a), 29 U.S.C. § 1083(a) (2012). Under ERISA § 301(a)(3), 29 U.S.C. § 1081(a)(3), a nonqualified retirement plan covering only "a select group of management or highly compensated employees"—that is, a top-hat group—is exempt from ERISA § 302, 29 U.S.C. § 1082 (2012), and ERISA § 303, 29 U.S.C. § 1083 (2012).

[124] ERISA § 403(a), 29 U.S.C. § 1103(a) (2012). Under ERISA § 401(a)(1), 29 U.S.C. § 1101(a)(1) (2012), a nonqualified retirement plan covering only "a select group of man-

Code provides that holding such assets in an exclusive-benefit trust triggers immediate taxation for the covered employees on all vested benefits.[125] Thus, except for the very rare case in which retirement benefits for rank-and-file employees exceed the limitations under § 415 of the Code,[126] a nonqualified 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 nonqualified retirement plans by employees below the level of the most senior managers.[127] According to one recent survey, substantially all corporations with nonqualified defined contribution plans cover their chief executive officers, presidents, and vice presidents in those plans.[128] But between one-fourth and one-third of such corporations also allow participation by highly compensated sales personnel and middle-level managers.[129] And fully half of the corporations that allow participation by non-executive employees set the compensation threshold for participation between $115,000 and $150,000—thereby opening plan eligibility to employees with comparatively modest earnings.[130]

3. *Deferral Elections and Vesting*

Nonqualified defined benefit plans normally provide for the deferral of compensation on a purely nonelective basis; such plans neither permit nor require managers to choose how much, if any, compensation to defer. By contrast, nonqualified defined contribution plans often (but not always) 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, nonqualified plans require that any such election be made before the compensation is earned. For example, a plan generally would require that a manager who elects to defer base salary earned during 2018

agement or highly compensated employees"—again, a top-hat group—is exempt from ERISA § 403(a), 29 U.S.C. § 1103(a) (2012).

125 IRC §§ 402(b), 83(a); see also Rev. Rul. 2007-48, 2007-2 C.B. 129.

126 ERISA § 4(b)(5), 29 U.S.C. § 1003(b)(5) (2012), 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 § 415 of the Code. As a practical matter, then, the exemption for excess-benefit plans has no application in providing retirement benefits to rank-and-file employees.

127 Chason, note 29, at 389-90.

128 The Newport Group, note 4, at 18.

129 Id.

130 Id. at 19.

make her deferral election during 2017. Again, the defining considerations here are the applicable tax rules. Under the Code, failure to require the manager's election before the compensation is earned exposes the manager to immediate taxation, a 20% tax penalty, and an interest charge.[131]

Nonqualified 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 nonqualified retirement pay, but it also is not uncommon for them to impose a graded- or cliff-vesting schedule.[132] A nonqualified 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 nonqualified defined contribution or defined benefit plan that supplements a tax-qualified plan ordinarily 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 nonqualified plan generally tracks the vesting schedule in the tax-qualified plan.

4. *Funding and Investment*

Amounts deferred under a nonqualified plan (including investment gains) remain subject at all times to the claims of the corporation's unsecured general creditors.[133] Thus, in the event of the corporation's insolvency, the manager stands in line with the corporation's other unsecured general creditors, potentially receiving little or nothing of her nonqualified retirement pay. This feature also derives straightforwardly from tax considerations. Funding a nonqualified retirement plan—that is, setting assets beyond the reach of the corporation's unsecured general creditors—triggers immediate taxation, tax penalties, and interest charges for the manager.[134]

---

[131] IRC § 409A(a)(4). Special rules in § 409A(a)(4) slightly relax the election-timing rules for the manager's first deferral election and for any election applicable to performance-based compensation earned over a period of at least twelve months.

[132] MullinTBG, note 4, at 6; The Newport Group, note 4, at 29-31, 44-45.

[133] See note 22.

[134] See note 23. In some cases, a corporation places the assets of a nonqualified 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 distribute the nonqualified retirement pay 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 nonqualified retirement plan using a rabbi trust is treated as an unfunded plan. See generally Bruce J. Mc-

Although the nonqualified plan must remain unfunded, the corporation may invest corporate assets to mark investment growth on the nonqualified retirement pay and to hedge the risk on its payment obligation. It is common for corporations to make such investments directly or through life-insurance contracts.[135] Less commonly, corporations hold their own stock as shares designated specifically for nonqualified retirement pay,[136] although corporations often own their own stock as unallocated treasury shares. These practices have solid foundations in the tax law. As shown above, the tax rates for investment income earned by a corporation are often lower—sometimes much lower—than the tax rates for investment income earned by a manager.[137] The corporation has a lower marginal tax rate than the manager for several types of investment income, such as interest and dividends, and the corporation pays no tax on long-term capital gains and dividends attributable to its own stock.[138] Additionally, a corporation pays no tax at all on investment income for any year in which the corporation has an operating loss (or to which the corporation carries back or carries forward a net operating loss from another year).[139] Such losses are common, even for large corporations,[140] and effectively make a corporation a tax-exempt investment vehicle for nonqualified retirement pay. Finally, investments of nonqualified retirement pay through life-insurance contracts are also exempt from tax,[141] although the same tax benefit would be available to a manager. Indeed, the manager has a broader range of options for investments through insurance-company products because the manager, unlike a corporation, is not subject to current tax on any investments made through a deferred annuity.[142]

5. *Distributions*

A nonqualified plan generally provides for distribution of the manager's nonqualified retirement pay to begin only after the manager's

---

Neil, Nonqualified Deferred Compensation Plans § 6:1 (2016-2017 ed.); A. Thomas Brisendine, Elizabeth Drigotas & Thomas R. Pevarnik, Deferred Compensation Arrangements, 385–5th Tax Mgmt. Portfolio (BNA) § VIII.B. (2017).

135 The Newport Group, note 4, at 49-53; Walker, note 83, at 25-28.

136 See Wells Fargo, 2014 Wells Fargo Nonqualified Plan Benchmarking Survey 4 (2014), https://www08.wellsfargomedia.com/assets/pdf/commercial/retirement-employee-benefits/perspectives/2014-nq-study.pdf; MullinTBG, note 4, at 6; The Newport Group, note 4, at 26, 28; HayGroup, note 61, at 7; Walker, note 83, at 29-33.

137 See Subsection II.B.1.

138 See notes 69-74 and accompanying text.

139 See notes 79-82 and accompanying text.

140 See Gov't Accountability Office, note 79.

141 See Walker, note 83, at 26.

142 IRC § 72(u).

retirement or other termination of employment and ordinarily gives the manager very limited control over distribution terms.[143] For a nonqualified 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 nonqualified plan may allow the manager to elect different distribution terms).[144] For a nonqualified 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 nonqualified plan may even permit distributions while the manager is still employed.[145] Most nonqualified plans also provide for immediate distribution of all benefits following a change of corporate ownership or control.[146] Importantly, nonqualified 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 change the time or form for distributions ordinarily 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. Nonqualified retirement plans do not permit managers to accelerate distributions.[147]

Once again, there are strong tax reasons for these specific contractual terms. As shown above, avoiding the $1 million deduction limitation under § 162(m) and avoiding state income taxes require that the manager's compensation be deferred until retirement or other termination of employment.[148] 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 change distribution times and forms, and banning the acceleration of distributions derive directly from § 409A.[149] Those limitations on the manager's control over the time and form of distributions of nonqualified retirement pay are strictly necessary to avoid immediate taxation, tax penalties, and interest charges for the

[143] HayGroup, note 61, at 7; MullinTBG, note 4, at 8; The Newport Group, note 4, at 33-37, 46-47; Wells Fargo, note 136, at 5.

[144] The Newport Group, note 4, at 46-47.

[145] Id. at 33-37.

[146] Id. at 33.

[147] See MullinTBG, note 4, at 8 ("[T]he vast majority of plan sponsors offer their eligible participants a range of distribution election choices that are permitted under [§] 409A."); see also notes 16–23 and accompanying text.

[148] See Subsections II.B.2. and II.B.3.

[149] IRC § 409A(a)(2)-(4).

manager. Given the very high tax stakes, it would be startling for a nonqualified plan not to conform to the distribution rules of § 409A.

III. Competing Accounts of Nonqualified Retirement Pay

The two leading corporate-governance explanations of manager compensation—the optimal-contracting account and the managerial-power account—attribute nonqualified 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 nonqualified retirement plans 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 nonqualified plans is to ensure outsized rewards for occupying managerial positions and to insulate those rewards from underlying business risks.

Both accounts are seemingly plausible explanations of manager-pay arrangements, but both are at best only partial explanations of nonqualified retirement pay. Although they initially appear to capture certain features of nonqualified 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 nonqualified 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 show that the tax account is essential to understanding nonqualified retirement pay.

A. *Optimal Contracting*

The optimal-contracting account is reasonably straightforward. Nonqualified 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 nonqualified retirement pay is one of the corporation's unsecured general creditors. By including nonqualified 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 nonqualified retirement pay as "inside debt" (as opposed to the "outside debt" that the corporation owes to nonmanager investors, such as banks and bondholders).[150]

The optimal-contracting account considers nonqualified retirement pay to be part of the solution to the familiar agency problem in the management of publicly held corporations.[151] 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");[152] similarly, compensating managers with debt instruments, such as nonqualified retirement pay, mitigates the problem with respect to the corporation's lenders (known as the "agency costs of debt").[153]

---

[150] See, e.g., Edmans & Liu, note 1, at 75 n.1.

[151] Anantharaman & Fang, note 105; Edmans & Liu, note 1; Sundaram & Yermack, note 1; see also Alex Edmans & Xavier Gabaix, Executive Compensation: A Modern Primer, 54 J. Econ. Literature (forthcoming 2016) (manuscript at 33–34); cf. Patrick Bolton, Hamid Mehran & Joel Shapiro, Executive Compensation and Risk Taking, 19 Rev. Fin. 2139 (2015) (arguing that "deferred compensation is not as effective as using [credit default swap] based compensation" in reducing manager risk taking); Michael C. Jensen & William H. Meckling, Theory of the Firm: Managerial Behavior, Agency Costs and Ownership Structure, 3 J. Fin. Econ. 305, 352–53 (1976) (while acknowledging that debt-based compensation could theoretically solve the agency cost of debt, the use of wage income, which has some characteristics of debt, could explain why debt-based compensation is not common among larger corporations). On the broader role of compensation arrangements and the agency problem of managers in large corporations, see John E. Core, Wayne R. Guay & David F. Larcker, Executive Equity Compensation and Incentives: A Survey, 9 Fed. Res. Bank N.Y. Econ. Pol'y Rev. 27 (2003); Anne T. Coughlan & Ronald M. Schmidt, Executive Compensation, Management Turnover, and Firm Performance, 7 J. Acct. & Econ. 43 (1985); Frank H. Easterbrook, Managers' Discretion and Investors' Welfare: Theories and Evidence, 9 Del. J. Corp. L. 540 (1984); Eugene F. Fama, Agency Problems and the Theory of the Firm, 88 J. Pol. Econ. 288 (1980); Joseph G. Haubrich, Risk Aversion, Performance Pay, and the Principal-Agent Problem, 102 J. Pol. Econ. 258 (1994); Michael C. Jensen & Kevin J. Murphy, Performance Pay and Top-Management Incentives, 98 J. Pol. Econ. 225 (1990); Kevin J. Murphy, Corporate Performance and Managerial Remuneration, 7 J. Acct. & Econ. 11 (1985); Kevin J. Murphy, Executive Compensation, in 3B Handbook of Labor Economics 2485, 2519–42 (Orley Ashenfelter & David Card eds., 1999); Andrei Shleifer & Robert W. Vishny, A Survey of Corporate Governance, 52 J. Fin. 737 (1997); David I. Walker, The Law and Economics of Executive Compensation: Theory and Evidence, in Research Handbook on the Economics of Corporate Law 232 (Claire A. Hill & Brett H. McDonnel eds., 2012). The loci classici for the agency problem in public corporations are Jensen & Meckling, supra, and Adolf A. Berle & Gardiner C. Means, The Modern Corporation and Private Property (1932).

[152] See Frederick Tung & Xue Wang, Bank CEOs, Inside Debt Compensation, and the Global Financial Crisis 7–8 (Bos. Univ. Sch. of L., Working Paper No. 11–49, 2011), http://www.bu.edu/law/workingpapers-archive/documents/tungf-wangx101311.pdf.

[153] See Anantharaman & Fang, note 105, at 140; Edmans & Liu, note 1, at 76; Sundaram & Yermack, note 1, at 1553, 1555, 1580, 1583; see also Divya Anantharaman, Vivian W. Fang & Guojin Gong, Inside Debt and the Design of Corporate Debt, 60 Mgmt. Sci. 1260,

Under certain conditions, then, the use of nonqualified 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.[154] Unlike other components of manager compensation (including salary and cash bonuses), nonqualified retirement pay encourages managers to consider "not only the probability of [the corporation's] default, but also recovery values in default."[155] That is, the manager's nonqualified 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 general creditors. Including nonqualified 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."[156] Empirical studies generally suggest that including nonqualified retirement pay in the compensation of corporate managers in fact aligns the interests of managers with the interests of other corporate creditors.[157]

1276 (2014); Cassell et al., note 13, at 589; Chenyang Wei & David Yermack, Investor Reactions to CEOs' Inside Debt Incentives, 24 Rev. Fin. Stud. 3813, 3814 (2011).

[154] See Edmans & Gabaix, note 1, at 429–93; Edmans & Liu, note 1, at 77–78; Sundaram & Yermack, note 1, at 1558.

[155] Edmans & Liu, note 1, at 77.

[156] Id.

[157] See, e.g., Anantharaman et al., note 153; Sjoerd van Bekkum, Inside Debt and Bank Risk, 51 J. Fin. & Quantitative Analysis 359 (2016); Mohamed Belkhir & Sabri Boubaker, CEO Inside Debt and Hedging Decisions: Lessons from the U.S. Banking Industry, 24 J. Int'l Fin. Mkt. Institutions & Money 223 (2013); Rosalind L. Bennett, Levent Güntay & Haluk Unal, Inside Debt, Bank Default Risk, and Performance During the Crisis, 24 J. Fin. Intermediation 487 (2015); Cassell et al., note 13; Sudheer Chava, Praveen Kumar & Arthur Warga, Managerial Agency and Bond Covenants, 23 Rev. Fin. Stud. 1120, 1141 (2010); Sandip Dhole, Hariom Manchiraju & Inho Suk, CEO Inside Debt and Earnings Management, 31 J. Acct. Auditing & Fin. 515 (2016); Guanming He, The Effect of CEO Inside Debt Holdings on Financial Reporting Quality, 20 Rev. Acct. Stud. 501 (2015); Yixin Liu, David C. Mauer & Yilei Zhang, Firm Cash Holdings and CEO Inside Debt, 42 J. Banking & Fin. 83 (2014); Ran Lu-Andrews & Yin Yu-Thompson, CEO Inside Debt, Asset Tangibility, and Investment, 11 Int'l J. Managerial Fin. 451 (2015); Hieu V. Phan, Inside Debt and Mergers and Acquisitions, 49 J. Fin. & Quantitative Analysis 1365 (2015); Abhishek Srivastav, Seth Armitage & Jens Hagendorff, CEO Inside Debt Holdings and Risk-Shifting: Evidence from Bank Payout Policies, 47 J. Banking & Fin. 41 (2014); Wei & Yermack, note 153; see also Wei Cen & John A. Doukas, CEO Risk Aversion, Firm Risk and Performance: Evidence from Deferred Compensation Returns Around the 2008 Financial Crisis (Jan. 10, 2012) (unpublished manuscript), http://www.efmaefm.org/0EFMAMEETINGS/EFMA%20ANNUAL%20MEETINGS/2013-Reading/papers/EFMA2013_0147_fullpaper.pdf; Feng Chen, Yiwei Dou & Xin Wang, Executive Inside Debt Holdings and Creditors' Demand for Pricing and Non-Pricing Protections (Sept. 30, 2010) (unpublished manuscript), https://www.researchgate.net/publication/228689869_Executive_Inside_Debt_Holdings_and_Creditors'_Demand_for_Pricing_and_Non-Pricing_Protections; Joseph Gerakos, CEO Pensions: Disclosure, Managerial Power, and Optimal Contracting (Pension Research Council, Working Paper No. WP2007-5, 2010), https://papers.ssrn.com/sol3/

This account ostensibly explains several aspects of nonqualified 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 nonqualified retirement pay. By placing a manager's deferred pay at risk in the event of corporate insolvency, a nonqualified 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 nonqualified 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.

However, tax considerations, which the optimal-contracting account generally sets to the side,[158] explain these and other aspects of nonqualified 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. Deferral of the manager's pay substitutes the corporation's lower tax rates

papers.cfm?abstract_id=982180; Ngoc G. Hoang, Inside Debt and Corporate Failure (2013); Gemma Lee & Hongfei Tang, CEO Retirement Benefits: The Determinants of CEO Pension and Deferred Compensation (Sept. 21, 2013) (unpublished manuscript), http://home.sogang.ac.kr/sites/econdept/seminars/Lists/b6/Attachments/147/CEO%20Retirement%20Benefits%20The%20Determinants%20of%20CEO%20Pension%20and%20Deferred%20Compensation.pdf; Yixin Liu, David C. Mauer & Yilei Zhang, Merger Decisions and Inside Debt (Oct. 2, 2012) (unpublished manuscript), https://papers.ssrn.com/sol3/papers.cfm?abstract_id=2170895; Xiaoxia Peng, Mergers and Acquisitions and CEO Debt-Like Compensation (July 2013) (unpublished Ph.D. thesis, University of Minnesota), http://conservancy.umn.edu/bitstream/handle/11299/159135/Peng_umn_0130E_14143.pdf; Shweta Srinivasan, What Drives Hedging Practices? An Examination of Managerial Inside Debt (Mar. 1, 2013) (unpublished manuscript), http://www.shwetasrinivasan.com/download/AFA2014_Inside_Debt_and_Hedging_Shweta_Srinivasan.pdf; Abhishek Srivastav, Seth Armitage & Jens Hagendorff, Better Safe Than Sorry? CEO Inside Debt and Risk-Taking in Bank Acquisitions (May 2014) (unpublished manuscript), https://papers.ssrn.com/sol3/papers.cfm?abstract_id=2339654; Cong Wang, Fei Xie & Xiangang Xin, Managerial Ownership of Debt and Corporate Financial Reporting (June 26, 2013) (unpublished manuscript), https://papers.ssrn.com/sol3/papers.cfm?abstract_id=1703478; Cong Wang, Fei Xie & Xiangag Xin, Managerial Ownership of Debt and Bank Loan Contracting (Nov. 27, 2011) (unpublished manuscript), http://www.saif.sjtu.edu.cn/upload/12d63acd480538cc160bdbb22d77ba7e.pdf. But see Xi Dong, Joseph T. Halford & Mingming Qiu, Default Risk, Inside Debt, and Debt Incentives (2016), https://papers.ssrn.com/sol3/papers.cfm?abstract_id=2871758.

[158] See, e.g., Edmans & Liu, note 1, at 76 n.4.

for the manager's higher tax rates on investment income, allows the corporation to avoid the $1 million deduction limitation of § 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 may provide a sufficient reason for deferring part of the manager's pay.

Moreover, tax rules dominate the contractual terms under which nonqualified retirement pay is funded and invested. The tax law flatly *requires* that nonqualified 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 nonqualified 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 § 162(m). In other words, setting aside assets to pay nonqualified retirement pay would more than 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 nonqualified retirement pay. Although deferral periods of years or even decades are broadly consistent with the characterization of nonqualified retirement pay as inside debt, the optimal-contracting account does not explain why the corporation's obligation to distribute a manager's nonqualified 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 2017 becomes payable in 2027, and compensation deferred in 2020 becomes payable in 2030—most nonqualified plans distribute or begin distributing a manager's nonqualified retirement pay soon after the manager leaves the corporation's employment.[159] 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 § 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 nonqualified retirement pay

[159] HayGroup, note 61, at 7; MullinTBG, note 4, at 8; Wells Fargo, note 136, at 5.

until the manager has established residency in a state that does not tax individual income. And the close link between a corporation's nonqualified plan and its tax-qualified plan, a link driven by the benefit limitations set out in the Code, encourages the distribution of nonqualified 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 nonqualified 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 as a cause of it.

B. *Managerial Power*

Like the optimal-contracting account, the managerial-power account is reasonably straightforward. On this explanation, nonqualified retirement pay represents "stealth compensation"—that is, compensation not readily understood by shareholders and other corporate stakeholders.[160] By providing a manager with nonqualified retirement pay, directors can "camouflage" part of the manager's pay package, thereby minimizing or even avoiding shareholder criticism of excessive compensation.[161] The critical feature of nonqualified 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 nonqualified retirement accruals can appear en-

---

[160] See Bebchuk & Fried, Pay Without Performance, note 8, at 95–96, 99–102, 105–07; Bebchuk & Fried, Stealth Compensation, note 8, at 295; Jackson & Honigsberg, note 6, at 485.

[161] See Bebchuk & Fried, Pay Without Performance, note 8, at 95–96, 99–102, 105–07; Lucian A. Bebchuk & Jesse M. Fried, Executive Compensation as an Agency Problem, J. Econ. Persp., Summer 2003, at 79 [hereinafter Executive Compensation]; Bebchuk & Jackson, note 8, at 824–25, 827–28; Jackson & Honigsberg, note 6, at 485; see also William W. Bratton, The Academic Tournament Over Executive Compensation, 93 Cal. L. Rev. 1557, 1563 (2005).

tirely 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 nonqualified retirement pay as a solution to the agency problem of managers in public corporations, the managerial-power account understands nonqualified retirement pay to be a manifestation of that agency problem. Managers, so the explanation runs, exercise outsized influence in setting their own pay.[162] Rather than bargain at arm's length with directors for compensation arrangements that encourage them to perform in the interests of investors, managers conspire with directors to extract rents from corporate assets.[163] 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).[164] It thus becomes important for rapacious managers and complicit directors to cover their tracks—to camouflage manager rents.[165] The general opacity of nonqualified retirement pay facilitates that because, for many years, nonqualified retirement pay simply was not subject to meaningful disclosure under federal securities laws.[166] Empirical studies find at least some support for the association of nonqualified retirement pay with managerial power and rent extraction.[167]

[162] See Bebchuk & Fried, Executive Compensation, note 161, at 75; Bebchuk & Fried, Stealth Compensation, note 8, at 293, 296; Bebchuk et al., note 95, at 754, 784–86, 846; Jackson & Honigsberg, note 6, at 484; Robert J. Jackson, Private Equity and Executive Compensation, 60 UCLA L. Rev. 638, 643–44 (2013).

[163] See Bebchuk & Fried, Stealth Compensation, note 8, at 293, 296; Bebchuk et al., note 95, at 754, 784–86, 846; Jackson & Honigsberg, note 6, at 485.

[164] Bebchuk & Fried, Executive Compensation, note 161, at 75; Bebchuk & Fried, Stealth Compensation, note 8, at 293–94, 296–98; Bebchuk et al., note 95, at 756, 786–88.

[165] See Bebchuk & Fried, Pay Without Performance, note 8, at 95; Bebchuk & Fried, Executive Compensation, note 161, at 76; Bebchuk & Fried, Stealth Compensation, note 8, at 294, 298–300; Bebchuk et al., note 95, at 756, 789, 846; Jackson & Honigsberg, note 6, at 485.

[166] See Bebchuk & Fried, Pay Without Performance, note 8, at 99–102, 105–07; Bebchuk & Fried, Stealth Compensation, note 8, at 295, 306–07, 314–16; Jackson & Honigsberg, note 6, at 485.

[167] See, e.g., Kelli A. Alces & Brian D. Galle, The False Promise of Risk-Reducing Incentive Pay: Evidence from Executive Pensions and Deferred Compensation, 38 J. Corp. L. 53 (2012); Cadman & Vincent, note 1; Joseph Gerakos, Chief Executive Officers and the Pay-Pension Tradeoff, 9 J. Pension Econ. & Fin. 303 (2009); Lisa Goh & Yong Li, Pensions as a Form of Executive Compensation, 42 J. Bus. Fin. & Acct. 1154 (2015); Jackson & Honigsberg, note 6; Paul Kalyta, Compensation Transparency and Managerial Opportunism: A Study of Supplemental Retirement Plans, 30 Strategic Mgmt. J. 405 (2009); Paul Kalyta & Michel Magnan, Executive Pensions, Disclosure Quality, and Rent Extraction, 27 J. Acct. & Pub. Pol'y 133 (2008); see also Wei Cen, The Determinants of CEO Inside Debt and Its Components (Nov. 10, 2010) (unpublished manuscript), https://papers.ssrn.com/sol3/papers.cfm?abstract_id=1716306; Lisa Goh & Yong Li, Executive Pensions and Excess Compensation (Sept. 2010) (unpublished manuscript), https://research.mbs.ac.uk/account-

The managerial-power account plausibly explains several aspects of nonqualified 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 and 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 actual or notional investment gains and losses during the deferral period. Any camouflage value there is limited to 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 nonqualified defined benefit plan typically supplements the corporation's tax-qualified defined benefit plan, the benefit formula under the nonqualified plan often incorporates the manager's years of service, average compensation, and a designated multiplier. Furthermore, the nonqualified 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 nonqualified 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

ing-finance/Portals/0/docs/2010/ExecutivePensionsandExcessCompensation.pdf; Lee & Tang, note 157.

factor. Although those values are not unknowable, they can be difficult to ascertain.[168]

Furthermore, the deferral of nonqualified 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 manager retired or otherwise left the corporation's employment.[169] On the managerial-power account, then, the government's regulatory policy made nonqualified 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 SEC's 2006 change in regulatory position requiring disclosure of all nonqualified retirement pay.[170] If nondisclosure was the reason for deferring manager pay, why do corporations and managers continue to defer manager pay now that the government mandates disclosure?[171] Heroic efforts by Jackson and Honigsberg notwithstanding, the managerial-power account offers no

[168] See Bebchuk & Fried, Pay Without Performance, note 8, at 100–01; Bebchuk & Fried, Stealth Compensation, note 8, at 306–08; Kalyta, note 167, at 408; Walker, note 151, at 245–47.

[169] See Bebchuk & Fried, Pay Without Performance, note 8, at 105; Bebchuk & Fried, Executive Compensation, note 161, at 80; Bebchuk & Fried, Stealth Compensation, note 6, at 293, 306–07; Bebchuk & Jackson, note 6, at 827–28.

[170] The disclosures are made through the "summary compensation" table, a "pension benefits" table, and a "nonqualified deferred compensation" table. SEC Reg. S-K, Item 402, 17 C.F.R. § 229.402(c) (summary compensation table), (h) (pension benefits table), and (i) (nonqualified deferred compensation table)(2015); cf. David I. Walker, The Challenge of Improving the Long-Term Focus of Executive Pay, 51 B.C. L. Rev. 435, 454 (2010) (arguing both that the SEC's 2006 regulatory change makes "subterfuge" of executive pensions "less 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").

[171] A recent study that otherwise claimed empirical support for the managerial-power account found very little evidence that corporations froze participation or benefit accruals for their nonqualified defined benefit plans after the change in the SEC disclosure requirements. Cadman & Vincent, note 1, at 797. Specifically, the study found that, out of 284 corporations in the S&P 500 reviewed for the period 2005 through 2010, only five froze participation or benefit accruals in their nonqualified defined benefit plans without taking parallel action under their tax-qualified defined benefit plans. Id.

adequate explanation for the persistence of nonqualified plans under a full-disclosure regime.[172] By contrast, the tax account imputes motivations for nonqualified retirement pay that remain valid even with disclosure. On the tax account, the deferral decision turns on substituting the corporation's lower tax rates for the manager's higher tax rates on investment income, avoiding the $1 million limitation on the corporation's compensation deduction, and avoiding state income taxes.[173]

[172] Jackson and Honigsberg argue that the SEC disclosure rules on nonqualified 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 & Honigsberg, note 6, at 504-06. Second, they say, the disclosure rules do not require corporations to reveal the distribution method used for a manager's nonqualified retirement pay and so do not permit investors to determine whether the nonqualified pay aligns the interests of the manager with those of the corporation's creditors. Id. at 504, 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 foregoes [sic] through deferral of its deduction.") (emphasis added). But as shown above in Subsection II.B.1, the corporation's marginal tax rate for investment income ordinarily is lower than the manager's marginal tax rate for investment income, and the corporation may well have operating losses that offset all investment income. 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 nonqualified 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 nonqualified 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 nonqualified retirement plan annually over the course of 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.

[173] Bebchuk and Fried acknowledge that the use of nonqualified retirement pay allows a corporation to avoid the $1 million deduction limitation, Bebchuk & Fried, Pay Without Performance, note 8, at 110-11, but they regard this as, at most, a supplement to the camouflage explanation for nonqualified pay rather than a competing explanation:

> Everything else being equal, shareholders might . . . prefer much of the executive's non-performance-based compensation to be paid after retirement, when [§]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 nonqualified retirement pay is that the corporation uses nonqualified pay to compensate its managers

Similarly, the managerial-power account's characterization of the benefit formulae in nonqualified plans as an exercise in camouflage appears less plausible on closer examination. First, the formula for a nonqualified 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.[174] It does, however, serve the objectives posited by the tax account. Second, even though the formula for a nonqualified 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 nonqualified plan supplements the tax-qualified plan by restoring the benefits lost to the tax-qualified plan under the 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 nonqualified plans cover only the corporation's managers and other highly paid employees. Surely, the argument runs, nonqualified plans must be inefficient; otherwise, the corporation would provide nonqualified retirement pay to all its employees rather than just those who, by hypothesis, have outsized influence over the corpora-

because nonqualified 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 nonqualified retirement pay—Bebchuk and Fried shift their stance, arguing that camouflage is simply an *effect* of using nonqualified pay. But if camouflage is simply an effect rather than the motivating cause, the use of nonqualified pay no longer provides sound evidence of rent extraction.

[174] As Jackson and Honigsberg note, there may still be limited camouflage opportunities to the extent that a corporation provides a manager with a pretax rate of return under a nonqualified defined contribution plan. Jackson & Honigsberg, note 6, at 518. For example, if a corporation commits to pay a manager a stated amount of deferred compensation as increased by the return on a ten-year U.S. Treasury bond, the corporation effectively commits to pay the manager a total amount determined by the following three components: (1) the stated amount of deferred compensation; (2) the increase in the value of (1) attributable to the corporation's after-tax return on a ten-year U.S. Treasury bond; and (3) the increase in value of (1) attributable to the difference between the nominal return on a ten-year U.S. Treasury bond and (2). Jackson and Honigsberg note that the SEC disclosure rules do not require separate reporting of (3). That said, Jackson and Honigsberg's own calculations show the value of (3) to be relatively modest. Jackson & Honigsberg, note 6, at 506. Additionally, this presents no issue at all in the case of a nonqualified defined benefit plan or in the case of a corporation that has operating losses (and for which, consequently, the pretax rate of return is equal to the post-tax rate of return).

tion's compensation practices.[175] This argument is badly misinformed. And, here again, the tax account explains the situation. Corporations do not cover rank-and-file employees under their nonqualified plans because they can provide full retirement benefits to those employees under tax-qualified plans and, more importantly, they cannot provide retirement befits to those employees under nonqualified plans.[176] As shown above,[177] tax-qualified plans are superior to nonqualified plans because they provide for the accumulation of retirement benefits at a pretax rate of return. Ceteris paribus, corporations rationally prefer to provide retirement benefits through tax-qualified plans. Although the tax laws limit the benefits that may be provided under tax-qualified retirement plans,[178] those limits generally have no effect on rank-and-file employees.[179] In other words, the availability of tax-qualified plans almost always forecloses the need to provide rank-and-file employees with retirement benefits under nonqualified plans.

Moreover, as explained above,[180] ERISA specifically mandates that a retirement plan covering rank-and-file workers satisfy minimum prefunding requirements and hold its assets in a trust for the exclusive benefit of the employees. But under the 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 § 415,[181] it is legally impossible to provide such employees with nonqualified retirement pay. The managerial-power account misses this basic but crucial point. Nonqualified plans cover only managers and other highly paid employees because ERISA, working

[175] See Bebchuk & Fried, Pay Without Performance, note 8, at 95–96, 98, 105; Bebchuk & Fried, Stealth Compensation, note 8, at 293, 295, 305, 313; Bebchuk & Jackson, note 8, at 829.

[176] Chason, note 29, at 388.

[177] See Section II.A.

[178] See notes 50-57 and accompanying text.

[179] Consider just the limitations under § 415, described above in notes 50-57 and accompanying text. For a defined benefit plan, the § 415 limitation on annual benefit payments is $215,000 (or the employee's compensation, if less); for a defined contribution plan, the § 415 limitation on annual contributions is $54,000 (or the employee's compensation, if less). Id. Those limitations far exceed typical benefits under tax-qualified retirement plans. As of 2012, the median income from a tax-qualified retirement plan for former employees aged 65 and older was $8712, and the mean income from a tax-qualified retirement plan for such employees was $2357. Employee Benefits Research Inst., EBRI Databook on Employee Benefits, Table 3.1, https://www.ebri.org/pdf/publications/books/databook/DB.Chapter%2003.pdf. Also as of 2012, the average *balance* (representing contributions for all years and investment earnings on those contributions) in tax-qualified § 401(k) accounts for all participants was $63,929; the median balance was $17,630. Id. at Fig.7.1a., https://www.ebri.org/pdf/publications/books/databook/DB.Chapter%2007.pdf.

[180] See Subsection II.C.2.

[181] See note 126.

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.[182] Efficiency, camouflage, and rent extraction are completely irrelevant in determining that rank-and-file workers may not participate in a nonqualified plan.

The managerial-power account also appears dubious in its understanding of the funding status of nonqualified retirement pay. If the objective of providing a manager with nonqualified retirement pay is simply to camouflage part of the manager's compensation, why is 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 nonqualified retirement pay remains at all times an unsecured obligation of the corporation.[183] That strongly implies that something more than—or different from—rent extraction is at work.[184] But, again, this feature of nonqualified retirement pay is straightforward on the tax account. Longstanding tax rules *prohibit* the corporation from securing nonqualified retirement pay against the claims of its general creditors.[185] Placing nonqualified retirement pay beyond the reach of the corporation's creditors triggers immediate taxation, tax penalties, and an interest charge to the manager.[186] What appears completely counterintuitive on the managerial-power account is easily explained by the tax account. Managers driven by rent-seeking should want full security for their nonqualified retirement pay, but managers driven by tax considerations should want to protect their tax deferral.

---

[182] Consistent with that position, the Department of Labor interprets the top-hat exemption as applicable only when the nonqualified 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, taking into consideration any risks attendant thereto, and, therefore, would not need the substantive rights and protections of Title I [of ERISA]." D.O.L. Adv. Op. Ltr. 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 Subsection II.C.2. In other words, many employees who participate in nonqualified plans are in no position to collude with directors for the extraction of rents. Cf. Kevin J. Murphy, Explaining Executive Compensation: Managerial Power Versus the Perceived Cost of Stock Options, 69 U. Chi. L. Rev. 847, 857-58 (2002) (demonstrating that stock options are not incentive compensation because they are provided not only to high-level executives but also to lower-level managers and employees who do not take direct action to impact company value).

[183] See Subsection II.C.4.

[184] Cf. Bebchuk & Fried, Pay Without Performance, note 8, at 101; Bebchuk & Fried, Stealth Compensation, note 8, at 308 (explaining how this risk disadvantages executive benefit plans as compared to lower-level employee plans).

[185] See note 22 and accompanying text.

[186] See note 23 and accompanying text.

The managerial-power account points to the investment of nonqualified retirement pay as a further indicator of rent extraction. Jackson and Honigsberg report that substantial amounts under nonqualified defined contribution retirement plans are notionally invested in the corporation's own stock.[187] That implies, according to Jackson and Honigsberg, that nonqualified retirement pay functions more like an investment in the corporation's equity than an investment in the corporation's debt[188]—and, correspondingly, that nonqualified retirement pay is more about seeking rents than about aligning the interests of managers with the interests of corporate creditors. But this argument overlooks two points. First, there are tax reasons to invest in the corporation's stock through a nonqualified retirement plan. Setting the corporation up as the investor on behalf of the manager—precisely the effect of using a nonqualified plan—reduces the marginal tax rate on dividends and capital gains from 23.8% to zero.[189] Second, the unfunded status of nonqualified retirement pay still leaves the manager in the position of an unsecured general creditor, even if the nonqualified 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 nonqualified plans better than the managerial-power account does. As Jackson and Honigsberg show, managers generally receive their nonqualified retirement pay shortly after retirement or other termination of employment.[190] 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.[191] Additionally, the tax qualified plans that nonqualified 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 § 409A for nonqualified retirement pay.[192]

---

[187] Jackson & Honigsberg, note 6, at 481, 493-98, 512; cf. The Newport Group, note 4 at 26, 28. This is a nonissue 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.

[188] Jackson & Honigsberg, note 6, at 493-94.

[189] See Subsections II.B.1-3.

[190] Jackson & Honigsberg, note 6, at 481-82, 499-502, 512.

[191] See Subsection II.B.2.

[192] See Subsection II.C.5.

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 nonqualified retirement pay for the corporation's most senior managers.[193] 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 nonqualified 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 nonqualified plans are not necessarily what they appear to be. They repeatedly claim that a manager may accelerate payments from a nonqualified plan in order to sidestep the risk of losing his nonqualified retirement pay in the event of corporate insolvency.[194] Thus, they say: "[E]ven those executives who plan to receive their retirement pay over time often can accelerate their payouts."[195] 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."[196] And, finally: "[E]ven executives who choose to receive their pay over time often retain the option to accelerate their payouts if bankruptcy looms."[197] That misstates the applicable tax rule. Section 409A not only prohibits a nonqualified retirement plan from accelerating the payment of a manager's nonqualified retirement pay; it also prohibits a plan from even providing for the acceleration of a manager's nonqualified retirement pay.[198] Any nonqualified plan that gives the manager "freedom" on this point or that provides the manager an "option" to accelerate payments would trigger immediate taxation for the manager, with a penalty tax and interest charge, ab initio.[199]

[193] The disclosures are made through the "summary compensation" table, a "pension benefits" table, and a "nonqualified deferred compensation" table. SEC Reg. S-K, note 170.

[194] See Jackson & Honigsberg, note 6, at 482, 502, 512.

[195] Id. at 482.

[196] Id. at 502.

[197] Id. at 512.

[198] IRC § 409A(a)(3); Reg. § 1.409A-3(j).

[199] IRC § 409A(a). In a footnote, Jackson and Honigsberg cite the § 409A anti-acceleration rule but then immediately dismiss it, saying that, "[i]n practice, directors can and do

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

Although the optimal-contracting and managerial-power accounts are in tension, they "are not mutually exclusive."[200] Each provides a plausible explanation both for the basic decision to defer manager compensation through nonqualified retirement plans and for the contractual terms of those plans. The tax account provides a different 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 to the underlying tax rules and tax considerations. It is tempting to conclude that the tax account answers the puzzle of nonqualified retirement pay.

That temptation must be resisted. It is important not to put more weight on the tax account than it can bear, and it perhaps cannot bear the entire weight of the problem. Certainly the tax account identifies valid motivations for the basic decision to defer manager pay. Nonqualified plans substitute lower corporate tax rates for higher individual tax rates, allow corporations to end-run the $1 million deduction limitation, and permit managers to end-run state income taxes. But simply identifying these tax motivations does not in itself refute either the creditor-alignment motivation of the optimal-contracting account or the rent-extraction motivation of the managerial-power account.

In fact, the tax account arguably could be incorporated into either of the other two accounts. Assume that the optimal-contracting ac-

---

amend these agreements to permit executives to accelerate retirement payments when the firm faces insolvency." Jackson & Honigsberg, note 6, at 502 n.56. 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 nonqualified plan to permit the acceleration of a manager's payments; indeed, the corporation almost always retains the power to amend its nonqualified 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 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.

[200] Jackson & Honigsberg, note 6, at 482, 489; see also Bebchuk & Fried, Executive Compensation, note 161, at 72-73; Bebchuk et al., note 95, at 755; John E. Core, Wayne R. Guay & Randall S. Thomas, Is U.S. CEO Compensation Inefficient Pay Without Performance?, 103 Mich. L. Rev. 1142, 1159-60 (2005). Not everyone necessarily agrees with that point. Kelli Alces and Brian Galle, for example, introduce their argument against the optimal-contracting account of nonqualified pay in the following terms: "Because our results cast doubt on the optimal contracting story for pensions, we offer substantial support for the managerial power theorists." Alces & Galle, note 167, at 56; see also id. at 62. Alces & Galle also do not consider a tax explanation for nonqualified retirement pay. Cf. id. at 85-86.

count correctly identifies the underlying motivation for nonqualified retirement pay—that is, assume that the basic point is to align the interests of managers with the interests of corporate creditors. In that case, nonqualified retirement pay may well be the best approach to implementing the creditor-alignment objective precisely because of the considerations identified by the tax account. Although a corporation could require a manager to hold the company's bonds or to make an unsecured loan to the company, nonqualified retirement pay necessarily makes the manager an unsecured general creditor of the corporation *and* potentially secures tax savings for both sides. The corporation may avoid § 162(m), the manager may avoid state income taxes, and the corporation and the manager together may reduce the overall tax burden on investment income. A compensation strategy that reduces the tax burden on the corporation, the manager, or both at the expense of the federal fisc certainly would be consistent with the broader claims of the optimal-contracting account. Thus, using nonqualified retirement pay would yield a sensible outcome, whether the tax motivation is primary and the creditor-alignment motivation is secondary or the creditor-alignment motivation is primary and the tax motivation is secondary.

Similarly, the tax account could be integrated into the managerial-power account. Assume that the managerial-power account correctly identifies the underlying motivation for nonqualified retirement pay—that is, assume that the basic point is to facilitate manager rent extraction from corporate assets. Even if the corporation and the manager are situated such that nonqualified retirement pay does not present a tax advantage to either side, investors may mistakenly assume that nonqualified retirement pay enjoys a tax subsidy and that it therefore costs the corporation less than it actually does. Similarly, the common practice of linking a corporation's nonqualified plan to its tax-qualified plan may mislead investors into thinking that the difference between retirement benefits paid to managers and retirement benefits paid to rank-and-file employees is simply one of scale. A compensation strategy that reduces the tax burden on the manager at the expense of the corporation certainly would be consistent with the broader claims of the managerial-power account. Thus, using nonqualified retirement pay would yield a sensible outcome, whether the tax motivation is primary and the rent-extraction motivation is secondary or the rent-extraction motivation is primary and the tax motivation is secondary.

It is also possible, however, to incorporate either the optimal-contracting account or the managerial-power account (or both) into the tax account. Assume that the tax account correctly identifies the underlying motivation for nonqualified retirement pay—that is, assume that the decision to defer manager compensation is driven by some combination of concerns to substitute lower corporate tax rates for higher individual tax rates, to avoid § 162(m), and to avoid state income taxes. In that case, the optimal-contracting account and the managerial-power account potentially conflate the *effects* of nonqualified retirement pay with the *cause* of nonqualified retirement pay. Even if the motivation for deferral were exclusively tax, the consequence would still be to make the manager an unsecured general creditor of the corporation or to obscure the amount of the manager's pay (or both). It is entirely possible that aligning the manager's interests with those of creditors and extracting rents from corporate assets contribute nothing to the deferral decision, even if the outcome of the deferral decision is consistent with the optimal-contracting story or the managerial-power story (or both).

Additionally, it is possible that the solution to the puzzle of nonqualified retirement pay might not be uniform across all corporations and all managers. The motivation for providing nonqualified retirement pay may differ from one corporation or one manager to another; in some cases, the motivation may be mixed. Because the three accounts are not mutually exclusive, it may be that the reasons for choosing deferred compensation over current compensation represent a complex interplay of tax considerations, alignment with creditor interests, and rent extraction. As an explanation of the underlying puzzle, the tax account challenges, or perhaps supplements, the optimal-contracting and managerial-power accounts, but it does not disprove them.

Whatever the final score on motivation, the story is very different with respect to the contractual terms of nonqualified plans. Here, the tax account stands in a superior position to the other two accounts and should displace them outright. 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 nonqualified retirement pay.[201] Jackson and Honigsberg sensibly step beyond that narrow inquiry and examine actual plan terms to see what they reveal about the motivation for deferral.[202] Although Jackson and Honigsberg find evidence supporting the optimal-contracting account, they see stronger indications of managerial power.[203] But they also consciously shunt tax considerations to the side.[204] Yet as shown

201 See, e.g., Edmunds & Liu, note 1.
202 See generally Jackson & Honigsberg, note 6.
203 Id. at 512-13.
204 Id. at 484 n.10.

above,[205] the tax account ultimately explains plan terms far better than either the optimal-contracting account or the managerial-power account.

That said, it is important not to conflate the contractual terms of nonqualified plans, which plainly are driven by tax considerations, with the underlying motivation for deferral, which may or may not be driven by tax considerations. As Jackson and Honigsberg assume, plan terms can be suggestive of manager and director motivations.[206] For example, a nonqualified plan bearing few indicia of corporate debt in the end may not represent an effort to align the interests of managers with those of the corporation's unsecured general creditors.[207] Thus, the close conformity of plan terms with applicable tax rules and tax considerations certainly points to the tax account as an important point in resolving the underlying puzzle. But it is not dispositive. The tax account's superior explanation of plan terms can be reconciled with the motivations posited by either the optimal-contracting or the managerial-power account. Even if a corporation and a manager agree to a nonqualified plan in order to facilitate rent extraction or to align the manager's interests with those of the corporation's unsecured general creditors, both sides nonetheless would want the plan terms to satisfy the applicable tax rules for nonqualified retirement pay in order to avoid current taxation, interest charges, and penalty taxes for the manager.

In short, the tax account provides a competing explanation for why corporations establish and maintain nonqualified plans and a superior explanation for the contractual terms of those plans. Neither of those two points establishes 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 nonqualified retirement pay remains unsolved.

IV. Policy Implications of the Tax Account

The tax account has two important implications for public policy concerning nonqualified retirement pay. First, the tax account suggests that there may be no compelling normative basis for policymakers either to encourage or to discourage the use of nonqualified retirement pay in manager pay arrangements. Second, the tax account suggests that any undertaking by policymakers to limit or to

[205] See Sections II.A and II.B.
[206] See Jackson & Honigsberg, note 6, at 513.
[207] Id.

reform nonqualified retirement pay must address the relevant tax considerations. The best mechanism for doing that would be the imposition of accrual-based taxation for nonqualified retirement pay.

A. *The Ambiguous Normative Status of Nonqualified Retirement Pay*

The optimal-contracting account and the managerial-power account, which have dominated the academic debate about nonqualified retirement pay, respectively imply optimistic and pessimistic normative judgments. On the optimal-contracting account, nonqualified 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.[208] In the absence of nonqualified 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 harming creditors. From this perspective, nonqualified 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 nonqualified retirement pay.

By contrast, the managerial-power account finds little redeeming value in nonqualified retirement pay. On this account, nonqualified retirement pay offers a vehicle for a corporation's manager and directors to disguise the manager's performance-insensitive compensation.[209] The lesson of the managerial-power account is that directors probably should not maintain nonqualified retirement plans at all; instead, they should compensate managers with currently taxable and easily quantifiable cash and equity interests. Eliminating nonqualified retirement pay from manager pay arrangements would facilitate shareholder understanding and monitoring of executive compensation, thereby forcing managers and directors to agree on pay packages that transparently serve shareholder interests. Policymakers, at a minimum, should require full and understandable disclosure of all aspects of nonqualified plans; at the extreme, they should consider measures to curb or eliminate such plans.

---

[208] See Section III.A.

[209] See Section III.B.

The tax account has more ambiguous normative implications. The use of nonqualified 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,[210] while working in New York, also a high-tax state,[211] 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 nonqualified 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 nonqualified retirement pay to avoid the $1 million deduction limitation under § 162(m) seems much less troubling because the limitation itself represents bad tax policy.[212] The premises underlying § 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 cost of compensating its employees represents a tax subsidy (the economic assumption) and that the federal fisc should not provide a subsidy for compensation in excess of $1 million paid to any senior manager unless the compensation depends on the manager's job performance (the policy judgment).[213] 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, should 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 precise incidence of which remains highly uncertain,[214] but which certainly burdens both share-

[210] See note 110.

[211] See note 111.

[212] See Subsection II.B.2.

[213] See notes 92-93 and accompanying text.

[214] See Alan J. Auerbach, Who Bears the Corporate Tax? A Review of What We Know, in 20 Tax Pol'y and the Econ. 1 (James M. Poterba ed., 2006); Wiji Arulampalam, Michael P. Devereux & Giorgia Maffini, The Direct Incidence of Corporate Income Tax on Wages,

holders and rank-and-filed employees.[215] Whether the burden of the corporate income tax falls more heavily on shareholders or rank-and-file employees, it makes no sense to punish either group for compensation decisions made by the corporation's directors and managers. It would seem all to the good, then, if the use of nonqualified retirement pay allows corporations to end-run § 162(m).

The use of nonqualified plans to provide managers with lower tax rates on investment returns is a somewhat closer call. At first pass, it may seem objectionable as a matter of tax policy to permit a manager

56 Eur. Econ. Rev. 1038 (2012); Kimberly A. Clausing, Who Pays the Corporate Tax in a Global Economy?, 66 Nat'l Tax J. 151 (2013); Jane G. Gravelle & Kent A. Smetters, Does the Open Economy Assumption Really Mean that Labor Bears the Burden of a Capital Income Tax?, 6 Advances in Econ. Analysis & Pol'y 1 (2006); Jennifer Gravelle, Corporate Tax Incidence: Review of General Equilibrium Estimates and Analysis, 66 Nat'l Tax J. 185 (2013) [hereinafter Corporate Tax Incidence]; Arnold C. Harberger, The Incidence of the Corporation Income Tax, 70 J. Pol. Econ. 215 (1962); Arnold C. Harberger, The ABCs of Corporate Tax Incidence: Insights into the Open-Economy Case, in Policy and Economic Growth 51 (1995) [hereinafter The ABCs]; Arnold C. Harberger, Corporation Tax Incidence: Reflections on What Is Known, Unknown, and Unknowable, in Fundamental Tax Reform 283 (John W. Diamond, George R. Zodrow & James A. Baker eds., 2008); Arnold C. Harberger, The Incidence of the Corporation Income Tax Revisited, 61 Nat'l Tax J. 303 (2008); Kevin A. Hassett & Aparna Mathur, A Spatial Model of Corporate Tax Incidence, 47 Applied Econ. 1350 (2015) [hereinafter Spatial Model]; Li Liu & Rosanne Altshuler, Measuring the Burden of the Corporate Income Tax Under Imperfect Competition, 66 Nat'l Tax J. 215 (2013); James R. Melvin, The Corporate Income Tax in an Open Economy, 17 J. Pub. Econ. 393 (1982); John Mutti & Harry Grubert, The Taxation of Capital Income in an Open Economy: The Importance of Resident-Nonresident Tax Treatment, 27 J. Pub. Econ. 291 (1985); Daniel Shaviro, Decoding the U.S. Corporate Tax 57-71 (2009); Mihir A. Desai, C. Fritz Foley & James R. Hines, Jr., Labor and Capital Shares of the Corporate Tax Burden: International Evidence (Harv. Bus. Sch. Div. of Research, 2007), https://www.aeaweb.org/conference/2011/retrieve.php?pdfid=326; R. Alison Felix, Passing the Burden: Corporate Tax Incidence in Open Economies (Fed. Reserve Bank of Kan. City, RRWP 07-01, 2007) https://www.kansascityfed.org/Publicat/RegionalRWP/RRWP07-01.pdf; William M. Gentry, A Review of the Evidence on the Incidence of the Corporate Income Tax, (U.S. Treas. Dep't, Office of Tax Analysis, OTA Paper 101, 2007), https://www.treasury.gov/resource-center/tax-policy/tax-analysis/Documents/WP-101.pdf; Jennifer C. Gravelle, Corporate Tax Incidence: A Review of Empirical Estimates and Analysis (Cong. Budget Office, Working Paper No. 2011-01, 2011) [hereinafter Estimates and Analysis], https://www.cbo.gov/sites/default/files/cbofiles/ftpdocs/122xx/doc12239/06-14-2011-corporatetax-incidence.pdf; William C. Randolph, International Burdens of the Corporate Income Tax (Cong. Budget Office, Working Paper No. 2006-09, 2006), https://cbo.gov/sites/default/files/cbofiles/ftpdocs/75xx/doc7503/2006-09.pdf; Kevin A. Hassett & Aparna Mathur, Spatial Tax Competition and Domestic Wages (Dec. 2010) (unpublished manuscript) [hereinafter Spatial Tax Competition], https://papers.ssrn.com/sol3/papers.cfm?abstract_id=2212975.

[215] In one open-economy model, domestic labor bears approximately 70% of the burden of the U.S. corporate income tax, and domestic capital bears approximately 30% of that burden. Randolph, note 214, at 25. And empirical investigation finds that labor bears between 45% and 75% of the corporate tax burden. Desai et al., note 214, at 2; see also Arulampalam et al., note 214, at 6; Liu & Altshuler, note 214, at 218; Hassett & Mathur, Spatial Model, note 214, at 1352; Harberger, The ABCs, note 214; Felix, note 214, at 14-22; Gentry, note 214, at 6; Hassett & Mathur, Spatial Tax Competition, note 214, at 20-23. But there are contrary views. See Clausing, note 214; Gravelle, Corporate Tax Incidence, note 214; Gravelle & Smetters, note 214; Gravelle, Estimates and Analysis, note 214.

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—or even to eliminate all taxation on investment returns if the corporation has an operating loss.[216] But it is critical here to pay close attention to the nature of the manager's interest. The manager whose nonqualified retirement pay is invested in the corporation's stock or any other financial instrument does not actually own the stock or 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.[217] Instead, the manager holds only an unsecured contractual claim against the corporation for payment in the future, and the manager faces the risk of nonpayment either because of corporate insolvency or because of the corporation's repudiation of the obligation.[218] There is, then, a genuine economic cost for the manager of substituting the corporation's lower tax rate for his own 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 an 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 nonqualified retirement pay, and it consequently raises doubt about whether there is any policy imperative to addressing nonqualified retirement pay through legislative or regulatory action. In the end, nonqualified 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 nonqualified retirement pay; other tax considerations—particularly the avoidance of the $1 million deduction limitation under § 162(m)—imply that corporations and managers should be left alone to work out whatever nonqualified 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 nonqualified retirement

[216] See Table 4.

[217] See Subsection II.C.4.

[218] Of course, as explained above, use of a rabbi trust protects the manager against the risk of repudiation by the corporation. See note 134.

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 nonqualified retirement pay through the 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 nonqualified plans.

Prior changes to the tax rules for nonqualified retirement pay have followed the misguided approach of imposing tax penalties on pay practices that legislators considered objectionable. Most prominently, in 2004 Congress enacted § 409A primarily to standardize the constructive-receipt rules for nonqualified plans and to prohibit certain aggressive funding practices.[219] Innocuous as that general purpose may have been, Congress foolishly imposed a 20% penalty tax on any manager whose nonqualified retirement pay fails the § 409A rules.[220] The punitive consequences under § 409A no doubt have encouraged conformity to the statutory rules. But they have also increased the cost of providing nonqualified retirement pay as managers understandably have demanded indemnification agreements from their corporate employers to cover any adverse outcomes under § 409A.[221]

Other manager-pay reforms have made the same mistake. The tax rules on golden parachutes, for example, impose tax dispreferences on both the manager and the corporation for certain payments made to managers as part of a corporate change in control.[222] Such penalty-based reforms rest on the flawed assumption that managers and corporations will either ensure that their pay practices conform to the new rules or 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 actually borne by the corporation.[223] As with the 20% penalty under § 409A, this has the effect of increasing the cost of compensation.[224] It does not, however, further the policy objectives that led Congress to enact the reform in the first place.

---

219 See Michael Doran, Time to Start Over on Deferred Compensation, 28 Va. Tax Rev. 223, 224-27 (2008).

220 IRC § 409A(a)(1)(B)(i); Doran, note 219, at 224-27.

221 See Doran, note 219, at 227.

222 IRC § 280G (denying a corporate tax deduction for excess parachute payments), § 4999 (imposing a 20% tax on the recipient of excess parachute payments).

223 Doran, note 219, at 227.

224 Bruce A. Wolk, The Golden-Parachute Provisions: Time for Repeal?, 21 Va. Tax Rev. 125, 139-42 (2001).

Daniel Halperin and Ethan Yale have suggested a different approach to reforming nonqualified retirement pay.[225] 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 nonqualified plans.[226] Yale and Gregg Polsky[227] and Eric Chason[228] also propose a corporate-level tax on investment earnings. This approach gets directly at the substitution of the corporation's lower tax rate for the manager's higher tax rate and thereby eliminates a significant tax rationale for nonqualified retirement pay. But the approach does not work if the corporation itself is not subject to U.S. tax,[229] it does little to address the use of nonqualified retirement pay to avoid state income taxes,[230] and it does nothing to address the use of nonqualified retirement pay to avoid the $1 million deduction limitation of § 162(m) (assuming that the latter is deemed objectionable).

As I first argued shortly after the enactment of § 409A in 2004, the best approach to reform, if reform must be had, is to impose accrual-based taxation on managers for their nonqualified retirement pay.[231] Under accrual-based taxation, the manager would include nonqualified retirement pay in her gross income as soon as her rights to that pay became vested, and the corporation would deduct such pay at the time of the manager's inclusion.[232] Accrual-based taxation is the correct approach as a matter of basic income-tax policy.[233] It also would

[225] See Daniel Halperin & Ethan Yale, Deferred Compensation Revisited, 114 Tax Notes 939 (Mar. 5, 2007). The proposal generally reiterates the proposal set forth two decades earlier by Halperin. See Halperin, note 25; see also Daniel Halperin, A Fairer and More Effective Approach to Deferred Compensation, 103 Tax Notes 1187 (May 31, 2004); Daniel Halperin, Section 457 Should Be Replaced by a Special Tax on Investment Income, 100 Tax Notes 730 (Aug. 4, 2003).

[226] Halperin & Yale, note 225, at 940-45; Halperin, note 25, at 544-50. The employee would include in gross income the full amount of nonqualified retirement pay distributed to her. Halperin, note 25, at 549.

[227] Ethan Yale & Gregg D. Polsky, Reforming the Taxation of Deferred Compensation, 85 N.C. L. Rev. 571, 599-634 (2007).

[228] Chason, note 90, at 1699-712; see also Chason, note 74, at 8-8 to 8-11.

[229] Section 457(f) imposes accrual-based taxation on employees of tax-exempt and governmental employers, and § 457A imposes accrual-based taxation on employees of employers not subject to U.S. taxation.

[230] 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.

[231] Doran, note 28, at 14-17.

[232] Id. at 4-5.

[233] See David J. Shakow, Taxation Without Realization: A Proposal for Accrual Taxation, 134 U. Pa. L. Rev. 1111, 1114-15 (1986). Depending on the details of implementation, accrual-based taxation potentially stands in some tension with ensuring neutrality between current and deferred compensation, which I and others have suggested as a policy objective of reform. Doran, note 28, at 1; see also Yale & Polsky, note 227, at 579. For example, accrual-based taxation, if implemented in the manner described in the text, would cause

directly address most of the tax considerations behind the deferral of manager compensation. It would eliminate the avoidance of state income taxes by taxing nonqualified retirement pay when that pay is earned (assuming, as seems almost certain, that the states would follow the federal tax code in imposing accrual-based taxation). Similarly, it would eliminate the avoidance of the $1 million limitation on deductible compensation under § 162(m) by bringing the manager's nonqualified retirement pay forward into current compensation. And it would subject annual investment returns to taxation at the manager's tax rate rather than the corporation's tax rate. Notably, the Tax Reform Act of 2014, introduced by David Camp, then Chairman of the Ways & Means Committee, generally followed my suggestion to adopt accrual-based taxation for nonqualified retirement pay (although it did not get the details quite right).[234]

The mechanism for implementing accrual-based taxation is straightforward. Every year, the manager would include in gross income (and the corporation would deduct from gross income) the change in the vested single-sum payout value of the manager's nonqualified retirement pay during that year.[235] For both the manager and the corporation, that change in the vested single-sum payout value would be treated as compensation income (or as a loss from a trade or business) and therefore would be taxed (or deducted) at the applicable tax rate for ordinary income.[236] The "single-sum payout value" is the amount that would be distributed to the manager from the nonqualified 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 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 nonqualified 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

---

the manager to include in gross income (and to deduct from gross income) changes in the value of the manager's nonqualified retirement pay attributable to unrealized gains (and losses). Additionally, it also would not discount the value of the nonqualified retirement pay included in the manager's gross income for the possibility that, as an unsecured general creditor of the corporation, the manager might lose part or all of that pay in the event of the corporation's insolvency.

[234] Tax Reform Act of 2014, H.R. 1, 113th Cong. § 3801 (2014). For example, the bill should have been limited to executives in a company's top-hat group and should have used the section 83 vesting rule.

[235] See Doran, note 28, at 6.

[236] See id.

year less the manager's account balance as of the start of the taxable year. In the more complicated case of a nonqualified 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,[237] on compensation deferred during that year and prior years (as well as on investment earnings on compensation deferred during that year and prior years).[238]

Accrual-based taxation of nonqualified retirement pay raises three principal administrative issues: determining when a manager's nonqualified retirement pay is vested, valuing a manager's nonqualified retirement pay, and providing for the payment of tax on amounts not receivable until a later taxable year.[239] 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."[240] Thus, a provision in a nonqualified 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[241]—do not defer vesting. These rules have broad application (subject to greater or lesser modifications) throughout the rules for the taxation of nonqual-

[237] This point bears 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 & Yale, note 225, at 943.

[238] For any year, the change in the single-sum payout value of a manager's nonqualified retirement pay could be either positive or negative. The manager would include any positive value in her gross income under § 61(a)(1), and would deduct any negative value from her gross income under § 165(a). Per § 165(c)(1), the manager's § 165(a) deduction would not be limited. See Chason, note 29, at 391.

[239] Cf. Shakow, note 233, at 1113 (describing the valuation issues associated with an accrual system).

[240] Reg. § 1.83-3(c)(1).

[241] Reg. § 1.83-3(c)(2).

ified retirement pay.[242] As such, they are familiar and generally not problematic.

Valuing a manager's nonqualified retirement pay is only somewhat more complex. For any nonqualified retirement plan that denominates the manager's benefit as an account balance (which includes most nonqualified defined contribution plans), the value of the manager's nonqualified retirement pay is simply the account balance itself. Thus, determining the change for any taxable year in the manager's payout value would require 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 nonqualified retirement plan that denominates the manager's benefit as a stream of payments (which includes most nonqualified defined benefit plans), the value of the manager's nonqualified retirement pay is the present value of that stream of benefits. Determining that present value requires making standardized assumptions about interest rates and mortality, which the government could provide through regulations.[243] For example, assume that a fifty-three-year-old manager has a vested right to annual nonqualified retirement pay of $10 million for life, beginning at age sixty-five. 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.[244] Any over- or under-inclusions resulting from the use of standardized assumptions could be corrected (with adjustment for the time value of money) as actual payments are made.[245]

[242] See, e.g., Reg. § 1.402(b)-1(a)(1) (taxation of manager's interest in nonqualified retirement plan using an exclusive-benefit trust); Reg. § 1.409A-1(d)(1) (taxation of manager's interest in nonqualified retirement plan failing substantive requirements of § 409A); Reg. § 1.457-11(a)(1) (taxation of employee's interest in nonqualified retirement plan maintained by tax-exempt organization or by state or local government that fails requirements of § 457(b)); Reg. § 31.3121(v)(2)-1(e)(3) (FICA taxation of manager's interest in nonqualified retirement plan). Chason suggests that accrual-based taxation of nonqualified retirement pay likely would lead managers and executives to greater use of "irrevocably funded arrangements." Chason, note 29, at 395. The reasoning here, apparently, is that because § 402(b) already applies accrual-based taxation to funded nonqualified retirement plans, the application of accrual-based taxation to unfunded nonqualified retirement plans would remove the tax disadvantage to using a funded arrangement. However, funding a nonqualified retirement plan would cause the plan to lose the top-hat exemption from the ERISA participation, vesting, funding, and fiduciary rules. See Subsection II.C.2. That likely would weigh heavily against the use of a funding arrangement, even in the event of accrual-based taxation for an unfunded plan.

[243] Halperin, note 25, at 541.

[244] 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.

[245] The accrual-based rules used in current law for specific aspects of nonqualified retirement pay generally botch the treatment of benefits that are difficult to value when earned. Section 457A provides that, if the amount of a payment is not "determinable" at the time

The liquidity issues associated with requiring managers to pay tax currently 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 nonqualified retirement pay is earned and vested. For example, if in 2017 a manager defers $10 million under her employer's nonqualified retirement plan, she would owe a 2017 tax liability of $3,960,000 on that deferral (assuming a 39.6% marginal tax rate and assuming that the manager is vested in the $10 million deferral). Under this approach, the manager would simply pay the government $3,960,000 with her 2017 tax return. Such undiluted accrual-based taxation of nonqualified retirement pay is hardly unprecedented: The law generally follows this approach for employment taxes on nonqualified retirement plans[246] and for income taxes on split-dollar life insurance arrangements,[247] nonqualified retirement plans failing certain statutory requirements,[248] nonqualified retirement plans funded through exclusive benefit trusts,[249] and nonqualified retirement plans maintained by tax-exempt organizations,[250] state or local governments,[251] or certain foreign corporations and partnerships.[252] Many senior managers no doubt have substantial liquid assets (including base salary) to cover the taxes imposed on their nonqualified 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 nonqualified retirement pay.[253] 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),[254] 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

---

the right to payment vests, the payment is subject to a 20% penalty tax and interest charge. IRC § 457A(c); Notice 2009-8, 2009-4 I.R.B. 347, 352-53. The imposition of the penalty tax and interest charge has no defensible basis in tax policy. Cf. notes 219-21 and accompanying text (discussing the poor tax policy behind the § 409A penalty). By contrast, the regulations under § 3121(v)(2), which subjects nonqualified retirement pay to accrual-based taxation, err in the other direction. Reg. § 31.3121(v)(2)-1(e)(4). Those regulations delay the taxation of any amount under a nonqualified defined benefit plan that is not "reasonably ascertainable." Id.; see also Chason, note 90, at 1688-89.

246 See IRC § 3121(v)(2).

247 Reg. § 1.61-22(d).

248 IRC § 409A(a)(1)(A).

249 IRC § 402(b).

250 IRC § 457(f).

251 Id.

252 IRC § 457A.

253 See Halperin, note 25, at 541.

254 See IRC § 3402(a).

example from above, the manager would include $10 million of nonqualified retirement pay in her 2017 gross income. However, the corporation would pay $3,960,000 to the government on the manager's behalf in 2017 and would reduce the manager's benefit under the nonqualified retirement plan by $3,960,000. On her 2017 tax 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 nonqualified 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 nonqualified retirement pay could be deferred, with an interest adjustment, until she actually receives her nonqualified retirement pay.[255] Under this approach, the manager would accrue a tax liability of $3,960,000 in 2017, but she would not pay that tax liability until she actually receives the distribution of her nonqualified retirement pay. If her nonqualified 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%). This approach minimizes liquidity problems for both the manager and the corporation.[256]

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."[257] 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.[258] As an example, he points to benefits that "are forfeited if death occurs before normal retirement age."[259] But such nonqualified retirement pay should not be vested for tax purposes and, thus, should not be subject to accrual-based taxation until the manager reached normal retirement age. Even in the

[255] See Shakow, note 233, at 1168-76.

[256] This approach also would help to address valuation problems because the tax imposed when the nonqualified retirement pay first vests could 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 would allow a "true-up" of the correct tax liability at the time the tax is first paid to the government.

[257] Halperin, note 25, at 541.

[258] See id.

[259] Id.

case of nonqualified 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.[260] The weak version of the objection is that present value of a manager's nonqualified retirement pay, determined under actual assumptions, may turn out to be more than the actual amount of the manager's nonqualified 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 could be adjusted at the time of actual receipt and any over-inclusions in past years could 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."[261] Of course, when Halperin first raised this objection in 1986, the 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 2017.[262] Additionally, the highest marginal tax rate applies to all income over amounts ($418,400 to $470,700)[263] that are really modest by the standards of senior corporate managers.[264] It is hard to imagine that taxation of nonqualified 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 nonqualified retirement pay is distributed[265] or would tax investment earnings currently—in which case, they say, accrual-based taxation "does not alleviate the need to develop a propo-

---

[260] See Chason, note 29, at 391-92.

[261] Halperin, note 25, at 542.

[262] Compare Rev. Proc. 2016-55, 2016-45 I.R.B. 707, 709-10 (providing the tax brackets for 2017), with Economic Recovery Tax Act of 1981, Pub. L. No. 97-34, § 101, 95 Stat. 172, 176 (1981) (providing tax brackets in effect in 1986).

[263] IRC § 1; Rev. Proc. 2016-55, 2016-45 I.R.B. 707, 709-10 (adjusting the income amounts in § 1 for inflation).

[264] In 2014, CEOs at the largest U.S. businesses earned an average of $16.9 million annually. Lawrence Mishel & Alyssa Davis, Econ. Pol'y Inst., Issue Brief No. 399, Top CEOs Make 300 Times More Than Typical Workers 4 (2015), http://www.epi.org/publication/top-ceos-make-300-times-more-than-workers-pay-growth-surpasses-market-gains-and-the-rest-of-the-0-1-percent/.

[265] Halperin & Yale, note 225, at 940. As they note, this is the approach followed by § 457(f) for certain nonqualified plans maintained by state or local governments or by tax-exempt organizations. Id.

sal to impose a special tax on the investment return."[266] But that last point does not follow. By taxing the manager on each year's change in the payout value of his nonqualified 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.[267]

Finally, Halperin and Yale object to accrual-based taxation on the ground that it "would inhibit deferred compensation arrangements, which would be said to serve an important business purpose."[268] I tend to agree with the point, which is why I remain skeptical that any reform of the tax rules for nonqualified retirement pay is appropriate. That said, the effect of accrual-based taxation—if implemented with sound actuarial assumptions and current deductions for losses—would closely track 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.

---

[266] Id.

[267] Cf. Chason, note 29, at 394.

[268] Halperin & Yale, note 225, at 940.