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## Has Congress Stopped Executives from Raiding the Bank? A Critical Analysis of I.R.C. §409A

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# HAS CONGRESS STOPPED EXECUTIVES FROM RAIDING THE BANK? A CRITICAL ANALYSIS OF I.R.C. § 409A

Michael J. Hussey\*

## I. INTRODUCTION

In the fall of 2001, energy giant Enron Corporation went spiraling into bankruptcy.<sup>1</sup> A number of on-going accounting abuses finally caught up with Enron and sent the corporation to its demise.<sup>2</sup> Congress acted swiftly and by July 2002 had enacted the Sarbanes-Oxley Act of 2002 to tighten corporate governance and hopefully prevent future Enrons.<sup>3</sup>

Not covered by Sarbanes-Oxley's provisions, though, were the nonqualified deferred compensation arrangements enjoyed by Enron's executives.<sup>4</sup> In these arrangements, the employer and executive agree that compensation earned currently by the executive will not be paid until a future tax year (for example, upon the executive's retirement).<sup>5</sup> This arrangement can allow the deferred compensation to grow tax-free for the executive until the cash is actually paid to the executive. This allows the executive to delay paying the income tax on compensation, which can be a big tax advantage.

While many rank-and-file employees invested and lost their entire savings in Enron stock, many of the executives who accumulated large balances in their nonqualified deferred compensation accounts received large distributions shortly before Enron's bankruptcy from those plans totaling over \$53 million.<sup>6</sup> In other words, Enron and the executives accelerated the payments of the deferred compensation to the executives immediately before Enron went bankrupt, while no similar accommodation was made for the rank-and-file employees.

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<sup>1</sup> See generally, BETHANY MCLEAN & PETER ELKIND, *THE SMARTEST GUYS IN THE ROOM: THE AMAZING RISE AND SCANDALOUS FALL OF ENRON* (Portfolio Hardcover 2003).

<sup>2</sup> *Id.*

<sup>3</sup> Sarbanes-Oxley Act of 2002, Pub. L. No. 107-204, 116 Stat. 745 (codified as amended in scattered sections of 11, 18, 28 U.S.C.).

<sup>4</sup> Drawing upon I.R.C. § 409A(d)(3), "plan," "arrangement," and "agreement" are used interchangeably even if referring to only one participant.

<sup>5</sup> *Id.*

<sup>6</sup> In the 6 weeks before Enron filed for bankruptcy, 117 employees and former employees requested and received accelerated distributions. STAFF OF THE JOINT COMMITTEE ON TAXATION, 107TH CONG., REPORT OF INVESTIGATION OF ENRON CORPORATION AND RELATED ENTITIES REGARDING FEDERAL TAX AND COMPENSATION ISSUES AND POLICY RECOMMENDATIONS 627 (Comm. Print 2003), [www.gpo.gov/congress/joint/jcs-3-03/vol1/index.html](http://www.gpo.gov/congress/joint/jcs-3-03/vol1/index.html) [hereinafter JCT ENRON REPORT]. The Houston Chronicle placed this number at 114. See, Eric Berger, *The Fall of Enron; Enron can go after deferred pay; Judge says money must be returned*, HOUSTON CHRON., Sept. 23, 2003 at B2. See also [www.employeecommittee.org](http://www.employeecommittee.org) (last visited July 21, 2006); David Barboza, *Enron Paid Some, Not All, Deferred Compensation*, N.Y. TIMES, Feb. 13, 2002 at C1.

The sharp contrast led to a general outcry over nonqualified deferred compensation.<sup>7</sup> In February 2002, the Joint Committee on Taxation, at the direction of the Senate Finance Committee, began investigating Enron. Despite enacting Sarbanes-Oxley, which addressed many corporate governance issues related to Enron's collapse, Congress felt more needed to be done. In October 2004, the legislative response to Enron continued.<sup>8</sup>

Congress, using the Joint Committee's report as a starting point, passed the American Jobs Creation Act ("AJCA") in October 2004.<sup>9</sup> The AJCA created new § 409A of the Internal Revenue Code ("I.R.C."). Section 409A contains detailed and restrictive provisions relating to nonqualified deferred compensation including rules on when distributions may be made, when the arrangement may be renegotiated, and new penalties applicable if a plan fails to qualify under § 409A.<sup>10</sup> Congress enacted I.R.C. § 409A to restrict the contractual freedom of executives and employers to negotiate executive compensation.<sup>11</sup>

Case law dating from the early 1940s had provided the framework for negotiating employment relationships between executives and employers.<sup>12</sup> Over the years, the Internal Revenue Service ("Service") issued guidance about tax consequences of various compensation arrangements.<sup>13</sup> Taxpayers, particularly highly-compensated executives, sought to structure their employment relationships so as to defer receipt (and income taxation) of compensation with minimal risk of eventual loss of the deferred compensation. As with many areas of the law, there was a risk-reward trade-off. The risk that the employer may not be able to pay the compensation when due accompanied the reward of delayed taxation. Too much, or possibly any, security in the right to be paid could cause the executive to be taxed on the compensation presently losing the reward of delayed taxation. On its face, the Enron scenario appeared to violate this risk-reward paradigm because the Enron executives enjoyed the reward of delayed taxation (while Enron was financially healthy) but had no risk because Enron was willing to pay the cash to the executives immediately when financial difficulties emerged.<sup>14</sup>

By enacting I.R.C. § 409A in response to the inequity of the Enron fall-out, Congress chose an unwieldy and confusing middle ground. As will be seen in this article, § 409A does little to prevent other executives from using (and potentially abusing) nonqualified deferred compensation. In fact, Congress has

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<sup>7</sup> See Melissa Jacoby, *Negotiating Bankruptcy Legislation Through the News Media*, 41 HOUS. L. REV. 1091 (2005).

<sup>8</sup> American Jobs Creation Act, Pub. L. No. 108-357, 118 Stat. 1418 (codified as amended in scattered sections of the U.S.C.) [hereinafter AJCA].

<sup>9</sup> *Id.*

<sup>10</sup> See 26 U.S.C. § 409A (2006).

<sup>11</sup> *Id.*

<sup>12</sup> See *Veit v. Comm'r (Veit I)*, 8 T.C. 809 (1947).

<sup>13</sup> See Rev. Rul. 60-31, Rev. Proc. 92-64, and Rev. Proc. 92-65, 1992-2 C.B. 428.

<sup>14</sup> The executives still forfeited 10% of the distribution. See *infra* notes 43-49. Following Enron's bankruptcy, the executives had to return these accelerated distributions as required by bankruptcy law. See *infra* notes 145-47.

provided a road map for executives and employers to draft nonqualified deferred compensation agreements.

Part II of this article explores why executives and employers would want to use nonqualified deferred compensation.<sup>15</sup> This part also details the nonqualified deferred compensation plan at Enron and what happened as Enron spun toward bankruptcy. It is necessary to have a basic understanding of Enron's nonqualified deferred compensation plan in order to understand what perceived abuses I.R.C. § 409A seeks to prevent.

Part III of this article examines the law regarding the timing of the inclusion of gross income. It traces the development of various principles that determine when an item of gross income is taxable, including the cash method of accounting, the constructive receipt doctrine, the economic benefit doctrine, and the Service's own position on the timing of the inclusion of gross income, including the use of so-called rabbi trusts.

Part IV of this article recounts the post-Enron developments by detailing the Joint Committee's investigation and report on Enron and by reviewing the detailed provisions of § 409A enacted by Congress. This part concludes that § 409A does not adequately address the perceived abuses regarding nonqualified deferred compensation.

Part V of this article offers two suggestions that would have better addressed the perceived abuses. This part first examines the differences between cash method accounting and accrual method accounting. It then recounts the history of § 132 of the 1978 Revenue Act and argues that repealing § 132 would have been a better course of action to rein in nonqualified deferred compensation. Second, this part considers the consequences if Congress simply requires employees to use the accrual method of accounting rather than allowing them to use the cash method. This article concludes that Congress should have either mandated accrual method accounting for individuals reporting wage income (with certain exceptions), or Congress should have repealed § 132 thereby giving the Service more latitude to pursue individual cases of taxpayer abuse. Either choice is preferable to the newly enacted § 409A.<sup>16</sup>

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<sup>15</sup> Although § 409A sweeps broadly over deferred compensation, this article explores only nonqualified deferred compensation agreements. *See* I.R.C. § 409A(d)(1) (2006). It leaves aside "qualified" arrangements, for example, IRAs, 401(k) plans, and 457(b) plans for tax-exempt employers, and other deferred compensation structures such as stock appreciation rights ("SAR") plans, phantom stock, and supplemental executive retirement plans ("SERPs").

<sup>16</sup> Another problem with I.R.C. § 409A is the incredible amount of time being expended by the government and taxpayers promulgating and understanding new rules and subsequently revising existing plans to comply with the new rules. *See* Notice 2005-1, 2005-1 C.B. 274. Additional guidance is still coming and is constantly being refined. *See* Prop. Treas. Reg. § 1.409A-1, 70 Fed. Reg. 75090 (Dec. 19, 2005). Final regulations are expected by January 31, 2007, but have already been delayed several times.

## II. NONQUALIFIED DEFERRED COMPENSATION INCENTIVES

### A. Reasons for Deferred Compensation Generally

A number of reasons exist for permitting nonqualified deferred compensation. From an executive's perspective, nonqualified deferred compensation provides a way to save money, often for retirement, on a tax-deferred basis. For an employer, nonqualified deferred compensation offers a way to compensate key employees when the employer might not otherwise have the current cash flow to do so. In nonqualified deferred compensation arrangements, executives and employers exercise their freedom of contract to negotiate compensation on terms agreeable to both parties.

Opponents of nonqualified deferred compensation argue that it undermines the qualified retirement savings vehicles by making employers less interested in providing retirement benefits for the rank and file workers. Opponents also argue that the restrictions upon which an executive relies to delay income taxation are, as a practical matter, illusory. Again, this delay benefits high wage earners at the expense of other taxpayers.

Nonqualified deferred compensation plans are attractive to some taxpayers, and conceived abusive by others, because these plans delay the inclusion of compensation in gross income. The timing of the inclusion of gross income is almost as important to a taxpayer as whether a particular item is gross income. Once a taxpayer has determined that an item is includible in gross income, then the taxpayer turns to determining *when* that item must be included.<sup>17</sup> With some exceptions,<sup>18</sup> most taxpayers would prefer not to pay any tax and when they must pay some tax, to pay as little as possible and as late as possible. To some degree, the answer to the timing question depends upon the taxpayer's method of accounting. A taxpayer might use a cash receipts and disbursements method, an accrual method, another method, or some combination of these methods. A taxpayer also must select either a calendar year or a fiscal year reporting period. Generally the method chosen must be consistently applied and must clearly reflect a taxpayer's income. Within these parameters, taxpayers have generally found themselves with great flexibility.

### B. From the Executive's Side

Many people who work for a living need to receive all their wages immediately – to pay the mortgage, to make the car payment, to pay the utilities. These people cannot afford to “defer” any of their compensation because they need all of it now. Thus, the potential tax advantages of nonqualified deferred

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<sup>17</sup> See generally, I.R.C. §§ 61, 446, 451 (2006).

<sup>18</sup> See David Cay Johnston, *The Ultra-Rich Give Differently from You and Me*, N.Y. TIMES, July 2, 2006, § 4, at 3; *Ralph Nader Takes on 'Vulture Tax,'* FIN. TIMES (London), Apr. 27, 2006, at 12.

compensation are not available to the vast majority of low-paid or middle-income workers.<sup>19</sup>

For those who can save some money, one way to save is through so-called “qualified” plans, for example, 401(k) plans, 403(b) plans,<sup>20</sup> and pension plans. These qualified plans are great ways to save because the employee can save on a pre-tax basis.<sup>21</sup> For example, if a portion of the employee’s wages are deferred into a 401(k) plan, the employee does not include the deferred wages currently in gross income,<sup>22</sup> and thus does not presently pay income tax on that portion of his or her wages. Furthermore, as that money earns interest or dividends, no income tax is paid until distributions are actually received at retirement or when the employee must take a minimum distribution in the year in which the employee attains age 70½.<sup>23</sup> Another benefit is that the deferred amounts are not subject to the employer’s creditors. The amount, however, that can be deferred under these qualified plans is limited.<sup>24</sup>

For certain employees who can afford to save even more, there is another way to save on a tax-deferred basis: nonqualified deferred compensation.<sup>25</sup> In

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<sup>19</sup> Those who inherit substantial wealth and those who can live off of the income earned by another family member might be interested in nonqualified deferred compensation.

<sup>20</sup> See I.R.C. §§ 401, 403 (2006).

<sup>21</sup> These “qualified” deferred amounts are still subject to FICA employment taxes. See I.R.C. § 3121(v)(2) (2006). Employees benefit from not including deferred amounts in gross income until distributions are made, generally after age 59 ½. Employees do not pay FICA taxes on amounts deferred, or often matched, by the employer. For example, if an employee contributes 6% of his or her compensation to a 401(k) plan and the employer matches the first 5% contributed to a 401(k) plan by each employee, the employee pays the FICA employment tax on the 6% but not on the 5% contributed to the 401(k) plan by the employer. This 5% escapes FICA taxation.

<sup>22</sup> This article uses the term “gross income” when the taxpayer must include the income on his, her, or its income tax return. Because of deductions and credits, it is conceivable that a taxpayer may have gross income but not have any taxable income and thus not pay any income tax. Given the alternative minimum tax, I.R.C. § 55 (2006), it is unlikely that an employee participating in a nonqualified deferred compensation plan would be in a situation of having gross income but no taxable income.

<sup>23</sup> The money invested in a qualified plan could also be invested in securities that are subsequently sold. Whether the additional income is in the form of ordinary income or in the form of capital gains is irrelevant for this income tax analysis. The income generated is not taxable to the employer or the employee unless distributed. See I.R.C. §§ 401(a), 402(a), 501(a) (2006).

<sup>24</sup> In 2006, generally an employee can only elect to defer \$15,000 into a 401(k) plan. See I.R.C. § 402(g)(1)(B) (2006). For those over age 50, EGGTRA of 2001 provides that additional make-up contributions be allowed. In addition to the \$15,000 limitation applicable to all employees, those over age 50 are able to contribute an additional \$5,000 each year to a qualified plan. See I.R.C. §§ 402(g)(1)(B), 414(v)(2)(B) (2006).

<sup>25</sup> See Employee Retirement Income Security Act of 1974 [hereinafter ERISA], Pub. L. No. 93-406, §§ 201(2), 301(a)(3), 401(a)(1), 88 Stat. 829, 852, 874-75 (1974). Top-hat plans are exempt from vesting, funding, and certain other ERISA requirements, while qualified pension plans are subject to ERISA. *Id.* The Department of Labor reasons that certain high ranking or highly paid individuals have the ability to negotiate, in consideration of the attendant risks, the particular design of their deferred compensation plans, therefore, eliminating the need for protections provided by

this type of plan, sometimes referred to as a “top-hat plan,” the executive and the employer agree that a certain amount or a certain percentage of the executive’s wages will be deferred and those wages will be paid when the executive retires or otherwise terminates employment.<sup>26</sup> In other words, the executive agrees that instead of taking cash now, the executive will take the employer’s unsecured and unfunded promise to pay the deferred amounts in the future, usually at retirement.<sup>27</sup> This is advantageous for the executive, because like a 401(k) plan, the executive does not pay income tax on the wages when he or she earns them, but defers the income tax liability until the cash is actually received at retirement.<sup>28</sup> Additionally, the executive does not pay income tax on the income earned during the deferral period. The deferred amounts remain the property of the employer and the employer pays the income tax on any earnings during the period of deferral.<sup>29</sup>

In contrast to a 401(k) plan or other qualified plan, an employer normally will allow only a “select group of management” or “highly compensated employees” to participate in a nonqualified deferred compensation plan. Participation in these plans is offered only to the top executives because otherwise the plan would be subject to a variety of requirements under the Employee Retirement Income Security Act (“ERISA”), such as minimum participation, funding, and vesting.<sup>30</sup> Being subject to ERISA’s requirements would eliminate the tax deferral benefits sought by the executive.<sup>31</sup> ERISA does

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ERISA. 90 Op. DOL 14A (1990). Top-hat plans are compensation plans for top executives. They are unfunded and benefit only “a select group of management or highly compensated employees.” See ERISA §§ 201(2), 301(a)(3), 401(a)(1).

<sup>26</sup> *Id.*

<sup>27</sup> Top-hat plans may also provide for payment to the executive upon disability, death, or change in control of the employer.

<sup>28</sup> Amounts deferred into a nonqualified deferred compensation plan are still subject to FICA employment taxes if the amount is not subject to a substantial risk of forfeiture. See I.R.C. § 3121(v)(2) (2006). For the OASDI portion, the employee pays 6.2% up to the limit set by the Social Security Administration, currently \$97,500 for 2007. I.R.C. § 3101(a) (2006). For the Medicare (HI) portion, the employee pays 1.45% on all nonqualified deferred compensation. I.R.C. § 3101(b) (2006). There is no ceiling over which the Medicare portion is not paid.

<sup>29</sup> If the employer has created a rabbi trust to fund its nonqualified deferred compensation obligations, the rabbi trust is a grantor trust for income tax purposes and the income generated by the trust assets is includible on the employer’s income tax return. Rev. Proc. 92-64, 1992-2 C.B. 422 § 1(c) of Model Trust.

<sup>30</sup> 29 U.S.C. §§ 1051(2), 1081(a)(2), 1101(a)(1) (2006).

<sup>31</sup> The general framework of ERISA is that all deferred compensation plans are covered by ERISA unless excluded. See ERISA § 3(3); 29 U.S.C. § 1002(3) (2006). Being subject to ERISA means that certain funding requirements must be met. See 29 U.S.C. § 1082 (2006). For income tax purposes, the downside of “funding” plans means that the executive will immediately be taxed on the benefit set aside for him or her under I.R.C. § 83 (2006). Under § 83, an employee will be taxed immediately on the receipt of “property” and an employer’s promise to pay money in the future will be “property” unless it is an “unfunded and unsecured promise to pay in the future.” Treas. Reg. § 1.83-1 (as amended in 2003).

As to so-called qualified plans, the Internal Revenue Code, up to certain limits, excludes amounts set aside to fund a plan until those amounts are paid to the executive. Thus the executive has no

not apply if the plan is only available to a “select group of management” or “highly compensated employees.”<sup>32</sup> These plans are not subject to ERISA because these executives do not need ERISA’s protection when negotiating with the employer.

In the executive’s perfect world, the executive would have the right to demand payment of the nonqualified deferred compensation at any time, so that if the executive wanted the money, he or she could reach it. A right to demand immediate payment would be particularly valuable to the executive because during the deferral period, the executive is merely a general unsecured creditor of the employer.<sup>33</sup> As a result, if the employer goes bankrupt, the executive may get pennies on the dollar – if the executive gets anything at all. Thus in the perfect world, the executive would want to be able to demand payment immediately if he or she fears that the employer will go bankrupt.

The tax world, however, is not the executive’s perfect world. If the executive has an unrestricted right of withdrawal, then, under the constructive receipt doctrine, the executive will be taxed on the money immediately, even if the executive elects not to receive the cash until retirement.

### C. From the Employer’s Side

It is not always about the executive, though. An employer seeking to improve its cash flow might seek a nonqualified deferred compensation arrangement. With payment to an executive deferred, an employer might use the cash that otherwise would have been paid currently as compensation to the executive to improve or expand operations or simply meet existing cash flow needs. For example, Mario Lemieux of the National Hockey League’s (“NHL”) Pittsburgh Penguins negotiated his contract with the team to provide him nonqualified deferred compensation.<sup>34</sup> After winning consecutive Stanley Cups,

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current income tax liability for deferred qualified plan amounts. Funding nonqualified deferred compensation, though, would cause the executive to have a present income tax liability – the exact result the executive is trying to avoid.

Thus, employers offering a nonqualified deferred compensation plan seek an exclusion from ERISA’s provisions. ERISA § 201(2) provides an exclusion from the participation and vesting requirements of ERISA for “a plan which is unfunded and is maintained by an employer primarily for the purpose of providing deferred compensation for a select group of management or highly compensated employees.” 29 U.S.C. § 1051(2) (2006). ERISA § 301(a)(3) provides a similar exception from ERISA’s funding requirement. 29 U.S.C. § 1081(a)(3) (2006). ERISA § 401(a)(1) provides a similar exception from ERISA’s fiduciary responsibilities. 29 U.S.C. § 1101(a)(1) (2006).

<sup>32</sup> 29 U.S.C. § 1051(2) (2006).

<sup>33</sup> Rev. Proc. 92-65, 1992-2 C.B. 428.

<sup>34</sup> On October 5, 1992, Mario Lemieux signed a seven-year, \$42 million contract with the Penguins. Although at the time of its signing details were not released as to the exact structure of the contract, many correctly speculated that the contract included significant nonqualified deferred compensation. The contract made Lemieux the highest paid player in NHL history. The Penguins won the Stanley Cup in 1991 and 1992. The Penguins’ ownership was eager to keep Lemieux with the team to try for more Stanley Cups. *Penguins Sign Lemieux to Record Deal 7-Year Contract is Worth \$42 Million*, BALT. SUN, Oct. 6, 1992, at 8B; Kevin Allen, *Lemieux: Whew! Penguins Star*



the team was eager to keep its star player for the long-term and made him the highest paid player in NHL history. Eventually the Penguins went bankrupt with Lemieux as its largest creditor. Lemieux ended up owning the team.<sup>35</sup>

Major League Baseball's Arizona Diamondbacks used nonqualified deferred compensation to finance their 2001 World Series Championship. In spring training 2001, the Diamondbacks and 10 players agreed to renegotiate binding multi-year contracts to defer some of each player's compensation to future years.<sup>36</sup> The renegotiations led to an extra \$16 million in cash flow that the Diamondbacks could use to sign new players.<sup>37</sup> Following the renegotiations, the Diamondbacks were projected to have a payroll of approximately \$83 million but only cash needs of \$50-55 million for the 2001 season.<sup>38</sup> Despite the risk of not being paid, the players were willing to renegotiate and defer compensation to "win now." The additional cash flow would allow the owners to assemble the best baseball team possible.<sup>39</sup>

An employer may also want a nonqualified deferred compensation arrangement as a means of hiring a highly sought-after executive. For example, a start-up business might want to hire a top executive. As a start-up business, cash flow to pay the executive will likely be an issue. It is unreasonable to expect that the executive will accept less pay than he or she is currently making. The small business owner could offer an equity interest in the business to the executive as an incentive, but the small business owner may not wish to part with any ownership of the business.<sup>40</sup> Another solution is a nonqualified deferred

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*Healthy, Earning Keep*, USA TODAY, Oct. 28, 1992, at 1C; *Millions of Thrills Mark Baldwin's First Year with Penguins*, PITT. POST-GAZETTE, Dec. 30, 1992, at A14.

<sup>35</sup> See Official Home of the Pittsburgh Penguins, [www.pittsburghpenguins.com/team/office.php](http://www.pittsburghpenguins.com/team/office.php) (last visited Jan. 3, 2007). The Penguins filed for bankruptcy in October 1998. Mr. Lemieux was able to assemble a small group to purchase the team. He serves as the chairman and in 2000 returned to playing for the team. He is the only owner-player of a sports franchise in the modern era. *Id.*

<sup>36</sup> Mark Gonzales, *10 D-Backs Defer Pay, Aid Cash Flow*, ARIZ. REPUBLIC, Feb. 23, 2001, at 1C. See also, Richard Obert, *Win Now, Pay Later for D-Backs More than \$120 Million in Players' Salaries Deferred*, ARIZ. REPUBLIC, July 21, 2001, at 1C. By August 2004, it was estimated that the Diamondbacks owed \$170 million in deferred salaries. A new ownership group forced out team founder Jerry Colangelo. Following the 2004 season, in which the Diamondbacks had the worst record (51-111) in major league baseball, the Diamondbacks traded away top players to reduce payroll. See Craig Harris, *Desire to Win, Resulting Debt Was D-Backs Founder's Undoing*, ARIZ. REPUBLIC, Aug. 7, 2004, at 1A. See also, *Yanks Reach Tentative Deal with Johnson*, SUN-SENTINEL (Fort Lauderdale, Fla.), Dec. 31, 2004, at 2C. Many major league baseball players have nonqualified deferred compensation arrangements, including stars Albert Pujols, Pedro Martinez, Carlos Beltran, and Tom Glavine. See *Cot's Baseball Contracts*, [www.mlbcontracts.blogspot.com](http://www.mlbcontracts.blogspot.com) (last visited Dec. 17, 2006).

<sup>37</sup> Gonzales, *supra* note 36.

<sup>38</sup> *Id.*

<sup>39</sup> In fact, one player's agent noted that an "IOU" from the Diamondbacks was better than an "IOU" from the Montreal Expos (now the Washington Nationals). Obert, *supra* note 31, at 1C. Players received 4-6% interest on their deferred compensation. *Id.*

<sup>40</sup> This may be even truer if the business is an established one that is struggling and the business has always been family-owned.

compensation agreement. The executive would agree to defer some of his or her compensation to help with the present lack of cash flow. If the business does well, it will have cash to pay the executive. If the business does poorly, then the executive will have nothing. In fact, if the business fails, the executive will fare slightly better with nonqualified deferred compensation than with an equity interest. With nonqualified deferred compensation, the executive is an unsecured creditor and will be paid along with the other unsecured creditors. If the executive were a shareholder, then he or she would receive whatever is left after the unsecured creditors are paid, which would likely be nothing.

#### **D. Nonqualified Deferred Compensation at Enron**

To better understand § 409A, it is necessary to examine the Enron Plan and its provisions. Enron had a number of nonqualified deferred compensation plans for its employees. The primary plan was the Enron Corporation 1994 Deferral Plan (the “Enron Plan”).<sup>41</sup> Participation in the Enron Plan was open to approximately 300 highly compensated and key employees as determined by the Deferral Plan Committee.<sup>42</sup> At the outset, approximately 100 employees elected to participate.<sup>43</sup> Over the years, eligibility varied for the Enron Plan. In 1999, plan participation was available to employees whose salary was \$130,000 or more.<sup>44</sup> In 2001, participating employees generally had to hold positions at the vice president level or above.<sup>45</sup> As a “top-hat” plan for a “select group of management” or “highly compensated employees,” the Enron Plan avoided the application of ERISA.<sup>46</sup>

Employees participating in the Enron Plan were required to defer compensation prior to the first day of the calendar year in which the

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<sup>41</sup> JCT ENRON REPORT, *supra* note 4, at 603. The Enron Plan was amended and restated a number of times. It was restated on August 11, 1997, and then again on October 6, 2000. It was amended on August 14, 2001. For this article, “Enron Plan” means the Enron Corp. 1994 Deferral Plan as amended and restated.

The other operational plan was the 1998 Expat Services, Inc. Deferral Plan. It was similar to the Enron Plan but participation was limited to expatriates who were employed by Enron Expat Services, Inc. and thus were ineligible to participate in the Enron Plan. *Id.* at 615-16.

Enron also had several other nonqualified deferred compensation plans. Generally, these plans either related to Enron’s overseas operations or were plans inherited when it acquired other corporations. The predecessor plans included the: InterNorth, Inc. Director’s Unfunded Deferred Income Plan; InterNorth Deferral Plan; Houston Natural Gas Corporation Deferred Income Program for Directors; HNG Deferred Income Plan; HNG/InterNorth Deferral Plan; Enron Corp. Deferral Plan; Enron Corp. 1988 Deferral Plan; Enron Corp. 1992 Deferral Plan; Enron Corp. Director’s Deferral Plan; Enron Deferral Repatriation Plan; Portland General Holdings, Inc. Management Deferred Compensation Plan; and Portland General Holdings, Inc. Outside Directors’ Deferred Compensation Plan. *Id.* at 619.

<sup>42</sup> *Id.* at 604, 605.

<sup>43</sup> *Id.* at 604.

<sup>44</sup> *Id.* at 606.

<sup>45</sup> *See id.*

<sup>46</sup> Pub. L. No. 93-406, 88 Stat. 829 (1974).

compensation was earned.<sup>47</sup> The Enron Plan allowed for generous deferral of compensation. A participant could defer up to 35% of base salary and up to 100% of bonuses and long-term incentives.<sup>48</sup> Although there was a minimal deferral amount, there was no maximum deferral amount other than these percentage limitations.<sup>49</sup>

The Enron Plan had the following features if a participant wished to receive payments (accelerated distributions) before separation from service or other events specified in the Enron Plan: (1) if the executive received an accelerated distribution, the executive had to forfeit 10% of that distribution to Enron;<sup>50</sup> (2) the plan trustee, in such trustee's sole discretion was to approve or deny each request for an accelerated distribution; and (3) the executive was ineligible to participate in the Enron Plan for three years following an accelerated

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<sup>47</sup> *Id.* at 606. For example, if an executive wanted to defer compensation for the 1998 taxable year, the last day to make an election to do so under the Enron Plan was December 31, 1997. Generally, this would be considered a conservative approach to nonqualified deferred compensation elections. The Service prefers that the election to defer compensation be made before the employee has begun working for the period in which the compensation is earned. *See* Rev. Proc. 71-19, 1971-1 C.B. 698 and Rev. Proc. 92-65, 1992-2 C.B. 465. The courts, though, have generally allowed executives to elect to defer compensation so long as the employer is not yet required to pay the employee. *See* *Martin v. Comm'r*, 96 T.C. 814, 822-23 (1991); *Oates v. Comm'r*, 18 T.C. 570, 584-85 (1952), *aff'd*, 207 F.2d 711 (7th Cir. 1953), *acq.*, 1960-1 C.B. 5; *Veit I*, 8 T.C. 809, 816-17 (1947). For example, if an executive is paid on the 30th of each month, the IRS would argue that at the very least the executive must make an election to defer the compensation for that month before it begins. *See* Rev. Proc. 92-65, 1992-2 C.B. 465. *See also* Rev. Proc. 71-19, 1971-1 C.B. 698. The courts would allow the employee to defer the compensation without being in actual or constructive receipt up until the employer is required to pay. Here, arguably the courts would allow deferral up until the 30th. *Martin*, 96 T.C. at 822; *Oates*, 18 T.C. at 584; *Veit*, 8 T.C. at 816.

<sup>48</sup> JCT ENRON REPORT, *supra* note 4, at 606.

<sup>49</sup> Participants had to defer at least \$2,000 for each category, but as stated above, there was no ceiling for the Enron Plan. When contrasted with the contribution restrictions for 401(k) and 403(b) plans, which generally allow a maximum employee contribution of \$15,000 per year, the Enron plan was generous to the participants. *See* I.R.C. § 402(g)(1)(B) (2006). Participants age 50 and over may make a \$5,000 make-up contribution to a 401(k) or 408(b) plan each year. *See* I.R.C. § 414(v) (2006). In *Minor v. United States*, 772 F.2d 1472 (9th Cir. 1985), the court allowed a physician to defer 90% of his income pursuant to a nonqualified deferred compensation plan. After conceding that the constructive receipt doctrine did not apply, the Service argued that the economic benefit doctrine required the physician to include the deferred compensation in his gross income. *Id.* *Snohomish Physicians*, the employer, adopted a nonqualified deferred compensation plan in 1967. *Id.* The plan allowed for deferrals from 10% to 90%, which the employer held in a separate trust. Finding that the assets of the trust remained subject to the claims of the employer's general unsecured creditors, the Ninth Circuit ruled that the employer's promise to pay Dr. Minor was incapable of valuation and therefore the economic benefit doctrine did not apply. *Id.* Noteworthy for this article is that the percentage deferred by Dr. Minor was never at issue.

<sup>50</sup> JCT ENRON REPORT, *supra* note 4, at 608-09: "If a participant elected an accelerated withdrawal, 10 percent of the elected distribution amount was required to be forfeited and 90 percent of the elected distribution would be paid to the participant." This 10% forfeiture did not apply to early distributions made for hardship. Hardship distributions could be approved for "unforeseeable circumstances causing urgent and severe financial hardship for the participant." *Id.* at 608.

distribution.<sup>51</sup> These were designed to prevent the executive from being in constructive receipt<sup>52</sup> of the deferred compensation (which would have caused the executive to be taxed immediately on the accrued benefit).

In reviewing the Enron Plan, the Joint Committee on Taxation concluded that these restrictions were illusory and argued the restrictions should not be respected to prevent the executives from having constructively received the deferred compensation.<sup>53</sup> Although the Joint Committee's conclusion is not devoid of truth, the illusory nature of the restrictions of the Enron nonqualified deferred compensation plan had more to do with the manner in which Enron administered its nonqualified deferred compensation plan than the restrictions themselves.<sup>54</sup> Some of the key features of the Enron plan are reviewed below to provide context for the Joint Committee's response, and subsequently, Congress's response, to nonqualified deferred compensation.<sup>55</sup>

### 1. Forfeiture for Early Distribution

As with all three features, the 10% forfeiture provision, also known as a "haircut," was designed to discourage executives from requesting an accelerated withdrawal.<sup>56</sup> This forfeiture was intended to operate as a substantial limitation or restriction on the right to receive the nonqualified deferred compensation and thereby prevent the executive from being taxed immediately (under the constructive receipt doctrine) on the deferred amounts.<sup>57</sup> In Enron's last desperate moments, the forfeiture provision did not stop many executives from

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<sup>51</sup> *Id.* at 629. The result of not respecting the restrictions is that the executives would then be in constructive receipt of the deferred amounts.

<sup>52</sup> The constructive receipt doctrine is discussed more fully below at pp. 16-21. Generally, the constructive receipt doctrine provides that a taxpayer must include in gross income items that are made available to the taxpayer without any substantial limitation or restriction even though such items are not actually received by the taxpayer. Treas. Reg. § 1.451-2(a) (1964).

<sup>53</sup> JCT ENRON REPORT, *supra* note 4, at 629.

<sup>54</sup> The new limitations and restrictions of § 409A are ill-conceived because the Joint Committee and Congress did not first look to see how the limitations and restrictions of the Enron Plan operated under "normal" operating conditions. If the employer is still going to go bankrupt, the executive will still request an accelerated distribution and suffer the adverse tax consequences. Thus, § 409A is ineffective to deter requests for accelerated distributions when the employer likely will go bankrupt. The bankruptcy trustee can recover amounts paid to insiders within one year of bankruptcy. See 11 U.S.C. § 547(b) (2006). If the issue is displeasure with subsequent elections, then the purpose of § 409A would seem to be discouraging executives from entering into arrangements at all. By providing a framework for nonqualified deferred compensation plans, Congress is allowing executives and employers to enter into these plans.

<sup>55</sup> The Joint Committee's report merits review as it formed the basis for the nonqualified deferred compensation provisions of AJCA. Large parts of the Conference Report summarizing the current law are nearly verbatim from the Joint Committee's report.

<sup>56</sup> Early distributions made on account of hardship were not subject to this 10% penalty. See JCT ENRON REPORT, *supra* note 4, at 608.

<sup>57</sup> See Treas. Reg. § 1.451-2(a) (as amended in 1979) ("Income is not constructively received if the taxpayer's control of its receipt is subject to substantial limitations or restrictions.").

requesting an accelerated distribution, which makes sense.<sup>58</sup> If the executive determines that the employer is heading into bankruptcy, wherein the executive's only remedy will be to stand in line with all of the other general unsecured creditors of the employer, why not request an accelerated distribution? Any money the executive receives is more money than the executive will likely receive in the bankruptcy proceedings. Arguably even a 50% forfeiture may not be steep enough to prevent requests for accelerated distributions when it appears the employer is heading into bankruptcy. The Joint Committee concluded that the 10% forfeiture imposed by the Enron Plan was not a substantial limitation or restriction on receiving the deferred compensation. As support, the Joint Committee pointed to the number of executives who requested and received accelerated distributions.<sup>59</sup>

The Joint Committee does not offer a forfeiture percentage that it believes is sufficient to operate as a substantial restriction to prevent constructive receipt by the executive.<sup>60</sup> Nevertheless, the Joint Committee misses the issue regarding the effectiveness of the accelerated distribution provisions. Arguably the Enron accelerated distribution provisions did work because no executives had requested or received an accelerated distribution prior to Enron being on the brink of bankruptcy.<sup>61</sup> The effectiveness of forfeiture provisions should be evaluated not when the employer is sinking into bankruptcy, but when the corporation is operating under "normal" conditions. The Bankruptcy Code prevents executives from reaching their deferred compensation at the crucial time before bankruptcy.<sup>62</sup>

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<sup>58</sup> Approximately 211 requests were made near Enron's collapse, with about 181 requesting distributions from the Enron Plan. JCT ENRON REPORT, *supra* note 4, at 622.

<sup>59</sup> Approximately 109 people received accelerated distributions. *Id.* at 624.

<sup>60</sup> I.R.C. § 409A(a)(1)(B)(i)(II) (2006) imposes an additional 20% tax on early distributions, notwithstanding some exceptions.

<sup>61</sup> JCT ENRON REPORT, *supra* note 4, at 622. The Joint Committee interviewed a number of current and former Enron employees who all said that prior to Fall 2001 there had been no accelerated distributions. Records provided by Enron to the Joint Committee show no accelerated distributions in 1998, 1999, or 2000. *Id.*

<sup>62</sup> 11 U.S.C. § 547 provides, with some exceptions, that a bankruptcy trustee "may avoid any transfer of an interest of the debtor in property . . . made on or within 90 days before the date of the filing of the petition; or between ninety days and one year before the date of the filing of the petition, if such creditor at the time of such transfer was an insider." 11 U.S.C. § 101(31)(B) provides that an insider of a corporation includes a director or officer of the corporation. On March 27, 2002, the U.S. Trustee in Enron's bankruptcy proceeding appointed the Employee Committee pursuant to 11 U.S.C. § 1102(a) and (b). *In re Enron Corp.*, 316 B.R. 434, 437 (S.D. N.Y. 2004). The Employee Committee was given authority to pursue the return of the accelerated distributions made from the Enron Plan to Enron executives in the days before Enron's bankruptcy. The Employee Committee offered a settlement to three groups of Enron executives. Group I, current executives, would have to repay 40% of the accelerated distribution. Group II, former executives whose employment was involuntarily terminated without cause after the bankruptcy filing, would have to repay 40% to 85% of the accelerated distribution. Group III, former executives who were not employed by Enron on the date of the bankruptcy filing, who voluntarily terminated employment after the bankruptcy filing, or who were terminated with cause after the bankruptcy

## 2. Trustee Approval of Accelerated Distributions

Under the Enron Plan, a request for an accelerated distribution was subject to approval by the plan trustee.<sup>63</sup> Enron developed three operating conditions to assist it in determining whether an accelerated distribution requested by a plan participant would be paid.<sup>64</sup> First, if Enron was operating in good health, then the distribution would be approved.<sup>65</sup> Second, if Enron was solvent but experiencing cash flow issues, then only requests by current employees would be paid and approval of requests by former employees would be delayed.<sup>66</sup> Current employees, so the thinking went, should be paid to motivate them to help turn around the company. Finally, if Enron was insolvent, then no distribution would be made.<sup>67</sup> On October 26, 2001, Ken Lay appointed Lawrence G. Whalley as the sole member of the Deferral Plan Committee.<sup>68</sup> Prior to Whalley's appointment, there is no record of such a committee.<sup>69</sup> The lack or absence of a committee does not necessarily evidence an unsound tax situation but rather evidences a corporate failure to follow the very rules Enron created for its nonqualified deferred compensation plan.

## 3. Period of Disqualification

If an executive received an accelerated distribution, he or she was ineligible from participating in the Enron Plan for three years.<sup>70</sup> Again, presumably this requirement was intended to operate as a substantial limitation or restriction on the executive's right to receive the deferred compensation thereby preventing the executive from being taxed on the benefit (under the constructive receipt

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filing, would have to repay 90%. All distributions had to be repaid by October 31, 2004. If an executive did not accept the settlement, the Employee Committee would pursue return of 100% of the accelerated distribution. See Deferred Compensation, [www.employeecommittee.org/sr-deferredcomp.asp](http://www.employeecommittee.org/sr-deferredcomp.asp) (last visited Nov. 22, 2006).

See also *In re Bank Bldg. & Equip.*, 158 B.R. 138 (E.D. Mo. 1993) (debtor's transfer of funds in rabbi trust to a nonqualified deferred compensation participant occurred when transfer was made from rabbi trust to participant, not when debtor initially transferred the funds to the rabbi trust).

<sup>63</sup> In a "qualified" plan, one in which the employee does not have to include the deferred compensation currently in gross income, loans are permitted to participants. See I.R.C. § 72(p)(1)(A) (2006).

<sup>64</sup> JCT ENRON REPORT, *supra* note 4, at 623.

<sup>65</sup> *Id.*

<sup>66</sup> Technically, no requests by former employees were denied. Action on the requests was delayed until the corporation was in a position that the requests could be honored. *Id.* Requests made by inactive participants (former employees) were approved on November 14, 2001. According to the Joint Committee, no requests by former Enron employees for accelerated distributions were approved after November 14, 2001. *Id.* at 624. Requests made by current employees on November 30, 2001, were not paid either. *Id.*

<sup>67</sup> *Id.* at 623.

<sup>68</sup> *Id.* at 611, 622. Lay had exclusive authority to appoint the members of the committee. *Id.* at 611.

<sup>69</sup> *Id.*

<sup>70</sup> *Id.*

doctrine). For executives eager to defer receipt of compensation, disqualification should operate as a disincentive. The period of disqualification likely will result in more gross income currently and presumably leave the executive with less cash at what would have been the end of the deferral period. With Enron's impending bankruptcy on the horizon, the three year participation exclusion did not seem to be a concern for anyone requesting an accelerated distribution.

#### 4. Rabbi Trust

Enron created an irrevocable grantor trust with Wachovia Bank, N.A. as trustee to hold assets to be used to fulfill Enron's promises to the executives participating in the Enron Plan.<sup>71</sup> Nothing required Enron to deposit the deferred compensation into the trust.<sup>72</sup> No payments were to be made from the trust if Enron was insolvent.<sup>73</sup> Enron listed a trust balance of \$31.1 million as of December 2001.<sup>74</sup> As of October 28, 2002, the rabbi trust had insurance policies with a cash surrender value of \$25 million.<sup>75</sup>

#### 5. Hypothetical Accounts

Although one advantage of nonqualified deferred compensation is the deferral of income tax,<sup>76</sup> an executive will not want to lose the time value of the deferred money.<sup>77</sup> As part of the nonqualified deferred compensation agreement, the employer and the executive can negotiate that the executive will be paid the deferred compensation plus some rate of return.<sup>78</sup>

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<sup>71</sup> *Id.* at 612-613. The original trust was created on April 5, 1994, with a replacement trust created on January 1, 1999.

<sup>72</sup> *Id.* at 614.

<sup>73</sup> *Id.*

<sup>74</sup> *Id.*

<sup>75</sup> *Id.* at 615.

<sup>76</sup> For example, assume that an executive in the highest marginal tax bracket receives a salary of \$500,000, and decides to defer \$100,000 of his or her compensation to be received as a lump sum in five years when the executive has retired. If the executive has no other income in the year of receipt, the executive will be in a lower marginal tax bracket. Using the 2006 income tax rates for a single individual, and assuming no change in rates between deferral and receipt, the executive would pay an additional income tax of \$35,000 if the deferred amount were received currently but would only pay \$19,965.50 in income tax if the \$100,000 is deferred five years. This calculation assumes a standard deduction of \$5,150 and a personal exemption of \$3,300. Even if the executive were in the highest marginal bracket, the executive would still have postponed the payment of tax.

<sup>77</sup> Assuming a 4.0% rate of inflation, \$100,000 today is worth approximately \$81,500 in five years.

<sup>78</sup> For example, John F. Welch, Jr., former chairman and CEO of General Electric, deferred \$1,000,000 of his 1995 compensation. GE promised to credit to his nonqualified deferred compensation bookkeeping account 14% interest per year for four years. For ease of calculation, a small matching contribution by GE has been ignored. Assuming no renegotiation of the agreement, GE would have owed Welch approximately \$1,688,690 at the end of four years. Welch did not lose the time-value of his money. Christopher Drew & David Cay Johnston, *Special Tax Breaks Enrich Savings Of Many in the Ranks of Management*, N.Y. TIMES, Oct. 13, 1996, § 1, at 1.

Crediting an executive's bookkeeping account with a fixed rate of return is risky for the employer in that the employer will have to take the deferred compensation and invest it to achieve the fixed rate of return, which may not happen, or the employer will have to generate the cash flow when the deferred payment is due. Employers will negotiate for a lower rate of return, which may make the nonqualified deferred compensation less attractive to the executive.

Hypothetical investment accounts can resolve this negotiating tension. Rather than agreeing to pay a fixed rate of return, an employer agrees to pay an executive the deferred compensation as adjusted up or down in reference to hypothetical investments designated by the executive. The reward of a strong market and the risk of a weak market are now borne by the executive. To prevent the executive from being taxed immediately on the deferred amounts (under the constructive receipt doctrine) because he or she exercises control over the funds, the agreement will provide that the employer is under no legal obligation to invest the deferred amounts as directed by the executive,<sup>79</sup> although an employer with the cash might do just that. In doing so, the employer would have no risk regarding the future payment.

The Enron Plan had hypothetical accounts. Initially, the investments made by the trustee corresponded to the investment elections made by the participants.<sup>80</sup> Enron discontinued this practice but did retain the hypothetical accounts.<sup>81</sup> Within the investments selected by Enron, an executive was able to direct how the earnings on his or her deferred compensation would be calculated.

### III. THE LAW REGARDING THE TIMING OF THE INCLUSION OF GROSS INCOME

Having summarized reasons for establishing nonqualified deferred compensation arrangements and the key features of the Enron Plan, the history of nonqualified deferred compensation needs to be reviewed to place the Enron Plan in context. This Part reviews the cash method of accounting, the constructive receipt doctrine, the economic benefit doctrine, Revenue Ruling 60-31, I.R.C. § 83, and rabbi trusts showing the development of the law relating to nonqualified deferred compensation.

#### A. Constructive Receipt Doctrine

Internal Revenue Code § 451 provides that items of gross income are to be included in the year in which such items are received.<sup>82</sup> But when is an item

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<sup>79</sup> See I.R.S. Priv. Ltr. Rul. 95-05-012 (Nov. 4, 1994) (demonstrating a hypothetical investment provision).

<sup>80</sup> JCT ENRON REPORT, *supra* note 4, at 614, 630.

<sup>81</sup> The Joint Committee recommended that participant-directed investment gave a participant control over the earnings which should then be includible in the participant's gross income. *Id.* at 636.

<sup>82</sup> I.R.C. § 451 (2006).



received? Taxpayers have long sought to structure their transactions to not only minimize the amount of tax paid but also to postpone including items in gross income and thereby postponing the taxation of those items.<sup>83</sup>

For the constructive receipt doctrine to apply, the taxpayer must have a right to receive the income and there must not be any substantial limitations or restrictions on that right.<sup>84</sup> If the taxpayer does not have the right to receive the income or there is a substantial limitation or restriction on the taxpayer's right to receive the income, then the taxpayer has not constructively received the income.<sup>85</sup>

It is generally accepted that a cash-basis taxpayer cannot turn his or her back on an item of income and claim that inclusion of the income should be deferred until a future year.<sup>86</sup> For example, if an employer has placed an employee's monthly paycheck for the month ending December 31, 2005, on the employee's desk, the employee must include that paycheck in gross income for 2005.<sup>87</sup> The employee is in constructive receipt of the paycheck because he or she had the right to receive the income and there were no substantial limitations or restrictions upon his or her ability to receive it.<sup>88</sup> If receipt of the payment is subject to a substantial limitation or restriction, then the taxpayer is not in constructive receipt of the item and therefore does not have to include such item in gross income until the restriction disappears.<sup>89</sup>

In contrast, a cash-basis taxpayer could agree to perform services in December 2005 conditioned upon not receiving payment for those services until January 2006. In such a case, the taxpayer would include payment for the services in the taxpayer's gross income for 2006. The year of receipt determines when the taxpayer includes the compensation in gross income.<sup>90</sup>

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<sup>83</sup> As the saying goes, a dollar deferred is a dollar saved.

<sup>84</sup> Treas. Reg. § 1.451-2(a) (as amended in 1979) provides that income, although not actually reduced to the taxpayer's possession, is constructively received in the taxable year during which it is credited to the taxpayer's account, set apart for the taxpayer, or otherwise made available so that the taxpayer may draw upon it at any time, or so that the taxpayer could have drawn upon it during the taxable year if notice of intention to withdraw had been given. However, income is not constructively received if the taxpayer's control of its receipt is subject to substantial limitations or restrictions.

<sup>85</sup> *Id.*

<sup>86</sup> *Hamilton Nat'l Bank of Chattanooga v. Comm'r*, 29 B.T.A. 63, 67 (1933) ("A taxpayer may not deliberately turn his back upon income and thus select the year for which he will report it.").

<sup>87</sup> In *Kahler v. Comm'r*, 18 T.C. 31, 32-4 (1952), the Tax Court held that the taxpayer had to include a check received after 5:00 p.m. on December 31, 1946, in gross income for 1946 even though it was too late in the year for the taxpayer to cash the check.

<sup>88</sup> Treas. Reg. § 1.451-2 (2006). *See also* *Kahler v. Comm'r*, 18 T.C. 31 (1952).

<sup>89</sup> *See generally* I.R.C. § 83 (2006). Also, Treas. Reg. § 1.451-2(a) provides "income is not constructively received if the taxpayer's control of its receipt is subject to substantial limitations or restrictions."

<sup>90</sup> *Amend v. Comm'r*, 13 T.C. 178 (1949) (For a number of years, a farmer agreed to deliver wheat in the current year with payment to be made the following January. The Tax Court held that the

The constructive receipt doctrine was developed to prevent taxpayers from manipulating the timing of receipt of gross income in order to produce an overall tax result more favorable to the taxpayer.<sup>91</sup>

When marginal tax rates were soaring toward 90% before and during World War II, executives began to seek ways to defer compensation.<sup>92</sup> The seminal case is *Veit v. Commissioner* (“*Veit I*”).<sup>93</sup> In 1939 and 1940, Howard Veit was employed by M. Lowenstein & Sons, Inc. (“Lowenstein”) as an executive vice president.<sup>94</sup> Veit’s employment contract provided that in addition to his salary, he would be paid a bonus of 10% of the net profits for 1939 and 1940.<sup>95</sup> The bonus was to be paid in two installments in 1941 provided that Veit remained employed by Lowenstein through the end of 1940.<sup>96</sup>

On May 16, 1940, Veit and Lowenstein entered into a contract wherein Veit received an additional bonus of \$15,000 for 1939. Also, Veit and Lowenstein agreed that Veit was owed \$82,000 for 1939, subject to reduction if Lowenstein had losses for 1940.<sup>97</sup> After reduction for amounts advanced by Lowenstein, Veit was owed \$85,000 for 1939 to be paid in two installments in 1941. Additionally, Veit was entitled to whatever bonus he might earn for 1940. Veit intended to retire at the end of 1940.

On November 1, 1940, at Lowenstein’s initiative, Veit and Lowenstein entered into a contract wherein the parties agreed that Veit would stay on with Lowenstein in a different role and on the West Coast.<sup>98</sup> Additionally, the compensation due to Veit for 1939 was now to be paid to Veit in 1940 and 1941

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wheat farmer properly included the payment in the subsequent years even though the recipients would have been willing to pay in the years of delivery.).

<sup>91</sup> See I.R.C. § 451 (2006); *Hamilton Nat’l Bank*, 29 B.T.A. at 67.

<sup>92</sup> In addition to the 6% “normal” tax, in 1940, an individual with \$100,000 of net income would pay \$36,780 of surtax plus 58% of any excess income. Revenue Act of 1940, Pub. L. No. 76-656, § 2, 54 Stat. 516 (1940). In 1941, the same \$100,000 of net income would generate \$49,780 of surtax plus 65% of any excess income. Revenue Act of 1941, Pub. L. No. 77-250, § 101, 55 Stat. 687 (1941). By 1942, the same \$100,000 of net income would generate \$59,140 of surtax plus 79% of any excess income. Revenue Act of 1942, Pub. L. No. 77-753, § 103, 56 Stat. 798 (1942). In other words, the combined marginal rates would be 64%, 71%, and 85% respectively.

<sup>93</sup> *Veit I*, 8 T.C. 809 (1947).

<sup>94</sup> *Id.* at 810.

<sup>95</sup> *Id.* at 811.

<sup>96</sup> The contract provided that half was to be paid by July 1, 1941, and the remaining half by October 1, 1941. *Id.*

<sup>97</sup> Veit’s contract, dated January 2, 1939, provided that additional compensation earned for 1939 and 1940 would be payable in 1941. *Id.* The contract required Veit to remain with the employer for 2 years. The contract provided a base salary of \$25,000 per year and 10% of the profits for 1939 and 1940. *Id.* If the employer suffered losses, Veit would repay the employer 10% of the losses up to the \$50,000 of compensation he received. *Id.* The employer also awarded Veit an extra bonus of \$15,000 for 1939. *Id.* Lowenstein owed Veit \$97,000 of additional compensation for 1939. *Id.* Two distributions totaling \$12,000 were made in 1940 leaving a total due to Veit of \$85,000. *Id.*

<sup>98</sup> For 1941, Veit was to receive a base salary of \$15,000 plus a percentage of west coast sales. *Id.*

rather than in two installments in 1941 as originally agreed.<sup>99</sup> Any bonus compensation attributable to 1940 was to be paid in quarterly installments in 1942.<sup>100</sup> Veit's bonus for 1940 was calculated to be \$87,000.<sup>101</sup>

On December 26, 1941, Veit and Lowenstein entered into yet another contract wherein Veit would continue his employment through 1943. The balance of the bonuses due to Veit was to be paid in five equal installments in 1942, 1943, 1944, 1945, and 1946.

In *Veit I*, at issue was the 1941 tax year. The IRS argued that Veit was in constructive receipt of the \$87,000 in additional compensation in 1941 when it would have been paid according to the terms of the 1939 employment contract. In 1941, Lowenstein paid Veit \$15,000 in salary, \$25,000 as a special bonus, and \$55,000 additional compensation for the 1939 year as provided under the November 1, 1940 agreement. Since the original January 2, 1939 contract provided that the payment for additional compensation attributable to service performed in 1940 was due in 1941, the IRS did not argue that Veit should be taxed in 1940 on the profit. This position is consistent with treating Veit as a cash-basis taxpayer. Because the liability was fixed in 1941 and the employer was an accrual-basis taxpayer, the employer claimed, and was allowed, a tax deduction for the compensation in 1941 even though Veit did not include the compensation in gross income until subsequent years.<sup>102</sup>

The United States Tax Court found that Veit was not in constructive receipt of the deferred compensation and was not subject to tax on the amounts until he actually received the cash. The Tax Court found the contract to defer the compensation from 1941 into 1942 to have been bi-laterally negotiated and "mutually profitable to both."<sup>103</sup>

In *Veit II*,<sup>104</sup> at issue was the further deferring of Veit's compensation as provided in the December 26, 1941 contract. Veit included in his 1942 gross income the first annual installment actually received under the December 26, 1941 agreement but did not include the full \$87,000 to which he was entitled.

The Service argued that unlike *Veit I* where the exact amount of Veit's compensation was not yet ascertainable,<sup>105</sup> all of the compensation attributable to service performed in 1940 should be includible in his 1942 gross income because the corporation had computed the liability, taken a deduction for it, and would have paid it in 1942 had Veit asked to be paid in 1942.

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<sup>99</sup> Veit was to receive \$20,000 [\$30,000 sic] upon the signing of the agreement (November 1, 1940) and quarterly payments of \$13,750 on the first of March, June, September, and December 1941. *Id.*

<sup>100</sup> The quarterly installments were to bear interest at 1.5% from October 1, 1940, and were to be paid on the first of March, June, September, and December 1942. *Id.*

<sup>101</sup> On June 18, 1941, Veit and Lowenstein agreed that Veit's bonus for work performed in 1940 was \$87,000 to be paid in quarterly installments of \$21,769 in 1942. *Id.* Interest was to accrue at 1.5% beginning on October 1, 1941. *Id.*

<sup>102</sup> *Veit I* arose before the enactment of the predecessor of I.R.C. § 404(a)(5).

<sup>103</sup> *Veit I*, 8 T.C. at 816.

<sup>104</sup> *Veit v. Comm'r (Veit II)*, 8 T.C.M. 919 (1949).

<sup>105</sup> The taxpayer was to receive 10% of the profits of the business. *Id.* It would be some time after the close of the taxable year before the employer would be able to calculate that number. *Id.*

The Tax Court rejected the Service's argument stating that there was no time when the remaining amounts were subject to withdrawal or payment upon Veit's demand. Without commenting as to its rationale, the Tax Court also rejected the Service's argument that payment of interest on the deferred amount indicated that Veit was in constructive receipt of the deferred amounts.

Prior to 1942, accrual-basis employers were able to take deductions for compensation that they promised to pay in future tax years even though the employee did not have to include such amounts in gross income until later years when the payments would actually be received. Following the *Veit* decisions, Congress put an end to this mismatching by enacting the predecessor of I.R.C. §404(a)(5) which provides that the employer is not entitled to a current deduction for compensation deferred into future taxable years.<sup>106</sup> The employer is entitled to the deduction when the amounts are actually paid to the employee or should be included by the employee in gross income.

In theory, the matching principle creates a tension between the executive and employer in negotiating a nonqualified deferred compensation agreement.<sup>107</sup> The executive wishes to postpone the inclusion of the deferred compensation into gross income until a future tax year. The employer is reluctant to agree to the deferral because the employer must postpone its tax deduction until the compensation is actually paid to the employee. In other words, a current deduction for the employer will mean current inclusion for the executive, and a deferred deduction for the employer will mean deferred inclusion for the executive. Given this tension, presumably the parties negotiate at arm's length and in good faith to reach an agreement regarding the timing of the payment.

## B. Revenue Ruling 60-31

In Revenue Ruling 60-31, the Service set forth three scenarios discussing when taxpayers are deemed in constructive receipt of deferred income and one scenario discussing the economic benefit doctrine.<sup>108</sup>

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<sup>106</sup> Section 23(p) of the 1942 Revenue Act is the predecessor of I.R.C. § 404(a)(5). I.R.C. § 404(a)(5) is an example of an employer being partially accrual-basis and partially cash-basis because the employer is not getting a deduction until the compensation is actually paid despite being on the accrual method.

<sup>107</sup> The Joint Committee on Taxation believes that this tension no longer exists. See JCT ENRON REPORT, *supra* note 4, at 627.

<sup>108</sup> 1960-1 C.B. 174. Revenue Ruling 60-31 also contains one scenario focusing on whether a joint venture was created. In Scenario 5, the Service determined that a boxer who entered into an arrangement to fight an opponent at a particular time and place and defer 75% of the boxer's compensation for the fight into the three following years was either a partner in a joint venture or was otherwise in constructive receipt of the deferred compensation. *Id.* The deferral was not customary in the boxing profession and was made at the demand of the taxpayer. The Service concluded that since the arrangement was made at the request of the taxpayer, the only thing preventing the taxpayer's receipt of his share of the fight receipts was the agreement with the promoter. *Id.* The Service argued that the boxer's share of the fight proceeds never belonged to the promoter but always belonged to the boxer. *Id.*

In Scenario 1, the taxpayer was an executive under contract with an employer for 5 years.<sup>109</sup> The employment agreement provided that a fixed amount of additional compensation was to be credited to a bookkeeping reserve account and paid in annual installments as provided in the employment contract.<sup>110</sup> In Scenario 2, the taxpayer was an officer and director of the employer. The taxpayer and employer agree that amounts above a set floor were to be credited to a separate account for the taxpayer.<sup>111</sup> The account was to be credited with any investment income that the deferred amounts earn. In Scenario 3, the taxpayer was an author who entered into a contract with a publisher. The author agreed to payments of 100x dollars per year and that amounts above 100x dollars would be deferred to future years.

Each taxpayer used the cash method of accounting. The Service concluded that “[t]he mere promise to pay, not represented by notes or secured in any way, is not regarded as a receipt of income within the intendment of the cash receipts and disbursements method.”<sup>112</sup> In reaching its conclusions, the Service discussed and focused on (i) when the taxpayer had the right to receive the compensation and (ii) the taxpayer’s present inability to reach the money. The Service determined that the limitations and restrictions were sufficient to prevent the taxpayers from being in constructive receipt of the deferred compensation.

The mere promise to pay, without more, is insufficient to cause the taxpayer to be in constructive receipt of the compensation deferred. If the taxpayer has no promissory note and no other security interest and the employer has not set aside assets to pay the liability which are protected from the claims of general unsecured creditors of the employer, then the taxpayer is not in constructive

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In *Robinson v. Commissioner*, 44 T.C. 20 (1965), acq., 1970-2 C.B. xxi, the boxer Sugar Ray Robinson challenged the Service’s determination that the deferred amounts he was to receive from a fight with Carmen Basilio at Yankee Stadium on September 23, 1957 were includible in 1957 despite his agreement with the promoter that the amounts were to be paid over four years (40% in 1957 and 20% each in 1958-1960). *Id.* The Tax Court found for Robinson. *Id.* At trial, the Service also argued that the contract was a sham and should not be respected. *Id.* The Tax Court found the parties intended to be bound by the contract. *Id.* Thus, the taxpayer was not in constructive receipt of the deferred compensation.

After losing *Robinson*, the Service conceded that the arrangement described in Scenario 5 was not a joint venture and subsequently revised Revenue Ruling 60-31. In Revenue Ruling 70-435, 1970-2 C.B. 100, the Service changed the facts of scenario 5 to more clearly create a joint venture. The revised scenario involves a partnership between a theatrical performer and a producer to stage a play. Despite the performer’s agreement to receive only 25% of his share of the profits each year the play is running with the balance to be paid in four equal annual installments after the close of the play, the performer and the producer have a partnership thus requiring the performer to include his share of the profits in gross income each year.

<sup>109</sup> 1960-1 C.B. 174

<sup>110</sup> Employers often establish a book-keeping account to track the nonqualified deferred compensation owed to the executive. Since the account is only a book-keeping one, no assets have been set aside to fund the employer’s liability to pay the nonqualified deferred compensation due. See *infra* Part III.F for a discussion of rabbi trusts.

<sup>111</sup> 1960-1 C.B. 174

<sup>112</sup> Rev. Rul. 60-31, 1960-1 C.B. 174, 177. This conclusion is later reiterated by the Service in Treasury Regulations issued for I.R.C. § 83. See Treas. Reg. § 1.83-1 (as amended in 2003).

receipt and has not obtained an economic benefit. Acknowledging that each case must be decided upon its own particular facts, the Service concluded that the above taxpayers were not in constructive receipt of the deferred compensation.<sup>113</sup>

### C. Economic Benefit

The economic benefit doctrine is a judicially-created doctrine holding that if a taxpayer has received an economic benefit, that benefit will be includible in gross income to the extent that the fair market value of the benefit can be determined. Whereas the constructive receipt doctrine is more focused on the timing of inclusion in gross income, the economic benefit doctrine is focused on whether the taxpayer has received property that can be included in gross income.

In *Commissioner v. Smith*,<sup>114</sup> the taxpayer received as compensation an option to buy stock. When the value of the stock had risen, the taxpayer exercised the option. The issue before the court was whether the difference between the option price and the fair market value of the stock at the time of the exercise was compensation received for the performance of services thus requiring inclusion in gross income in the year of the exercise. The taxpayer had exercised options in 1938 and 1939 when the fair market value of the stock exceeded the option price by \$81,021 and \$71,663 respectively. The Supreme Court affirmed the Tax Court's finding that "the option was given to [the taxpayer] as compensation for services, and implicitly that the compensation referred to was the excess in value of the shares of stock over the option price whenever the option was exercised."<sup>115</sup> The taxpayer had to include the proceeds when the option was exercised and not upon its grant. Although the Court acknowledged that the law was broad enough to find that an option could confer an economic benefit requiring inclusion in gross income when granted, *Smith* was just not that case.

Revenue Ruling 60-31, discussed above, also addressed the economic benefit doctrine. In scenario 4, a professional athlete requested that some of his compensation be placed in escrow and paid to him according to the terms of the escrow agreement. The Service concluded that the player had received an economic benefit which must be included in his current gross income because the amounts held in escrow were not subject to the claims of the employer's general creditors.

### D. I.R.C. § 83

Enacted in 1969, § 83(a) generally provides that the fair market value of property transferred in connection with the performances of services, less any amount paid for such property, is includible in gross income unless the property is not able to be transferred by the service provider or is subject to a substantial

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<sup>113</sup> Rev. Rul. 60-31, 1960-1 C.B. 174, 177.

<sup>114</sup> 324 U.S. 177 (1945).

<sup>115</sup> *Id.* at 182.

risk of forfeiture.<sup>116</sup> Treasury Regulation § 1.83-3(e) provides that “an unfunded and unsecured promise to pay money or property in the future” is not property for § 83 purposes.

If all an executive has received is the employer’s promise to pay, then the executive does not have to include the value of the promise in gross income under § 83. In simple form, a nonqualified deferred compensation agreement is nothing more than an unfunded and unsecured promise to pay money at a future date.<sup>117</sup> As such, these promises expressly fall outside of the scope of § 83.

When an executive receives more than the employer’s unfunded and unsecured promise to pay, the executive’s right to receive the deferred compensation must be limited by a substantial risk of forfeiture to avoid current inclusion under § 83.<sup>118</sup> For example, if an employer places deferred compensation into a trust for the benefit of the executive and the terms of the trust provide that the trust property can only be used for the benefit of the executive and are not subject to the claims of the employer’s creditors and cannot be used by the employer for any other purpose, then the executive has received “property” in connection with the performance of services that is not subject to a substantial risk of forfeiture.<sup>119</sup> Under I.R.C. § 83, the executive must include the value of property in gross income.<sup>120</sup>

If the executive’s right to receive the deferred amounts is subject to a substantial risk of forfeiture, then under § 83, an executive can postpone

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<sup>116</sup> I.R.C. § 83 provides

[I]f, in connection with the performance of services, property is transferred to any person other than the person for whom such services are performed, the excess of (1) the fair market value of such property (determined without regard to any restriction other than a restriction which by its terms will never lapse) at the first time the rights of the person having the beneficial interest in such property are transferable or are not subject to a substantial risk of forfeiture, whichever occurs earlier, over (2) the amount (if any) paid for such property, shall be included in the gross income of the person who performed such services in the first taxable year in which the rights of the person having the beneficial interest in such property are transferable or are not subject to a substantial risk of forfeiture, whichever is applicable. The preceding sentence shall not apply if such person sells or otherwise disposes of such property in an arm's length transaction before his rights in such property become transferable or not subject to a substantial risk of forfeiture.

*Id.*

<sup>117</sup> As seen in *Veit I* and *Veit II*, the promise made by the employer was to pay the deferred compensation at a specific time in a future tax year. Veit did not have any security other than the contractual relationship with the employer.

<sup>118</sup> I.R.C. § 409A(d)(4) (2006) provides that amounts subject to a substantial risk of forfeiture are not covered by § 409A.

<sup>119</sup> Treas. Reg. § 1.83-3(e) (as amended in 2005).

<sup>120</sup> The executive may have to include his or her beneficial interest under the economic benefit doctrine even though the executive has yet to receive any distributions from the trust. The executive must include the fair market value of that economic benefit in gross income. At a minimum, the fair market value of the economic benefit will be less than the amount contributed by the employer because of the executive’s delay in being able to reach the deferred amounts.

including compensation in gross income until the substantial risk of forfeiture lapses.<sup>121</sup> Conditioning the right to receive the deferred compensation upon the future performance of substantial services is a substantial risk of forfeiture.<sup>122</sup> When the substantial risk of forfeiture lapses, the value of the compensation must be included in the executive's gross income (assuming the employer has set aside amounts that are not subject to the claims of the employer's general creditors).

### **E. Proposed Regulation 1.61-16**

In 1978, the Treasury Department sought a more aggressive means of challenging nonqualified deferred compensation.<sup>123</sup> Proposed Treasury Regulation § 1.61-16 provided that if under a plan or arrangement a taxpayer's compensation, including salary and bonuses, was deferred at the taxpayer's individual option, then the amount deferred would be included in the taxpayer's income in the year in which the services were performed despite any risk of forfeiture.<sup>124</sup> The proposed regulation represented a departure from the prevailing understanding of the constructive receipt doctrine.<sup>125</sup> Congress reacted quickly by enacting §132 of the Revenue Act of 1978 ("§ 132").<sup>126</sup> Section 132 provides that the Service, when challenging nonqualified deferred compensation, is to apply the law as it existed just before Proposed Regulation § 1.61-16 was issued.<sup>127</sup>

### **F. Rabbi Trusts**

Since 1978, what little guidance the Service has issued regarding nonqualified deferred compensation has addressed the use of so-called rabbi trusts. In Private Letter Ruling 81-13-107, a synagogue wished to provide

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<sup>121</sup> Alternatively under § 83(b), the executive could elect to currently include the property transferred in gross income with the risk that if the property is later forfeited the executive will not receive a deduction.

<sup>122</sup> See I.R.C. § 83(c)(1) (2006). See also I.R.C. § 409A(d)(4) (2006).

<sup>123</sup> See Deferred Tax Treatments for Amounts of Compensatory Payments, 43 Fed. Reg. 4638 (proposed Feb. 3, 1978) (to be codified at 26 C.F.R. pt. 1).

<sup>124</sup> *Id.*

<sup>125</sup> In *Veit I*, the Tax Court stressed the importance of the bi-lateral negotiation of the employment contract in holding that Veit was not in constructive receipts of amounts deferred from 1941 into 1942. *Veit I*, 8 T.C. at 809.

<sup>126</sup> Proposed Regulation § 1.61-16 was issued on February 3, 1978 and the 1978 Revenue Act, Pub. L. No. 95-600, was enacted on November 6, 1978.

<sup>127</sup> Section 132 provides that the law as it existed on February 1, 1978 must be applied. Specifically, §132(a) says that "[t]he taxable year of inclusion in gross income of any amount covered by a private deferred compensation plan shall be determined in accordance with the principles set forth in regulations, rulings, and judicial decisions relating to deferred compensation which were in effect on February 1, 1978."



nonqualified deferred compensation for its rabbi.<sup>128</sup> The synagogue proposed to establish a trust to hold the deferred amounts. The trust assets would be available to the synagogue's general unsecured creditors in the event of the synagogue's bankruptcy but otherwise would be available only to pay the nonqualified deferred compensation to the rabbi. The Service ruled that the rabbi would not be in constructive receipt of the deferred compensation.

In Revenue Procedure 92-64, the Service issued a model rabbi trust agreement.<sup>129</sup> Not limited to rabbis, a rabbi trust, generally is created by an employer to meet its obligations under a nonqualified deferred compensation arrangement. The employer is the grantor and beneficiary of the rabbi trust. The rabbi trust provides that the amounts contributed to the trust can be used only (i) to satisfy the employer's obligation to pay nonqualified deferred compensation or (ii) to pay the employer's general unsecured creditors if the employer is insolvent.<sup>130</sup> Revenue Procedure 92-64 provides that the trustee must be an independent third party.

It is advantageous to the executive for the employer to establish a rabbi trust because the executive will have additional protection that cash will be available to pay the executive when the nonqualified deferred compensation payments are due. Cash flow may be an issue preventing the employer from paying the nonqualified deferred compensation. If an employer uses a rabbi trust, the executive has the assurance of knowing that the funds needed to make future payments to the executive have been segregated from the employer's other funds. Because the funds in the rabbi trust are still subject to the claims of the general unsecured creditors of the employer in the event of the employer's bankruptcy, the executive is not in constructive receipt of the amounts used to fund the rabbi trust.<sup>131</sup> Since a rabbi trust is a grantor trust for federal income tax purposes, the

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<sup>128</sup> I.R.S. Priv. Ltr. Rul. 81-13-107 (Dec. 31, 1980). The name "rabbi" is commonly attached to these trusts because the first private letter ruling approving their use involved a synagogue providing deferred compensation for its rabbi. Any employer may establish a rabbi trust. Private letter rulings are applicable only to the taxpayer to whom they are issued. See I.R.C. § 6110 (2006). Nonetheless, private letter rulings provide significant guidance to taxpayers about the Service's position on a particular topic.

<sup>129</sup> In 1992, the Service issued Rev. Proc. 92-64, 1992-2 C.B. 422. Rev. Proc. 92-64 contained a Model Rabbi Trust agreement. Taxpayers creating rabbi trusts following 1992 are well-advised to use the model trust agreement. *Id.* The Service also issued Rev. Proc. 92-65, 1992-2 C.B. 428 providing that "the Service will determine whether the doctrine of constructive receipt is applicable on a case-by-case basis. The Service will ordinarily issue rulings regarding unfunded deferred compensation arrangements only if the requirements of Rev. Proc. 71-19 are met and, in addition, the arrangement meets the following guidelines" of Rev. Proc. 92-65. *Id.*

<sup>130</sup> See Rev. Proc. 92-64 § 1(d) of Model Trust.

<sup>131</sup> For an interesting discussion of one practitioner's effort to have the best of all worlds, see MICHAEL GOLDSTEIN ET AL., TAXATION AND FUNDING OF NONQUALIFIED DEFERRED COMPENSATION: A COMPLETE GUIDE TO DESIGN AND IMPLEMENTATION 160-162 (1998). In I.R.S. Priv. Ltr. Rul. 95-08-014 (Feb. 24, 1995), the Service approved what Goldstein coined a rabbicular trust. A rabbicular trust is a rabbi trust containing a provision that upon some financial trigger, short of the employer's bankruptcy, the rabbi trust converts to a secular trust. In I.R.S. Priv. Ltr. Rul. 95-08-014 (Feb. 24, 1995), the financial trigger was the employer's net worth falling below \$10 million.

employer is taxed on the earnings of the rabbi trust.<sup>132</sup> In some sense, the employer will have segregated assets to pay the nonqualified deferred compensation but not in a manner that causes the executive to be in constructive receipt or that triggers a funding under ERISA. Most executives fear the bankruptcy of the employer less than the executives fear the employer spending the money needed to pay the nonqualified deferred compensation on other projects. This is particularly true if the executive has left his or her employment before payments are due under the nonqualified deferred compensation agreement.

#### IV. POST-ENRON DEVELOPMENTS

##### A. Joint Committee Response to Enron

Following Enron's collapse, the Senate Finance Committee directed the Joint Committee on Taxation to investigate Enron and prepare a report for Congress.<sup>133</sup> After a year-long investigation, the Joint Committee issued its report and made several recommendations.<sup>134</sup>

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As a secular trust, the employee would be immediately taxed on all amounts for his or her benefit held by the trust. At this point, the trust would only be available to the employer to pay its nonqualified deferred compensation promises. The taxpayer's rationale for choosing a rabbi trust would be the immediate taxation on the full amount is better than standing in line with the general unsecured creditors for pennies on the dollar. Better to lose the benefits of deferral and suffer the higher marginal tax rates than to be left with little or nothing following the bankruptcy. I.R.C. § 409A(b)(2) expressly puts an end to the Rabbi trust concept by providing that a transfer to a trust which has a provision restricting the use of the deferred compensation triggered upon a change in the employer's financial health will be a transfer for the purpose of §83. In other words, if a rabbi trust provides that upon a change in the employer's financial health that the rabbi trust will convert to a secular trust, the executive will be treated as having received a transfer for § 83 purposes at the time of the initial transfer regardless of whether the triggering event ever occurs.

<sup>132</sup> See I.R.C. §§ 671-677 (2006).

<sup>133</sup> Letter from Senate Finance Committee to the Joint Committee on Taxation; JCT ENRON REPORT, *supra* note 4, vol. II, app. A at A-2, <http://www.gpo.gov/congress/joint/jcs-3-03/vol2/apre.pdf>. On February 15, 2002, Congress instructed the Joint Committee on Taxation to prepare a report on Enron. Senators Max Baucus and Charles E. Grassley of the Senate Committee on Finance sent a letter to Lindy Paull, Chief of Staff of the Joint Committee on Taxation requesting that the Joint Committee

undertake a review of Enron's Federal tax returns, tax information, and any other relevant information as [the Joint Committee] deem[s] necessary . . . to assist us in evaluating if the Federal tax laws facilitated any of the events or transactions that preceded Enron's bankruptcy. The review should examine the adequacy of present tax law, particularly in the areas of tax shelters and offshore entities. It should also include a review of the compensation arrangements of Enron employees, including tax-qualified retirement plans, nonqualified deferred compensation arrangements, and other arrangements, and an analysis of the factors that may have contributed to any loss of benefits and the extent to which losses were experienced by different categories of employees.

The Report surveyed the current law regarding nonqualified deferred compensation. It further reviewed the Enron Plan and made numerous suggestions for changing the law including the repeal of § 132. Of particular concern to the Joint Committee were: accelerated distributions, participant-directed investment, subsequent elections, reporting of nonqualified deferred compensation amounts, and the use of rabbi trusts.

### B. Congressional Response

On October 22, 2004, President Bush signed the American Jobs Creation Act creating a new section of the Internal Revenue Code.<sup>135</sup> Section 409A applies to all deferred compensation except deferred compensation which is specifically excluded, for example, 401(k) plans and 403(b) plans.<sup>136</sup> The Joint Committee's Report formed the basis of the nonqualified deferred compensation portions of the Act.

When reviewing the Enron Plan, the Joint Committee highlighted three items and said that "when viewed collectively . . . [they] lend credence to the argument that the doctrine of constructive receipt should apply."<sup>137</sup> Those items are: (1) plans containing provisions for accelerated distributions should be considered as triggering immediate income tax liability for the executive under the constructive receipt doctrine; (2) the ability to make subsequent elections and further postpone payment of deferred compensation should trigger constructive receipt; and (3) that if participants are allowed to direct the investment of their deferred compensation, even indirectly, such "control" should trigger constructive receipt.<sup>138</sup>

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*Id.* Senators Baucus and Grassley were expressly troubled by press reports that Enron insiders benefited in the months before Enron's collapse while many Enron employees suffered pension losses. *Id.*

<sup>134</sup> On February 13, 2003 the Joint Committee submitted its 2,691 page report (including appendices) to Congress. Covering a wide range of topics, the Report devotes approximately 178 (545-723) in text pages and 270 (115-385) pages in appendices D to the compensation of Enron's executives. The amount of pages devoted to nonqualified deferred compensation plans is smaller, 45 (592-637) pages and 9 (300-309) pages respectively.

See Joint Committee on Taxation, WRITTEN TESTIMONY OF THE STAFF OF THE JOINT COMMITTEE ON TAXATION ON THE REPORT OF INVESTIGATION OF ENRON CORPORATION AND RELATED ENTITIES REGARDING FEDERAL TAX AND COMPENSATION ISSUES, AND POLICY RECOMMENDATIONS, JCX-10-03 (Comm. Print 2003). See generally JCT ENRON REPORT, *supra* note 4.

<sup>135</sup> Pub. L. No. 108-357, 118 Stat. 1418, (2004)(codified as amended in scattered sections of the U.S.C.).

<sup>136</sup> Technically, any deferred compensation is allowed by the I.R.C. *Id.* What is lacking is favorable income tax treatment of the deferred compensation. *Id.*

<sup>137</sup> JCT ENRON REPORT, *supra* note 4, at 629.

<sup>138</sup> Generally, employees deferring compensation want more than the employer's mere promise to pay the deferred sum at some specified time in the future. If an employee decides in the current year to defer \$20,000 to be payable as a lump sum in 5 years, the employee will be economically worse off because of inflation. Presumably, \$20,000 in 5 years is worth less than \$20,000 today. This argument assumes, though, that the tax rates, including the employee's marginal tax rate, remains relatively unchanged. Nonqualified deferred compensation plans commonly provide that

Some of the Joint Committee's recommendations are incorporated in § 409A, but not all.<sup>139</sup> Although in large part a reaction to the collapse of Enron, some variation of § 409A has long been sought by Treasury.<sup>140</sup>

Section 409A makes nonqualified deferred compensation arrangements considerably less flexible for executives by imposing new requirements that (i) distributions can only be made upon listed triggering events, (ii) penalties are owed on non-permitted distributions, and (iii) subsequent elections to further defer previously deferred compensation must occur twelve months before the deferred payment is due and the election must further defer the compensation at least five years.<sup>141</sup>

If the plan fails at any time to meet the requirements of § 409A, then the executive will be in constructive receipt of all of the deferred compensation.<sup>142</sup> Additionally, the executive will be subject to interest and penalties and also additional interest on the deferred compensation.<sup>143</sup>

In many ways, § 409A dramatically changes the landscape of the tax treatment of nonqualified deferred compensation. As seen above, the pre-§ 409A income tax treatment of nonqualified deferred compensation, as developed by both the courts and the Service, hinged on the bargaining positions of the

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the amount paid to the employee will be increased or decreased as if the amounts were hypothetically invested in particular assets. See I.R.S. Priv. Ltr. Rul. 95-05-012 (Nov. 4, 1994). The parties to the agreement would be free to choose any measure to determine the increase or decrease. The employer seeking to minimize its risk would actually invest in the assets selected even though it would be under no obligation to do so. The more daring, or maybe more astute, employer would think that it could beat the return on the selected assets and thus would invest in what it believes to be more productive investments. Either way, the employer is obligated to meet the rate of return for the hypothetical investments designated by the participant. The nonqualified deferred compensation agreement may provide that the employer on some regular basis is able to change the hypothetical investments. Giving the employee the ability to directly control the underlying investment of the deferred compensation is generally thought to result in the employee constructively receiving the nonqualified deferred compensation. See, e.g., Rev. Proc. 92-64 § 5.01, providing that the trustee of a rabbi trust must "be given some investment discretion, such as the authority to invest within broad guidelines established by the parties." *Id.*

<sup>139</sup> For example, § 409A does not make any provision restricting the use of hypothetical accounts to measure the deferred compensation due to the executive. Section 409A does not address the use of domestic rabbi trusts despite the Joint Committee's recommendation that rabbi trusts be revisited. Section 409A does address offshore rabbi trusts and clearly prohibits their use. See I.R.C. § 409A(b)(1) (2006). The transferring of nonqualified deferred compensation assets to an offshore rabbi trust will trigger constructive receipt for the executive because as practical matter the offshore rabbi trust places the assets beyond the reach of the employer's creditors. *Id.*

<sup>140</sup> See e.g., Prop. Treas. Reg. § 1.61-16.

<sup>141</sup> Section 409A also contains some changes regarding the definitions of disability and change of control of corporation, and the treatment of some payments as excess parachute payments regardless of whether the requirements of § 280G are met. § 409A. For more on these issues, see Richard J. Bronstein & Michael D. Levin, *A Reasonable Approach to Deferred Compensation in the Post-Enron Climate*, 103 TAX NOTES 215 (2004).

<sup>142</sup> The executive must include all compensation deferred even if only part of the compensation fails to qualify under § 409A.

<sup>143</sup> See I.R.C. § 409A(a)(1)(B) (2006).

executive and the employer entering into an arm's length agreement. The agreement was exempt from ERISA, and thus its funding requirement, because the executive did not need ERISA's protections presumably because he or she had sufficient leverage to negotiate on equal footing with the employer.<sup>144</sup> Section 409A severely limits the ability of the executive and employer to negotiate a compensation package tailored to the needs of each party.

In other ways, the scenery is unchanged. For example, an executive and an employer are still able to enter into a nonqualified deferred compensation agreement deferring substantial amounts of the executive's compensation. Section 409A imposes no limits on the amount of compensation that may be deferred. Further, a rabbi trust still may be used providing the executive with some sense of security but not enough to trigger inclusion in gross income.

Overall, the changes are not well-considered, leave much to be desired, and do little to address the abuses, perceived or real, of nonqualified deferred compensation.<sup>145</sup> In order to understand how Congress has missed the mark with § 409A, we need to see how § 409A operates. This article now examines two provisions of § 409A adopted to address the specific concerns of the Joint Committee.<sup>146</sup>

### C. Accelerated Distributions and Subsequent Elections – Generally

While technically separate issues, the executive's ability to cause an accelerated distribution of the nonqualified deferred compensation and to make a subsequent election to continue the deferral of nonqualified compensation are interrelated. The underlying question for both is: What control does the executive have over the timing of the payment of the nonqualified deferred compensation?

Concerned with an executive's perceived ability to reach the deferred compensation, § 409A introduces the following two major restrictions. First,

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<sup>144</sup> See 29 U.S.C §§ 1051(2), 1081(a)(2), 1101(a)(1) (2000).

<sup>145</sup> *Commenters Seek IRS Guidance to Clarify Myriad 409A Compensation Issues*, 89 DAILY TAX REP., May 10, 2005, at G-1.

<sup>146</sup> On December 20, 2004, the Treasury Department issued Notice 2005-1 providing transitional guidance on the implementation of § 409A. Notice 2005-1, 2005-1 C.B. 274. In Notice 2005-1, the Service states that "although [§ 409A] makes a number of fundamental changes, § 409A does not alter or affect the application of any other provision of the Code or common law tax doctrine." *Id.* Repeating the language of § 409A, Notice 2005-1 provides that compensation which is not subject to a substantial risk of forfeiture must be included in gross income unless such income was previously included or unless certain requirements are met. *Id.*

On October 4, 2005, the IRS issued proposed regulations. Application of Section 409A to Nonqualified Deferred Compensation Plans, 70 Fed. Reg. 57930 (proposed Oct. 4, 2005) (to be codified at 26 C.F.R. pt. 1). This guidance has generated a flood of questions from practitioners regarding its application to nonqualified deferred compensation agreements, both existing agreements and future agreements. See, e.g., Joseph DiSciullo, *ABA Tax Section Aims Again at Deferred Compensation Plan Regs*, 112 TAX NOTES 251 (2006). Final regulations are expected in Fall 2006 with an effective date of January 1, 2007.

§ 409A restricts the situations in which a distribution may be made. Generally, deferred amounts may not be distributed before (i) a separation from service, (ii) a participant's disability, (iii) a participant's death, (iv) a specified time, (v) upon a change of control, or (vi) an unforeseeable emergency.<sup>147</sup> There are also special rules related to the separation from service of key employees.<sup>148</sup>

Second, § 409A restricts the ability of the executive and the employer to negotiate a further deferral of the executive's compensation.<sup>149</sup> If the plan allows for a subsequent election, such election must be made more than twelve months before the payment is due and must defer the payment not less than five years from the date the payment would have been made.<sup>150</sup>

#### **D. Accelerated Distributions**

When a nonqualified deferred compensation plan is drafted, customarily it provides that the executive receives the deferred compensation when the executive terminates employment. Termination can be voluntary, involuntary, or a result of becoming disabled, retiring, or dying. This "termination of employment" approach likely would violate § 409A because it would allow distributions prior to a "separation of service" or other permitted distribution event. For example, if an executive becomes a consultant, there would be a termination of employment, but not a separation from service. Similarly, if the executive terminates employment but goes to work for an affiliated entity, arguably there has been a termination of employment, but no separation of service.

In most, if not all, nonqualified deferred compensation agreements, the executive does not have the right to demand an accelerated distribution.<sup>151</sup> Some executives will want provisions providing that distributions be made upon the executive's death, disability, or if the employer experiences a change of control. If the executive dies, the executive will want the deferred compensation to be available to his or her family. Similarly, if the executive becomes disabled, the executive likely will need the deferred compensation to compensate for the reduced income the executive will experience as a result of being disabled and no longer able to work. If there is a change of control of the employer,

Before § 409A, accelerated distributions generally involved some trigger that caused the nonqualified deferred compensation to be due and payable to the executive sooner than termination of employment. Accelerated distributions could also be made if negotiated between the executive and the employer.

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<sup>147</sup> See I.R.C. § 409A(a)(2)(A) (2006).

<sup>148</sup> See § 409A(a)(2)(B)(i). See also Dennis B. Drapkin, *Separation From Service Issues in Nonqualified Plan Regs*, 110 TAX NOTES 1103 (2006).

<sup>149</sup> Section 409A departs from existing case law and requires that the executive make an election to defer compensation before the end of the previous tax year. See I.R.C. § 409A(a)(4)(B)(i) (2006).

<sup>150</sup> I.R.C. § 409A(a)(4)(C) (2006).

<sup>151</sup> The right to demand an accelerated distribution strengthens the argument that the employee is in constructive receipt of the deferred compensation.

Again, because of the bilateral nature of the nonqualified deferred compensation agreement, the original agreement should not cause the executive to be in constructive receipt of the deferred amounts just because the agreement might be renegotiated by the parties.<sup>152</sup>

The Joint Committee hinted that there might be some current situations where early distributions should be permitted before the date or event specified in the nonqualified deferred compensation agreement.<sup>153</sup> These situations, however, are extremely limited. The Joint Committee notes that current arrangements permit distributions for: “financial hardship, death, disability, retirement, the passage of a period of time specified by the employee (e.g., three years), and change in control.”<sup>154</sup>

Section 409A provides that in order to avoid constructive receipt, the nonqualified deferred compensation plan must provide that no accelerated distributions are permitted. Nonetheless, some exceptions are allowed. As noted above, § 409A provides that an executive may receive distributions upon separation from service, disability, death, expiration of a specified time, a change in ownership (subject to regulations to be promulgated by the Secretary of the Treasury), or occurrence of an unforeseeable emergency.

### **E. Income Tax Consequences of Accelerated Distributions**

Although facially prohibiting accelerated distributions, § 409A does address the tax ramifications when for any number of reasons the nonqualified deferred compensation arrangement allows or makes a distribution at a time which is not permitted under § 409A. First, all deferred amounts, including those amounts deferred in prior years, must be included in the executive’s gross income in the current year.

Second, interest is imposed on those deferred amounts and is calculated from the date the deferred amounts would have been paid if not for the nonqualified deferred compensation agreement. The interest rate is the rate for the underpayment of tax, plus an additional one percent. Depending on the length of the deferral, and with daily compounding, the interest owed could be significant.<sup>155</sup> Additionally, the executive must pay a twenty-percent penalty.<sup>156</sup> In effect, the benefits of deferral are lost.

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<sup>152</sup> See, e.g., *Veit I*, 8 T.C. 809 (1947).

<sup>153</sup> JCT ENRON REPORT, *supra* note 4, at 636.

<sup>154</sup> *Id.*

<sup>155</sup> The interest due will be incredibly difficult to compute and will not be clearly identifiable to the executive who might be contemplating the request of an accelerated distribution or the unwinding of a nonqualified deferred compensation agreement.

<sup>156</sup> I.R.C. § 409A (2006). It is interesting to note that the House version had no penalty provision at all while the original Senate version had a 10% penalty imposed in lieu of the additional 1% addition to the interest rate. H.R. Rep. No. 108-755 at 727 (2004) (Conf. Rep.) The 10% penalty would have made the nonqualified deferred compensation plan look more like qualified plans where a 10% penalty is imposed on distributions made before age 59½. See I.R.C. § 72(t) (2006).

### F. Subsequent Elections<sup>157</sup>

Executives find subsequent elections attractive because, with the agreement of the employer, the executive can continue the deferral of the compensation. With the further deferral comes not only the further deferral of the payment of the income tax liability on the deferred amounts but also continued growth of the deferred money without any current income tax consequences to the executive. The executive need not as accurately gauge his or her future cash flow needs. The executive might not have an idea of what his or her financial situation will be in 10 years.

Section 409A severely limits the executive's ability to continually postpone payments of nonqualified deferred compensation. After the initial election, the executive must decide one year prior to any payments being due whether the executive wishes to further defer those payments. If the executive decides to postpone a payment (or change the manner of the payment, for example from a lump sum payment to a payment over a specific number of years, or vice versa), then the payment must be deferred for at least five years.

When drafting nonqualified deferred compensation agreements, executives favor accelerated withdrawals and subsequent elections because they provide flexibility in the timing of distributions. It is important to remember that the original agreement is a binding contract negotiated between the executive and the employer. The executive has received only the employer's promise to pay the executive at some specified point in the future. Any renegotiation of the original agreement must be a bilateral effort.<sup>158</sup> The employer must agree to an executive's subsequent election to defer the compensation further. Bilateral negotiation is a point the Service seems to begrudgingly concede.<sup>159</sup>

As discussed above, the *Veit II* court addressed a situation where the executive and employer agreed that the compensation due the executive would be further deferred. Prior to the compensation being payable, i.e., prior to the date on which the executive was to be paid, the parties agreed that the compensation would be deferred over the next three years. The Service challenged this arrangement arguing that because the original agreement provided that compensation was to be paid in 1942, the taxpayer should include the full amount in 1942 even though 75% of the payment due was being further deferred.

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<sup>157</sup> The Senate version took this a step further and proposed allowing only one subsequent election. H.R. Rep. No. 108-755 at 728 (2004) (Conf. Rep.).

<sup>158</sup> Independence Air's CEO, Kerry Skeen, had only an unsecured claim to his over \$3 million in deferred compensation before renegotiating his contract in March of 2005. David S. Hilzenrath, *Flyi's Skeen May Have Averted Pay Loss, CEO's Renegotiated Contract Makes \$3.4 Million Harder for Creditors to Reach*, WASH. POST, Jan. 5, 2006, at D4. Skeen's renegotiated contract gave him control of a life insurance policy which contained the deferred compensation funds. *Id.* In November, Independence Air filed for bankruptcy. *Id.* Independence Air shut down January 6, 2006. *Id.* Under federal bankruptcy law, it is unlikely that Skeen will be able to keep his deferred compensation payment. *Id.*

<sup>159</sup> See *Veit II* at 923 (IRS conceded further deferral was bilaterally negotiated).



The Service was concerned that the executive and the employer might agree to defer the compensation for an indefinite number of years thus greatly delaying the inclusion of the compensation in the executive's gross income. With marginal rates soaring during World War II,<sup>160</sup> it is not inconceivable that an executive would want to keep postponing receipt of this compensation. Presumably, Veit had sufficient means to support himself that he did not need this compensation to pay his every-day living expenses and therefore could afford further deferral of this compensation.

Before the enactment of I.R.C. § 404(a)(5), the employer, as an accrual-basis taxpayer, had already taken an income tax deduction for the compensation it was obligated to pay the executive. As in the *Veit* cases, Lowenstein presumably had no disincentive not to defer the compensation. Today, the employer's deduction for the compensation is delayed until the compensation is actually paid to the executive or includible by the executive in gross income.<sup>161</sup> Thus, the employer must be realizing some benefit by further deferring the executive's compensation, for example, an improved cash flow. If there is no benefit, then the employer will not renegotiate the contract but pay the compensation when provided for in the agreement.

If the Congressional concern is that the employee has the *unilateral* ability to extend the deferral, Congress should consider removing the executive's unilateral ability to further defer the compensation by requiring that the employer consent to any extensions.<sup>162</sup> If the employer would be able to take an income tax deduction of the amount paid when originally called for under the deferred compensation plan, this would create an "adverse interest" and seems to be a more reasonable answer to the subsequent election issue. The executive could then have, for example, a rolling one-year plan, but if the company was in need of an income tax deduction, then the company could deny the request and pay the nonqualified deferred money as provided by the terms of the existing agreement.<sup>163</sup>

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<sup>160</sup> See *supra* note 83.

<sup>161</sup> I.R.C. § 404(a)(5) (2006).

<sup>162</sup> Given Prop. Treas. Reg. § 1.61-16, Treasury is concerned about the executive's unilateral ability to elect nonqualified deferred compensation. One wonders whether Congress gave serious consideration to repealing § 132 of the 1978 Revenue Act when enacting § 409A.

<sup>163</sup> This would be similar to a rolling two or three year period that previously was used by tax-exempt employers because of the rules that apply to tax-exempt employers under I.R.C. § 457(f). It seems that this concept could easily be adapted for nonqualified deferred compensation plans of for-profit entities to address the concerns over constructive receipt regarding subsequent elections. A rolling risk of forfeiture is customarily used with a § 457(f) plan that requires a substantial risk of forfeiture. *Id.* Section 457(f) plans are ineligible plans for a select group of management or highly compensated employees of state and local governments and tax-exempt organizations. They operate similarly to the nonqualified deferred compensation plans discussed above except that there must be a substantial risk of forfeiture as to the deferred amounts, which is usually the future performance of substantial services by the participant. *Id.*

## V. ALTERNATIVES SUGGESTED

Given the complexity<sup>164</sup> of new § 409A, and the Service's desire to severely restrict, if not eliminate, nonqualified deferred compensation, Congress should have declined to enact § 409A and either (i) amended § 446 to provide that for purposes of reporting compensation income, taxpayers must use the accrual method of accounting, or (ii) repealed § 132 of the 1978 Revenue Act thereby allowing the Service to issue updated guidance on nonqualified deferred compensation plans. This Article now addresses both alternatives, but first notes that a third alternative does exist.

Congress could have chosen to do nothing and allow existing law to resolve the problem. The Bankruptcy Code sets aside preferential payments made within 90 days of the debtor's filing a bankruptcy petition or payments made to insiders within one year of the petition filing.<sup>165</sup> With Enron, the Bankruptcy Court appointed the Employee Committee to pursue payments made from the Enron Plan to executives in the weeks before Enron's bankruptcy.<sup>166</sup> The Employee Committee was able to recover substantial amounts of the nonqualified deferred compensation paid.<sup>167</sup>

### A. Cash Method versus Accrual Method Taxpayers

Taxpayers generally are either cash-basis taxpayers or accrual-basis taxpayers. Taxpayers engaged in more than one trade or business may use a different method of accounting for each business.<sup>168</sup> In all cases, though, the

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<sup>164</sup> See, e.g. New York State Bar Association Tax Section, *The New Nonqualified Deferred Compensation Regime: Comments on the Proposed Regulations*, 111 TAX NOTES 459, 461 (2006) (requesting "generally that Treasury and the IRS consider whether the next round of guidance should be in the form of temporary or repropounded regulations, in light of the number and complexity of the issues that remain").

<sup>165</sup> 11 U.S.C. § 547(b) (2006).

<sup>166</sup> Eric Berger, *The Fall of Enron; Enron can go after deferred pay; Judge says money must be returned*, HOUSTON CHRON., Sept. 23, 2003, at 2.

<sup>167</sup> See Press Release, Kronish, Lieb, Weiner & Hellman, LLP, *Enron's Employee Committee Reaches Settlement for an Additional \$21.1 Million For Creditors* (May 24, 2006), <http://www.cooley.com/news/inthenews.aspx?ID=000040288120&print=true> (announcing that, to date, \$36 million has been recovered). Nevertheless, there are some inefficiencies in allowing the bankruptcy laws to be the only remedy. As evidenced by the Kronish, Lieb press release, \$17 million of the accelerated distributions remain unrecovered. *Id.* Additionally, there are the costs associated with pursuing the return of the accelerated distributions.

<sup>168</sup> I.R.C. § 446(d) (2006). This treatment allows the taxpayer to more clearly reflect income for each line of business and thus to have the tax consequences follow suit. *Id.* For example, an individual sole proprietor may be engaged in a manufacturing business and also a personal services business. See Treas. Reg. § 1.446-1(d)(1) (2006). The taxpayer may account for the manufacturing business on the accrual method and the personal services business on the cash receipts and disbursements method. *Id.* Provided that the taxpayer keeps separate books for both businesses, this combination of accounting methods is permissible. Treas. Reg. § 1.446-1(d)(2).

method selected by the taxpayer must clearly reflect the taxpayer's income.<sup>169</sup> If the Secretary determines that the taxpayer's method does not clearly reflect income, then the Secretary can choose a method to compute a taxpayer's income.<sup>170</sup>

### B. Cash Basis

Most, if not nearly all, individual taxpayers use the cash receipts and disbursements method.<sup>171</sup> These taxpayers are called cash-basis taxpayers. The cash method is believed to be a simpler reporting system for individuals. Cash-basis taxpayers include items in gross income in the year in which such items are received, and take deductions for the year in which expenses are actually paid. Generally, it is the actual receipt of an item of income or the actual payment of a deductible expense that determines in which tax year gross income is included or a deduction is taken. Arguably, there is room for manipulating the timing of including gross income or taking deductions. A taxpayer looking to increase his or her deductions may make an extra mortgage payment in late December rather than in January so that the interest paid will be deductible in the prior year rather than the later year.<sup>172</sup> The IRS and Congress do not appear concerned with taxpayers who accelerate deductions in this manner.

### C. Accrual Method

Taxpayers using an accrual method of accounting, however, include items in gross income and take deductions when the amount of those items of income

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Admittedly, the President's Tax Reform Panel's proposal is dead, but the Simplified Income Tax Plan – Corporate called for the exploration of whether corporations should be allowed to file income tax returns based upon financial accounting income rather than tax accounting income. The proposal demonstrates that thought is still being given to how a taxpayer's method of accounting clearly reflects the taxpayer's income. See PRESIDENT'S ADVISORY PANEL ON FEDERAL TAX REFORM – FINAL REPORT – NOVEMBER 1, 2005, CHAPTER SEVEN, THE GROWTH AND INVESTMENT PLAN, 151-152, [http://www.taxreformpanel.gov/final-report/TaxReform\\_Ch7.pdf](http://www.taxreformpanel.gov/final-report/TaxReform_Ch7.pdf).

<sup>169</sup> Treas. Reg. § 1.446-1(a)(2) provides “[h]owever, no method of accounting is acceptable unless, in the opinion of the Commissioner, it clearly reflects income.” The taxpayer selects his, her, or its method of accounting on the first tax return filed by the taxpayer. See IRS Publication 538 (2004). Some taxpayers are prevented from using a particular method. For example, corporations taxable under subchapter C (“C corporations”) may not use the cash receipts and disbursements method if they have gross receipts over \$5,000,000. See I.R.C. §§ 448(a)(1), (b)(3) (2006).

<sup>170</sup> I.R.C. § 446(b) provides that “if the method used does not clearly reflect income, the computation of taxable income shall be made under such method as, in the opinion of the Secretary, does clearly reflect income.”

<sup>171</sup> See *Sproull v. Comm’r*, 16 T.C. 244, 246 (1951) (noting that “[the cash method] is the most common method of reporting income”) *aff’d* *Sproull v. Comm’r*, 194 F.2d 541 (6th Cir. 1952).

<sup>172</sup> This assumes that the taxpayer meets all applicable criteria for deducting the interest. See I.R.C. § 163 (2006). Likewise, taxpayers may make early payments on property taxes so as to be entitled to a deduction in the earlier tax year. See I.R.C. § 164 (2006).

or liabilities has become fixed with a reasonable amount of accuracy.<sup>173</sup> When determining whether an item must be included in gross income, the timing issue for accrual-basis taxpayers hinges upon the right to receive the income and whether the amount can be estimated with reasonable accuracy. In the case of a deduction, the timing issue hinges on the obligation to pay the expense.

The accrual method stands in contrast to the cash method in that the actual receipt or the actual payment does not determine when the accrual-basis taxpayer must report the event on an income tax return. Arguably, accrual-basis accounting treats taxpayers more fairly in that taxpayers are able to better match items of income with the deductible expenses incurred to generate such income even if the actual receipt of the income and the payment of the expenses do not occur in the same taxable year. Conversely, an accrual-basis taxpayer may be at a disadvantage in relation to a cash-basis taxpayers in that an accrual-basis taxpayer may have to pay tax on an item before he or she receives the cash.<sup>174</sup>

#### D. Combination of Methods

A combination of accounting methods is expressly permitted by I.R.C. § 446(c)(4) provided that it is allowed by the treasury regulations. Further, taxpayers engaged in more than one line of business may use different methods of accounting for each line of business.<sup>175</sup> For example, the issue in *Peterson Produce Co. v. United States*<sup>176</sup> was whether the taxpayer's new broiler division constituted a "new, separate and distinct business"<sup>177</sup> such that the taxpayer could properly elect the cash method of accounting for the broiler division while continuing to use the accrual method for the taxpayer's feed and hatchery business divisions, thus reporting income based upon a combination of methods.<sup>178</sup>

In *Peterson*, the taxpayer was able to manipulate the timing of income by having the feed and hatchery divisions sell feed and chicks, at cost, to the broiler

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<sup>173</sup> Treas. Reg. § 1.446-1(c)(1)(ii) provides "income is to be included for the taxable year when all the events have occurred that fix the right to receive the income and the amount of the income can be determined with reasonable accuracy."

<sup>174</sup> For example, assume that a carpenter, who happens to be an accrual-basis taxpayer, performs work in December 2005. All of the work is completed in 2005 and the carpenter has calculated the amount due from the customer for the work. The customer, though, does not send payment until January 2006. An accrual-basis carpenter must include the amount in gross income for 2005, not 2006 meaning that the carpenter must include in gross income an item of income not yet received. On one hand, this is a disadvantage when compared with the cash-basis taxpayer because the carpenter is paying tax on income not yet received. On the other hand, the carpenter is able to use expenses incurred while performing this job, e.g., an apprentice's wages, tools, supplies not paid directly by the customer, maintenance for the truck, to offset the income from this job. Income and expenses are better matched for the accrual-basis taxpayer.

<sup>175</sup> I.R.C. § 446(d) (2006).

<sup>176</sup> 313 F.2d 609 (8th Cir. 1963).

<sup>177</sup> *Id.* at 611.

<sup>178</sup> *Id.*

division. Using the cash method for the broiler division, the taxpayer claimed a deduction for the “amounts expended in processing the chicks unsold . . . .”<sup>179</sup> The income received by the broiler division from its sale of the chicks would be realized in a future tax year while the deduction for the expenses was taken in a prior year.

Although the taxpayer kept separate books for each division, the taxpayer maintained only one bank account.<sup>180</sup> The court found that the divisions “were too interdependent and well-integrated to be considered separate and distinct; that there was not a sufficient separation of the books and records; that regardless of how the above issues were resolved, there was not a clear reflection of income for the year in question through the method employed by the taxpayer.”<sup>181</sup> Despite the result in *Peterson*, a taxpayer can clearly use multiple methods of accounting.<sup>182</sup> The problem in *Peterson* was the manipulation of the timing of income inclusion. If a combination of methods clearly reflects the taxpayer’s income, and thus is not manipulative, the taxpayer’s choice of accounting method will be respected.

### E. Conclusion and Summary of accounting methods

If individuals were required to report compensation income on an accrual basis and could report other income on a method selected by the taxpayer and changed only with the approval of the Secretary, any abusive issues concerning the manipulation of the timing of gross income would be minimal.

It is important to remember that in allowing different methods of accounting, the Congressional goal is to have a method of accounting for each taxpayer that clearly reflects the taxpayer’s income. Changing individual taxpayers to an accrual method for reporting compensation would clearly reflect an individual taxpayer’s income.<sup>183</sup>

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<sup>179</sup> *Id.* at 610.

<sup>180</sup> *Id.*

<sup>181</sup> *Id.* at 611.

<sup>182</sup> As noted above, § 404(a)(5) requires a taxpayer-employer using the accrual method of accounting to delay its tax deduction for nonqualified deferred compensation due to an executive even though the employer is presently entitled to the deduction as an accrual basis taxpayer. In this example, the employer is treated like a cash basis taxpayer because the employer is not allowed a tax deduction until the executive must include the compensation in gross income, usually when the compensation is actually paid to the executive.

<sup>183</sup> Normally, I.R.C. § 446(e) provides that a taxpayer seeking to change his or her method of accounting must seek and obtain the approval of the Commissioner. Without such a requirement, taxpayers could switch methods often and manipulate the timing of income. Requiring the Commissioner’s approval seeks to prevent this abuse.<sup>183</sup> See, e.g., *Witte v Comm’r*, 513 F.2d 391, 394 (D.C. Cir. 1975) (holding “the purpose of the consent requirement is to enable the Commissioner to prevent distortions of income that often accompany changes in accounting methods”).

### F. Effect of Changing to Accrual

If Congress amended § 446 to provide that employees must use the accrual method of accounting for reporting compensation income, then nonqualified deferred compensation, as discussed in this article, would end. If the Congressional motivation in enacting § 409A was to remedy the abuses of Enron by ending nonqualified deferred compensation, then changing taxpayers to accrual method taxpayers for purposes of reporting compensation income would be a better solution than § 409A. Under § 446 the Secretary has discretion to determine a taxpayer's method of accounting. It is clearly contemplated that a mixing of methods is permissible.

This limited change in accounting method would have little effect on most taxpayers despite the large number of taxpayers with compensation income. Employers could adjust Forms W-2 to report compensation paid after the close of a taxable year for services performed in the prior year.

Treasury Regulations provide at least one situation where payments made by an employer to an employee after the close of a taxable year are includible in the employee's taxable income for the prior taxable year, not in the year the payment is received.<sup>184</sup> A similar rule could be adopted to address compensation earned by employees.

For example, bonuses paid to employees after the close of the taxable year could cause concern because the right to receive the bonus would not have accrued at the end of the taxable year because the amount of the bonus might not be able to be calculated with reasonable accuracy. The bonus might be based on an employer's year-end figures requiring additional time to be calculated by the employer. Congress could provide that bonuses earned for services performed in the prior taxable year are includible on that year's income tax return if the amount of the bonus is calculated on or before March 15 of the following taxable year. Such a rule would give employers ample time to calculate the bonus amount. Additionally, Congress could adopt a *de minimis* provision such that

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<sup>184</sup> For example, 401(k) plans must meet certain nondiscrimination tests each year to ensure that the highly-compensated employees are not benefiting from the 401(k) plan at the expense of lesser paid employees. If lesser paid employees are not participating in the 401(k) plan, then the highly compensated employees may be limited in the amount they can contribute even though that amount is less than the statutory maximum allowed by I.R.C. § 402(g)(1)(B). An employer must refund the excess amount, if any, to the employee within 2½ months of the close of the plan year. For example, a highly compensated employee might elect to defer \$15,000 into the 401(k) plan but because of the application of the 401(k) nondiscrimination test, the highly-compensated employee is limited to deferring \$12,000. The employer is required to refund the \$3,000 difference. The Regulations provide that the excess contributions paid to the employees within 2½ months after the end of the taxable year are included in the prior taxable year unless the amount repaid is less than \$100. Treas. Reg. § 1.401(k)-2(b)(2)(vi)(B) (2006). If the amounts are paid after the two and a half month window, then the amounts are included in the taxable year in which those amounts are paid. As a practical matter, employers often offer what is known as a "tandem" plan where any amounts to be refunded are transferred to a nonqualified deferred compensation plan rather than being refunded to the highly-compensated employee. *Id.*

amounts paid in this two and a half month window that fell below a certain dollar amount would be reported in the following taxable year.<sup>185</sup> A safe harbor rule would also avoid disputes about the proper tax treatment of situations where at the end of the taxable year it is known that the employee's bonus is at least \$x but might be up to \$y.<sup>186</sup>

The practical and political realities of an accounting change of this size make its implementation unlikely. Changing all taxpayers to the accrual method of accounting is a broad solution to remedy the perceived abuses of a few taxpayers. It is also a difficult sell for Congress to convince millions of taxpayers that they need to change to prevent another Enron when in fact it is those millions of taxpayers who lost their investments in Enron and feel wronged.

### G. Repeal of § 132

Alternatively, if Congress were not willing to change individual taxpayers to accrual-basis taxpayers for the purposes of reporting wage income, then Congress should repeal § 132 of the Revenue Act of 1978. This would give the Service the ability to issue additional guidance on nonqualified deferred compensation and pursue abusive transactions. It would also breathe new life into Proposed Regulation § 1.61-16. Taxpayers and the Service likely would end up litigating what restrictions are sufficient to avoid constructive receipt.

In 1978, the Treasury Department wished to severely limit the use of nonqualified deferred compensation.<sup>187</sup> Proposed Regulation § 1.61-16 provided that if under a plan or arrangement a taxpayer's compensation, including salary and bonuses, was deferred at the taxpayer's option, then the amount deferred would be included in the taxpayer's income in the year in which the services were performed despite any risk of forfeiture.<sup>188</sup> The proposed regulation was a departure from the prevailing understanding of the constructive receipt doctrine and would have pushed individual taxpayers closer to being accrual basis taxpayers.

Under Proposed Regulation § 1.61-16, for an executive to avoid constructive receipt, the employer had to require the deferral of compensation.<sup>189</sup>

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<sup>185</sup> See, e.g., Treas. Reg. § 1.401(k)-2(b)(2)(vi)(B).

<sup>186</sup> For example, an employer might know that an employee will get at least a \$5,000 bonus but depending upon final accounting numbers for the year, the bonus might be up to \$7,000. Without a safe harbor or grace period, the taxpayer and the Service might end up arguing about whether the \$5,000 is includible in the prior year even though the exact bonus amount is not determined until the subsequent year. Likewise, guidance could be issued allowing an employee a deduction in a future tax year if the employer fails to pay the bonus.

<sup>187</sup> Deferred Tax Treatments for Amounts of Compensatory Payments, 43 Fed. Reg. 4638 (proposed Feb. 3, 1978) (to be codified at 26 C.F.R. pt. 1).

<sup>188</sup> *Id.*

<sup>189</sup> These types of arrangements are frequently called "Supplemental Executive Retirement Plans" or "SERPs" because the employer is providing additional (or "supplemental") compensation on top of the salary and bonus already payable to the executive.

If the taxpayer had the option to defer or to receive the compensation, then the proposed regulation provided that the taxpayer had to presently include the compensation in gross income.<sup>190</sup>

But would this or a similar restriction have made any difference at Enron? The answer seems to be no. At Enron, the problem, if any, with nonqualified deferred compensation was the lack of independence and the lack of appropriate review of requests for early withdrawals. As was seen above, 117 Enron employees and former employees received \$53 million in accelerated nonqualified deferred compensation payments in the six weeks before Enron went bankrupt. Ken Lay appointed Lawrence Whalley to review the requests. Whalley based his decisions to grant the requests upon whether Enron had the cash flow to pay the requests. It appears no consideration was given to whether it was in Enron's best interest to honor these requests.

If the Service's proposed regulation had been enforced, meaning that compensation could not be deferred at an executive's individual option, then employers would simply structure nonqualified deferred compensation so that the employee did not have an "option" to defer compensation. This could be achieved by the employer making an initial offer providing that a fixed amount or percentage of the executive's compensation be deferred. As long as the employer requires the executive to defer a certain amount or percentage of compensation, presumably the deferral would not be at the taxpayer's individual option and thus the taxpayer could defer the compensation to a future tax year or years. Savvy employers seeking to retain and reward highly compensated executives would ask each year whether the executive wanted to defer part of his or her compensation. If the executive did not want to defer compensation, then the executive would reject the offer and receive all of his or her compensation currently. This structure would not have triggered taxation under Proposed Regulation § 1.61-16. If the executive did want to defer compensation, then the executive would accept the employer's offer.

As a reaction to Proposed Regulation § 1.61-16, Congress enacted § 132 of the Revenue Act of 1978.<sup>191</sup> Section 132 provides that: "[t]he taxable year of inclusion in gross income of any amount covered by a private deferred compensation plan shall be determined in accordance with the principles set forth

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<sup>190</sup> I.R.C. § 162(m) provides that a publicly-traded corporation's deduction for compensation paid to its chief executive officer and its four other highest paid executives is limited to a \$1 million deduction for each executive. It may not matter to an employer whether an executive defers compensation. If the executive is one of the individuals named in I.R.C. § 162(m) and the executive's compensation is greater than \$1 million, then the corporation is not forgoing a deduction by deferring the executive's compensation. Also, the corporation may be willing to postpone its deduction in order to please an executive and thereby keep a valued employee happy. Performance-based compensation, as defined in I.R.C. § 162(m)(C), is not subject the \$1 million limitation.

Proposed Regulation § 1.61-16 says that it is immaterial to inclusion in the gross income of the taxpayer whether the amount deferred is ultimately forfeited. It appears that the executive would not have been allowed a deduction in a later year if in fact the amount deferred was forfeited.

<sup>191</sup> Revenue Act of 1978, Pub. L. No. 95-600.



in regulations, rulings, and judicial decisions relating to deferred compensation which were in effect on February 1, 1978.”<sup>192</sup> Since Proposed Regulation § 1.61-16 was published on February 3, 1978, Congress effectively prevented the proposed regulation from having any effect and also prevented the Service from issuing further substantial guidance on nonqualified deferred compensation.<sup>193</sup>

Despite the Joint Committee’s recommendation for repeal and initial support in the Senate,<sup>194</sup> repeal of § 132 never made it into the final bill.<sup>195</sup> In limiting the ability of the Treasury to provide guidance and then not providing guidance itself, Congress has caused tax policy and the development of tax law to stall. If Congress does not approve of Treasury’s published guidance on this matter or any matter, then Congress can act affirmatively to address whatever issue Congress does not like.

Even if the application of Proposed Regulation § 1.61-16 could have been easily skirted, repealing § 132 still makes sense. With the ability to issue additional guidance the Service could set the parameters for nonqualified deferred compensation. For example, the Service could issue guidance regarding the use of hypothetical investment accounts. The Joint Committee thought that Enron’s use of hypothetical investment accounts gave the executives too much control over their nonqualified deferred compensation.<sup>196</sup> A revenue ruling could provide that an executive using a hypothetical investment account will be in constructive receipt of amounts earned over the applicable federal interest rate. If a fixed rate of return is negotiated, then no constructive receipt for the executive.

The Senate version of AJCA provided that the hypothetical investment options for a nonqualified deferred compensation plan must be comparable to the employer’s qualified plan with the fewest investment options.<sup>197</sup> Such a restriction would have the advantage of protecting the rank-and-file workers in that employers will not be able to favor nonqualified plans at the expense of qualified plans. It would also have the effect of providing for more reasonable rates of return.<sup>198</sup>

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<sup>192</sup> *Id.* at § 132(a).

<sup>193</sup> JCT ENRON REPORT, *supra* note 4, at 41 (“The lack of guidance over the last 25 years has given taxpayers latitude to use creative nonqualified deferred compensation arrangements to push the limit of what is allowed under the law.”).

<sup>194</sup> See STAFF OF JOINT COMMITTEE ON TAXATION, DESCRIPTION OF THE SENATE FINANCE COMMITTEE CHAIRMAN’S MARK OF THE “NATIONAL EMPLOYEE SAVINGS AND TRUST EQUITY GUARANTEE ACT,” JCX-77-03 (2003) (providing for repeal). *But see* S. 1637, 108th Cong. (2003) (containing no provision for repealing § 132).

<sup>195</sup> The House version of the AJCA never contained a provision to repeal § 132. See H.R. 4520, 108th Cong. (2003).

<sup>196</sup> JCT ENRON REPORT, *supra* note 4, at 630, 636.

<sup>197</sup> H.R. REP. NO. 108-755 at 728 (2004) (Conf. Rep.).

<sup>198</sup> See *supra* note 70 (discussing Jack Welch’s nonqualified deferred compensation with G.E.).

## VI. CONCLUSION

If Congress is serious about ending the perceived abuse of nonqualified deferred compensation, then Congress should make taxpayers accrual basis taxpayers with respect to reporting their compensation or should repeal § 132 of the 1978 Revenue Act. A required shift to the accrual method of accounting would eliminate the opportunity for taxpayers to manipulate the timing of their compensation income. Taxpayers who perform work in a particular taxable year must include the income received or to be received in the future in gross income for the taxable year in which the work was performed. A special rule could be drafted to allow for the inclusion of compensation in the taxable year in which the work was performed even if the amount due is not able to be ascertained with reasonable accuracy until after the close of the taxable year. I.R.C. §§ 404 and 409A both have provisions exempting from nonqualified deferred compensation treatment payments that are made within two and a half months of the close of the taxable year. A special rule of this nature would allow for bonuses, which are often dependent upon the performance of the employer, to be included in the taxable year in which the work was performed even if it is not possible to know how well the employer did until after the close of the taxable year.

For most taxpayers, a change to the accrual method of reporting for wage income would have little effect because nonqualified deferred compensation plans are usually only available to a highly select group of management. In the initial year of conversion, some employees might see a slight increase in the amount of gross income.<sup>199</sup> In subsequent years, there should be no effect. Employers preparing Forms W-2 would have to make adjustments when completing the Forms W-2 to account for the pro-rating of paychecks for different taxable years. With good software, this should not be an obstacle.

This change would affect a significant number of taxpayers even if the impact might be minimal. It is conceivable that Congress would not want to disturb the many so that the abuses of the few might be stopped. Further, one must also question whether Congress in fact wants to end nonqualified deferred compensation.

Despite its complexity, I.R.C. § 409A does not come close to ending nonqualified deferred compensation. In some sense, very little has changed with § 409A particularly if the executive correctly chooses the timeframe in which he or she wants to receive the deferred compensation. The major changes to nonqualified deferred compensation plans brought by § 409A involve accelerated distributions and subsequent elections.<sup>200</sup> Often accelerated distributions and

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<sup>199</sup> For example, in a week in which December 29 is on a Monday and January 2 is on a Friday, an employee who is paid every Friday under an accrual method of reporting would have to include 3 days of pay (29, 30, and 31) in gross income in the prior year that the employee would otherwise be able to defer until the subsequent year if using the cash method of reporting.

<sup>200</sup> The funding of off-shore rabbi trusts triggering constructive receipt is also a significant change for plans which used that technique. For plans without an off-shore rabbi trust the change is of no consequence. Enron's rabbi trust was on-shore.

subsequent elections came into play because the executive incorrectly negotiated a suitable time of deferral. With accelerated distributions, the time negotiated was too long. With subsequent elections, the time negotiated was too short, or the executive negotiated a short time hoping that subsequent elections to further defer would not be difficult to obtain. If, though, the executive was correct in his or her estimation of when the deferred compensation was needed, then the executive had no need of renegotiating the deferral. Section 409A does nothing to change the tax treatment if the executive and the employer have no need to revisit the deferral.

It seems that Congress may actually be encouraging nonqualified deferred compensation by enacting § 409A. With § 409A, Congress has provided a roadmap, albeit in parts confused, as to how nonqualified deferred compensation plans should be structured to avoid constructive receipt. Will this encourage more executives and employers to enter into these agreements? What § 409A does highlight is the apparent lack of Congressional will to kill nonqualified deferred compensation. One commentator has noted Congress's timidity to adopt a clean slate.<sup>201</sup> Given this timidity, changing all taxpayers to accrual basis taxpayers for the purpose of reporting wage income seems unlikely. This leads to the further conclusion that repeal of § 132 of the 1978 Revenue Act would have been the better course of action.

Repealing § 132 would allow Treasury to issue guidance about what arrangements will be respected for purposes of avoiding the application of the constructive receipt doctrine. In releasing Proposed Regulation § 1.61-16, Treasury was providing additional guidance. Just because Treasury has issued guidance, does not necessarily end the inquiry. Proposed Regulation § 1.61-16 was just that – proposed. Public comment might have caused Treasury to revise the regulation, withdraw it, or not seek its finalization. Courts may have declared the regulation invalid. Taxpayers might have planned their transactions so as to avoid the application of Proposed Regulation § 1.61-16. Without the ability to issue guidance that might narrow and tighten up nonqualified deferred compensation, Treasury and the Service's ability to prevent perceived abuses, such as Enron, is limited.

All of this leads back to the point that the perceived abuses at Enron remain largely unfixed following the enactment of § 409A. Enron's impending bankruptcy caused many of its executives to request, and receive, accelerated distributions from the Enron Plan. These distributions were part of the trigger that caused the Congressional investigation of Enron. That investigation in turn showed the loose and fast manner in which Enron administered the Enron Plan. The bankruptcy court was successful in recovering much of the accelerated distributions.<sup>202</sup> What § 409A should be addressing is tighter administration of these plans. Treasury could be issuing guidance about what facts and circumstances will be considered when determining whether a plan is properly

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<sup>201</sup> See Lee Sheppard, *The Proposed Safe Harbor for Marking to No Market*, 107 TAX NOTES 1222 (2005).

<sup>202</sup> See Kronish, Lieb, Weiner & Hellman, *supra* note 152.

administered thereby avoiding the application of the constructive receipt doctrine.

Before Enron was on the brink of bankruptcy, there was nearly no interest in accelerated distributions.<sup>203</sup> Arguably the unfavorable provisions of the Enron Plan deterred executives from requesting accelerated distributions. The better question for Congress to ask is how to make sure the executive can only reach the deferred compensation by following the terms of the plan documents. For example, the Enron Plan provided that a committee was to review requests for accelerated distributions. A one-person committee was appointed six weeks before Enron went bankrupt. It does not appear that Enron respected the terms of the plan, so why should the Service?

On a case by case basis, parameters could be set outlining what is permissible and impermissible in creating and maintaining a nonqualified deferred compensation plan. The most egregious cases would result in the executive being in constructive receipt of the deferred amounts. Situations involving a bona fide, arm's length negotiation between executives and employers, who all subsequently respect the agreement, would be permitted. Congress's unwillingness to completely end nonqualified deferred compensation must be seen as an indication that Congress will permit this form of compensation to continue.

Another underlying difficulty with § 409A is that by providing a framework for nonqualified deferred compensation, Congress is giving guidance on how to structure these plans. To some degree, the uncertainty regarding the tax treatment and the application of the constructive receipt doctrine may have discouraged some taxpayers from entering into nonqualified deferred compensation altogether, or to proceed on the more cautious side. The marketing of nonqualified deferred compensation plans may be easier with § 409A because the rules are more clearly defined. What remains to be seen is whether the new rules will be acceptable to taxpayers.

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<sup>203</sup> JCT ENRON REPORT, *supra* note 4, at 625 ("Documents provided by Enron show that one hardship request was granted from the 1992 Deferral Plan in 1998.").