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Executive Compensation

By Steven Gerlach
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When deciding how to compensate its executives, a business must examine not only the array of incentive and compensation strategies, but how they are regulated. Several major strategies can be used to compensate executives, but this commentary focuses on nonqualified deferred compensation (NQDC) and its regulation through the tax code. Ultimately, I believe certain provisions of the code provide appropriate regulation, whereas other provisions should be repealed.

Neither the Tea Party nor the Occupy movement has the right view of regulation. I take the seemingly ever-widening middle ground — appropriate government regulation. Appropriate regulation sets and enforces ground rules, and treats all players fairly, but does not micromanage.

Here is a brief introduction to the major types of executive compensation strategies:

- **Nonqualified deferred compensation** — a promise to pay amounts deferred upon the occurrence of some future event;

- **Supplemental executive retirement plans** — a form of deferred compensation intended to make up for the savings limits imposed on qualified retirement plans;

- **57(b) and 457(f) plans** — forms of deferred compensation used by nonprofits, subject to stricter rules than the NQDC arrangements of for-profit businesses;

- **Stock options** — the executive is granted the right to purchase shares of the company at a stated price;

- **Stock grant** — the executive is granted (or sold at a discount) stock in the company, usually subject to a vesting period; and

- **Stock or equity appreciation rights** — the executive is granted a right to share in the growth of the company, but is not granted actual equity ownership.

Various provisions in the tax code regulate each of these types of arrangements, but nowhere are the strengths and weaknesses of regulation more evident than in the code's treatment of NQDC. In its simplest form, NQDC is an incentive arrangement under which, for work currently performed, a business promises to pay its executive at some future date. Until that date, the business retains control of the promised funds and the executive is not taxed until the funds are received. Two contrasting code provisions regulate NQDC, Sections 451 and 409A.

The regulations under Section 451 define "constructive receipt." Dating back to the 1913 tax code, "constructive receipt" means that an individual is taxed on income she controls whether or not she actually receives it. In a straightforward example, the business gives its executive her bonus on Dec. 30, 2011, but the executive asks the business to hold the check until Jan. 3, 2012. Under the doctrine of constructive receipt, the executive is taxed on that paycheck in 2011 because she controlled the money as of Dec. 30. Applied to NQDC, constructive receipt prevents executives from exercising too much control over deferred amounts prior to "receiving" them.

Constructive receipt is appropriate regulation. It prevents an executive from gaming the system, it applies evenhandedly to all taxpayers and does not micromanage the relationship between the business and the executive. It merely taxes the income once the executive controls it.

Section 409A is constructive receipt on steroids. Effective in 2005, it also attempts to prevent executives from gaming the system, but it does so with a labyrinth of requirements regarding when and how income can be deferred and paid. Specifically, 409A only allows payments of NQDC on six permitted events: death, disability, separation from service, unforeseen emergency, fixed date or schedule, or change in control (of the business). Moreover, it provides specific and often difficult definitions for these events.

For example, to meet the definition of "disability" an executive must be totally and permanently disabled. Section 409A does not allow payments when a person is merely disabled with respect to his current position. Section 409A will not permit payment upon the sale of a division of the business (unless it comprises 40% or more of the assets of the company) — even if it is the division the executive has worked hard to build. This is micromanagement.

Section 409A is especially burdensome to small businesses, which typically lack the budget and infrastructure to maintain complicated NQDC arrangements. Prior to 409A, I saw perfectly adequate one-page arrangements. Now, a similar arrangement could require 10 pages or more of legalese.

To survive and thrive, businesses need to offer competitive compensation arrangements to their executives. To do this effectively, businesses also need a regulatory scheme that is predictable and fair, but does not micromanage. Section 409A is neither predictable nor fair, and micromanages the relationship between businesses and their executives. It should be repealed.

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