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INTRODUCTION

Any system of income taxation must deal with the problem of treating unfunded deferred compensation.[1] The United States and the Federal Republic of Germany income tax systems provide dramatically different approaches to this problem. Although neither system taxes the employee until payments are actually received, the West German system allows the employer a deduction in the current year, while the U.S. system postpones the deduction until the year of actual payment.

An analysis of this central difference between the two approaches reveals that the apparent tax break flowing to the employer under the West German system does not represent a special tax subsidy for unfunded pension plans, but rather is consistent with the general West German treatment of long-term annuities. On the other hand, both systems provide inappropriate tax benefits to employees whose tax bracket is lower in the year of receipt than in the year the compensation is deferred. Thus, some employees will decide whether to defer compensation or receive it currently based on tax-related rather than financial factors. This shared failing in the two approaches violates the principle of neutrality, which holds that a good tax system should not alter economic behavior. This article suggests alternative approaches to the taxation of unfunded deferred compensation which would make the income tax system

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1. Deferred compensation is compensation to be paid in a future year for services performed in the current year. It is "unfunded" if not secured by an employer-provided fund.

neutral as to the decision whether to defer compensation or receive it currently.

I.
THE WEST GERMAN SYSTEM

The most significant type of pension plan[2] in the Federal Republic of Germany is a form of unfunded deferred compensation known as the balance sheet reserve plan (Direktzusage).[3] Under such a plan, the employer makes a binding promise to provide pension benefits and establishes a reserve on its balance sheet to cover the anticipated cost. Normally, no special funds are set aside to fund the benefits, instead the benefits are financed from current cash flow as they become payable.[4]

Since unfunded plans are completely dependent on the employer's ability to pay the benefits when due, these benefits could be jeopardized if the employer became insolvent. To protect employees from losing their pensions due to employer insolvency, in 1974 the West German Parliament established the Pension Guarantee Association (Pensions-Sicherungs-Verein, Versicherungs Verein auf Gegenseitigkeit [hereinafter PSVaG]).[5] As a quasi-

2. There are four types of pension plans available to employers: balance sheet reserve plans (Direktzusage or Pensionsrückstellungen), pension funds (Pensionskassen), support funds (Unterstützungskassen), and insurance contract plans (Direktversicherung). Important differences among these plans include the timing of the actual cash cost to the employer, the tax treatment of the contributions and benefits, the availability of accumulated funds as a source of capital for the employer, and the degree of certainty as to the actual future cost. For a useful description of the system of private pension plans in West Germany, see M. HORLICK, PRIVATE PENSION PLANS IN WEST GERMANY AND FRANCE, U.S. DEPT. OF HEALTH AND HUMAN SERVICES, SOCIAL SECURITY ADMINISTRATION, OFFICE OF POLICY, OFFICE OF RESEARCH AND STATISTICS, (Research Report No. 55 1980). As in the United States, employers are not required to provide a pension plan and are generally free to select the type of plan (or plans) which best meets their needs. All plans, however, must meet certain minimum requirements (*e.g.*, minimum vesting and minimum accrual of benefits) of German labor law. The relevant statute is the Gesetz zur Verbesserung der betrieblichen Altersversorgung [BetrAVG] of December 19, 1974, 1974 Bundesgesetzblatt, Teil I [BGBl I] 3610, as amended. Most of these requirements have close parallels under U.S. labor laws. The relevant U.S. statute is the Employee Retirement Income Security Act of 1974 [hereinafter ERISA], Pub. L. No. 93-406, 88 Stat. 829 (codified as amended in scattered sections of the I.R.C. and in 29 U.S.C. §§ 1001-1461 (1985 Supp.)). The BetrAVG was enacted just a few months after the enactment of ERISA.

3. More than two-thirds of the value of pension benefits is in the form of balance sheet reserve plans. P. AHREND, W. FÖRSTER & N. RÖßLER, STEUERRECHT DER BETRIEBLICHEN ALTERSVERSORGUNG pt. 2, at 16 (1985). In the manufacturing sector, seventy percent of the work force is covered by such plans. Kaukewitsch, *Verbreitung der betrieblichen Altersversorgung im Produzierenden Gewerbe*, 1984 WIRTSCHAFT UND STATISTIK 708.

4. The ability of West German employers to provide this type of plan to large groups of employees is a profound difference between the West German and U.S. pension laws. In the United States, ERISA establishes mandatory minimum funding standards. ERISA § 302. Certain plans are exempted, such as unfunded deferred compensation plans for a select group of management or highly compensated employees and plans providing so-called "excess benefits" as an addition to an otherwise qualified plan. ERISA §§ 4(b) & 301(a). However, the typical West German unfunded plan, covering a large percentage of the work force, would be illegal in the United States.

5. BetrAVG § 14.

public insurance company[6] the PSVaG insures payment of vested[7] benefits up to a statutory maximum.[8] The PSVaG is financed through mandatory premiums paid by employers whose plans are subject to the insurance.

An important difference between West German and U.S. pension laws is the requirement under West German statutory law that ongoing[9] pension payments be reviewed by the employer every three years to determine whether cost-of-living increases should be made.[10] The statute requires the employer to make such a decision in good faith, considering both the interests of the beneficiaries and the employer's own economic situation.[11] This rather vague requirement has led to considerable litigation and uncertainty.[12] Also, data indicate that this provision along with accompanying case law has been a factor in the recent slow-down in both the establishment of new plans and the expansion of existing ones.[13]

An employer who establishes a balance sheet reserve plan is generally permitted to treat additions to the reserve as a tax deductible business expense.[14] The employee, however, is not taxed until he actually receives payment of the benefit. This section closely examines this tax treatment and its

6. The West German Pension Guarantee Association [hereinafter PSVaG] is somewhat analogous to the Pension Benefit Guarantee Corporation established in the United States by ERISA § 4002. Unlike the PSVaG however, the Pension Benefit Guarantee Corporation insures only funded retirement plans.

7. Benefits are insured if they would have vested under the minimum vesting requirement of BetrAVG § 1 and the minimum accrual rule of BetrAVG § 2. BetrAVG § 7(2). Benefits which become vested due to a more generous vesting rule provided by the employer are not insured. *See* Judgment of August 3, 1978, Bundesarbeitsgericht [BAG], W. Ger., 2 Entscheidugen des Bundesarbeitsgericht [BAGE] 45.

8. The maximum insured benefit is equal to three times the West German social security wage base. BetrAVG § 7(3). In 1985, the social security wage base was 64,800 DM making the maximum annual insured benefit during that year 194,400 DM. This is slightly more than $108,603 at current exchange rates, which is far higher than the insured maximum of $20,250 under U.S. law in 1985. ERISA § 4022(b)(3); 2 Pens. Plan Guide (CCH) ¶ 10,141A (1986).

9. The requirement does not apply to deferred compensation payable as a lump sum. BetrAVG § 16.

10. *Id.*

11. *Id.*

12. For example, much dispute has arisen over how to compute the appropriate adjustment. Although the courts have adopted a rule that pension increases should generally be based on the price index for a median income four-person family, they have permitted the increase to be based on the actual increase in net income of active employees, but only if this latter increase is smaller. Judgment of August 11, 1981, BAG, W. Ger., 36 BAGE 39.

13. *Bericht der Bundesregierung über die Situation und Entwicklung der betrieblichen Altersversorgung*, BUNDESTAG DRUCKSACHE 10/2681, 10 (January 2, 1985).

14. To qualify for the tax deduction the plan is required to satisfy only three basic tests set out in the income tax statute: the beneficiary must have a legal right to a lump sum or periodic pension payment; the employer may not reserve the right to reduce or eliminate accrued or current benefits, except where the reservation can be exercised only in good faith under general legal principles; and the pension promise must be in writing. *See* Einkommensteuergesetz [EStG] (individual income tax) § 6a(1), 1985 BGBl I 977. The income tax regulations provide acceptable sample clauses reserving the employer's right to reduce or eliminate benefits. *See* Einkommensteuerrechtlinien [EStR] (individual income tax guidelines) § 4 1(3), I Bundessteuerblatt

effect on the economics of the choice between current and deferred compensation.

A. The Employer's Tax Treatment

Before discussing the details of how the balance sheet reserve is computed, some general observations about accounting for deferred compensation are in order. A pension benefit is part of an employee's compensation. It differs from salary and wages in that it is normally paid to the employee in a future year, after the employee retires or leaves employment. From the employer's perspective, it is a cost of acquiring the services of an employee which is paid after the services are performed. An employer attempting to track the profitability of his enterprise would overstate his current profits if he failed to account for this future cost in computing current income. This could cause flawed decision making and mislead creditors and investors.

Accountants generally agree that the accurate measurement of the employer's income requires the use of accrual accounting concepts.[15] However, the appropriate accrual method for pension plan accounting has been a source of disagreement among accountants in the United States.[16] By their very nature, pension plans present two difficult problems for accrual accounting. First, assumptions must be made concerning future events affecting the amount and timing of benefits, e.g., compensation increases, cost of living adjustments, employee turnover, early retirement, marital status and mortality. Second, an approach to allocating the cost of the benefits to a given year of employee service must be selected. This cost allocation generally requires that assumptions be made which account for the time value of money so that future payments can be discounted to present value.

West German tax law deals with the first problem by providing that uncertain prospective increases or decreases in pension benefits are to be disregarded when valuing the pension obligation.[17] Thus, projected compensation increases, promotions, early retirement, and cost of living increases in the pension benefit are all ignored. Employee turnover is taken into account only in a very limited sense: the statute permits reserves to be created only for employees who have reached age thirty.[18] Only certain actuarial assumptions are permitted, i.e., mortality, average incidence of married employees, and

[BStBl], Sondernummer 4 (1984). In particular, these sample clauses allow an employer to withdraw pension benefits from a grossly unfaithful employee or from an employee who has committed an act justifying immediate dismissal.

15. *See, e.g.*, P. WALGENBACH, N. DITTRICH & E. HANSON, PRINCIPLES OF ACCOUNTING 17 (2d ed. 1980).

16. EMPLOYERS' ACCOUNTING FOR PENSIONS, STATEMENT OF FINANCIAL ACCOUNTING STANDARDS NO. 87, Financial Accounting Series No. 12, 1 (1985) [hereinafter FASB NO. 87].

17. EStG § 6a(3)1.

18. *Id.* § 6a(2)1. This rule is essentially equivalent to an assumption of 100 percent turnover for employees under thirty and zero percent turnover for employees over thirty.

average age of the beneficiary group. The failure to make reasonable assumptions regarding future benefits would not be a permissible U.S. financial accounting method.[19]

As to the second problem, West German tax law allocates the cost of the pension obligation to a given year by creating a reserve on the balance sheet, additions to which are in effect deducted from income. As shown below, the reserve amount is equivalent to what the employer would have had in an interest bearing bank account at the end of the taxable year, assuming the employer had made level deposits at the beginning of each year designed to fund the retirement benefit. The statute arrives at this figure by a rather circuitous route. The allowable reserve is defined as the difference between the actuarial present value of the future pension benefits and the actuarial present value of a stream of fictional annual premiums.[20] This premium is defined as the level annual amount which would be actuarially necessary to fund the pension obligation.[21] The discount rate used in making these computations is set at six percent by statute.[22]

The basic structure of the West German accounting method can be illustrated by the following example. Assume that an employee is hired at the beginning of year one and will be entitled to a lump-sum pension of $5,000 at the end of the fifth year. For simplicity, we shall ignore mortality. The discounted present value of this pension, using the six percent discount rate required by statute, is $3,736 at the beginning of year one. The fictional yearly "premium" is $837. Table I illustrates how the reserve grows over time. At the end of year five, the reserve equals the amount of the pension.

Table I

End of Year	Present Value of Pension	Present Value of Future "Premiums"	Reserve	Current Year Addition to Reserve
1	3960	3073	887	887
2	4198	2371	1827	940
3	4450	1626	2824	997
4	4717	837	3880	1056
5	5000	—	5000	1120

Assume that the employer decided to fund this pension by putting aside funds in an investment at the beginning of each year so that after the five years the employer would have exactly $5,000. If the investment yields six percent, the employer must put aside $837 each year. The growth in the investment is shown in Table II.

19. *See* FASB No. 87, *supra* note 16, at 13, ¶ 46.

20. EStG § 6a(3).

21. The funding is assumed to begin at the start of either the taxable year in which the employment relationship began or the middle of the first taxable year after the employee has reached age thirty, whichever is later. The age thirty limitation has the effect that benefits accrued due to service prior to age thirty are amortized from age thirty to the normal retirement date.

22. EStG § 6a(3) (last sentence).

Table II

Year	Addition to Investment	Return on Investment	Balance of Investment
1	837	50	887
2	837	103	1827
3	837	160	2824
4	837	219	3880
5	837	283	5000

A comparison of the two tables reveals that the deduction for additions to the pension reserve allowed by the West German law is equivalent to allowing a deduction for level contributions to an investment to fund the pension and an additional deduction for the income generated by the investment, assuming a six percent rate of return. Thus, the basic assumption of the West German pension accounting method is level funding of the pension obligation.

The level funding approach is not the only possible method, nor is it clearly the proper method. The generally accepted U.S. financial accounting method, for example, assumes that the employer annually funds the cost of the benefit accrued by the employee each year.[23] If, in the above example, we view the pension benefit as accruing equally over each year of service,[24] then each year the employer obligates himself to pay an additional $1,000 (one-fifth of $5,000) at the end of year five. The cost to the employer of this obligation in year one is less than the cost in year five. It takes only $747 invested at the beginning of year one to provide $1,000 at the end of year five, assuming a six percent rate of return. However, $943 must be invested at the beginning of year five to produce the required $1,000.

In addition to this yearly "service" cost of funding the pension reserve,[25] U.S. financial accounting permits the employer to reduce his income by its interest cost, a result identical to that achieved under the West German approach. The interest cost is the presumed interest earned by the reserve accumulated to fund the pension. Table III illustrates the computation of the annual pension cost of the above example under U.S. financial accounting rules, again assuming a six percent discount rate.

23. *See generally*, FASB No. 87, *supra* note 16.

24. The U.S. financial accounting rules state that the portion of the pension benefit attributable to a given year is ordinarily "based on the plan's benefit formula to the extent that the formula states or implies an attribution." *Id.* at 11. Level accrual is thus the most plausible assumption since under West German labor law a vested benefit accrues equally over each year of service. BetrAVG § 2(1).

25. FASB No. 87, *supra* note 16, at 6.

Table III

End of Year	Service Cost	Interest Cost	Accumulated Benefit Obligation	Pension Cost
1	792	—	792	792
2	840	47	1679	887
3	890	101	2670	991
4	943	160	3773	1103
5	1000	227	5000	1227

A comparison of the final columns in Tables I and III reveals that the West German method permits a slightly more accelerated deduction of pension costs than the U.S. financial accounting method. If the comparison were between realistic pension plans, this difference between the two systems would likely be overshadowed by other more significant differences. In particular, U.S. financial accounting allows projected compensation and cost of living increases to be taken into account in valuing the pension benefit.[26] Also, for U.S. financial accounting purposes, the discount rate is not fixed by statute, but may fluctuate based on the judgment of the plan actuary.[27]

Thus, despite significant differences in detail, the basic approach of West German tax (and financial) accounting for unfunded deferred compensation, namely a current deduction for additions to a discounted reserve for accrued benefits, is consistent with U.S. *financial* accounting. However, as discussed more fully below, U.S. *tax* accounting does not permit any accrual of the cost of unfunded pension benefits. The reason the U.S. tax rules depart from proper financial accounting is that the accrual of an employer's expense coupled with the deferral of the employee's recognition of income leads to an unwarranted tax subsidy for such unfunded plans.

B. The Employee's Tax Treatment

The employee is not taxed under West German law until benefits are actually paid.[28] This follows from the general rule that income is not taxable

26. *Id.* at 13. The treatment of increases in future pension benefits also differs. The West German system treats the cost of an increase in benefits as equally applicable to each year of service after age thirty. The full cost allocable to prior years of service is added to the reserve (i.e., deducted) in the year the benefits begin to accrue. The currently accepted U.S. financial accounting rules do not permit this cost to be taken into account in one year. Instead, it is treated as a cost of future service and amortized over the employee's future period of service. *Id.* at 7.

27. *Id.* at 12.

28. The pension benefits actually paid (including benefits paid to survivors) are treated as income from employment and in principle are fully taxable. EStG § 19(1)2. The classification of pensions as income from employment means that the recipient is entitled to the 600 DM Christmas exclusion (Weihnachts-Freibetrag) and the 480 DM employee exclusion (Arbeitnehmer-Freibetrag). *Id.* §§ 19(3) & (4).

However, the statute also provides an exclusion (Versorgungs-Freibetrag) for forty percent of the pension benefits, up to 4,800 DM per year. *Id.* § 19(2). This exclusion was created as a step toward harmonizing the taxation of pensions, especially civil service pensions, with the taxation of social security benefits. *See* Raupach, *Möglichkeiten der Neubesinnung*, in A. RAUPACH,

until it is received[29] in the form of cash or a cash equivalent.[30] The fact that an employer may set aside funds or even purchase an insurance policy, naming itself as the beneficiary, to fund its pension obligations is irrelevant to the employee's tax liability.[31]

This treatment of unfunded plans should be compared with the West German treatment of insurance plans (Direktversicherung), where the employer purchases an insurance contract to fund the pension benefit naming the employee as the beneficiary. The payment of insurance premiums by the employer is treated as a current receipt for the employee and subject to taxation in the current year.[32] In some instances, a limited portion may be taxable at a reduced rate.[33]

The dramatic difference in the taxation of the employee between the unfunded plan and the direct insurance plan is difficult to justify. In both cases, the employee receives a contractual right to future pension benefits. One might support the difference in treatment by arguing that insurance companies, whose solvency is government regulated, make a promise in direct insurance plans and, therefore, the employee is given a somewhat more tangible and valuable right. In most cases, however, the promises of the unfunded plan are also insured by the PSVaG.[34] Thus, viewed from the employee's perspective, in both instances he has a contractual right to future payments guaranteed by an insurance company.

K. TIPKE & A. UELNER, NIEDERGANG ODER NEUORDNUNG DES DEUTSCHEN EINKOMMENSTEUERRECHTS? 102 (1985). Social security benefits are taxed as annuities, which means that only a relatively small portion of the benefit is taxed, *e.g.*, twenty-four percent for someone whose benefits commence at age sixty-five. EStG § 22(1), Table. Professor Tipke describes the current system of taxation of social security benefits as a major error and views the forty percent exclusion (Versorgungs-Freibetrag) as a minor error designed to compensate for this major error. K. TIPKE, STEUERRECHT 205 (1985).

Notwithstanding the exclusion, the current differences in the taxation of pensions and social security have been held to violate the equal protection clause (Gleichheitsgrundsatz) of the West German Constitution. Judgment of March 26, 1980, Bundesverfassungsgericht [BVerfG], W. Ger., II Bundessteuerblatt [BStBl] 545 (1980). The court requested that legislation to correct the problem be enacted within a reasonable time. A Commission was created which presented various alternative proposals in its report. BUNDESMINISTERIUM FÜR ARBEIT UND SOZIALORDNUNG, SACHVERSTÄNDIGENKOMMISSION ALTERSICHERUNGSSYSTEME (Report of November 19, 1983). No legislative action has been taken to date.

29. EStG § 11(1).

30. *Id.* § 8(1).

31. Lohnsteuer-Durchführungsverordnung [LStDV] (implementation of employment tax regulations) § 2(3)2, 1984 BGBl I 1313.

32. LStDV § 2(3)2.

33. The first 312 DM of insurance premiums is excluded from income. *See generally* P. AHREND, *supra* note 3, pt. 4, at 36. The employer can also elect to pay the income tax on the first 2,400 DM of these premiums at a special rate of ten percent. EStG § 40b(1). In the case of group insurance, the special ten percent rate can apply to the first 3,600 DM as long as the average for each employee does not exceed 2,400 DM. If the employer makes this election, neither the premiums nor the ten percent tax are included in the employee's taxable income.

34. *See supra* notes 5-8 and accompanying text. Even if the unfunded promise is not insured by the PSVaG, as is the case for promises to controlling shareholders, it is still possible to secure the promise so that the employee has the equivalent of an insured promise. The employer can take out an insurance policy (Rückdeckungsversicherung) to fund the promised benefits and

C. *The Economics of the West German Approach*

In analyzing a particular approach to the taxation of unfunded deferred compensation, an important consideration is whether it creates special incentives (or disincentives) to defer compensation. Such incentives (or disincentives) would violate the principle of neutrality, which holds that a desirable attribute of a tax system is that it not alter economic behavior.[35] This section demonstrates that the West German approach of allowing an accrued deduction to the employer and postponing taxation of the employee until receipt is inconsistent with a neutral tax system. The implications of this departure from neutrality are discussed in Part III of this article.

The basis for the analysis is a rather simple deferred compensation example: as part of the employee's compensation for year one, the employer promises to pay the employee $1,000 at the end of year five.[36] We shall assume initially that both the employer's and employee's before-tax discount rate is six percent and that both are in the fifty percent tax bracket.

The general West German approach allows a deduction by the employer equivalent to the discounted present value (using the statutorily fixed six percent rate) of the $1000 future compensation and further deductions each year for the increase in the present value of that amount. Table IV shows that the $1,000 deferred compensation is equivalent to a cash compensation of $792 paid at the end of year one. In other words, the employer is indifferent to

Table IV

Year	Cash Payments	Tax Deduction	Tax Saving	Net Cash Outflow	Discounted Net Cash Outflow[37]
1		792	396	−396	−396
2		48	24	−24	−23
3		50	25	−25	−24
4		53	27	−27	−24
5	1000	57	28	972	863
				Total	396
		Before-tax Cash Equivalent (Total/(1 - tax rate))			792

at the same time, name itself as the beneficiary. The employee has no right to the proceeds and is therefore not taxed on the premiums. The employer can then give the employee a security interest in the policy, as security for the payment of the promised pension benefits. Even in this case, the German tax law does not view the employee as receiving taxable income when the employer pays the premiums. Bundesministerium der Finanzen [BMF] (Report of April 16, 1982) 1982 DER BETRIEB 880. *See also* H. REUTER, DIE LEBENSVERSICHERUNG IM STEUERRECHT 159 (1984).

35. *See, e.g.*, G. BREAK & J. PECHMAN, FEDERAL TAX REFORM 7 (1975); Sneed, *The Criteria of Federal Income Tax Policy*, 17 STAN. L. REV. 567, 587 (1965).

36. This example ignores the typical complex actuarial computations associated with realistic pension promises which accrue over many years. The example reduces the basic economics of deferred compensation to its essentials. A full mathematical treatment would not alter the basic economic conclusions, it would simply make it more difficult to understand. *See* Sieber, Schmahl & Vinneman, *Echte Steuervorteile durch Pensionsrückstellungen?*, 1975 DER BETRIEB 6, 7.

37. This column is the cash flow discounted to the end of year one using the employer's after-tax discount rate of three percent.

paying $792 at the end of year one or $1,000 at the end of year five. This result is independent of the employer's tax rate if the statutory discount rate (currently six percent) equals the employer's before-tax discount rate.[38]

Examining the transaction from the employee's perspective, the deferred compensation of $1,000 would leave the employee with $500 after taxes at the end of year five. The employee could have acquired this $500 by investing $444 at the end of year one at a six percent before-tax (three percent after-tax) rate of return. Due to the employee's fifty percent tax bracket, to obtain this $444 the employee would have to receive $888 of cash compensation at the end of year one. Thus, the employee is indifferent to receiving $888 at the end of year one or $1,000 at the end of year five.

It costs the employer only $792 to promise the future $1,000, but because the promise is worth $888 to the employee, the employee has an incentive to defer compensation. The reason for this difference in value is that the employer, by deferring payment of the compensation, can make a tax-free investment return on the deferred compensation.[39] If the employer pays the employee $792 at the end of year one, the employee has $396 after taxes. Only when the employee obtains a six percent *tax-free* rate of return can this compensation grow to $500 at the end of year five (i.e., to the after-tax equivalent of the $1,000 deferred compensation). An employee who would be willing to invest at a six percent tax-free rate of return would obviously be willing to forego $792 of current salary in return for the $1,000 later.

This incentive in the West German system to defer compensation violates the principle of neutrality. If the tax system is otherwise neutral, the West German approach will cause the employee's investments to flow toward employers, even though such investments may not be the most productive. For example, assume an employee could make a seven percent taxable investment, but the employer's business can only generate a six percent rate of return. An employee in the fifty percent tax bracket will still find it

38. This result can be seen without resort to tables similar to Table IV. The employer receives the same $792 deduction in year one whether he pays the $792 currently or not. If he defers the compensation, he retains the $792. Nevertheless, the retention of the funds is of no benefit since this amount, invested at six percent, will exactly equal the employer's obligation. The employer also receives no further income tax benefit. The deduction the employer receives each year representing the increase in value of the deferred compensation promise exactly equals and offsets the six percent income. The employer is in effect merely a custodian for funds that ultimately will be paid to the employee.

39. This analysis assumes that the employee's marginal tax rate stays constant and can be demonstrated by mathematical formula. The employee defers an amount of his salary, S, for n years, the before-tax rate of return is i, and the marginal tax rate is t. Then the employee would receive a payment at the end of n years equal to $S \times (1 + i)^n$, of which he would retain $[S \times (1 + i)^n] \times (1 - t)$ after taxes. However, if instead the employee had received the salary, paid the tax, and invested the amount remaining tax-free, at the end of n years, he would have $[S \times (1 - t)] \times (1 + i)^n$. The two final amounts are equal.

advantageous to invest in the employer, i.e., agree to the deferred compensation.[40] The employee's investment in a less productive activity represents an economic loss to society, commonly referred to as the dead weight loss due to taxation.[41]

This lack of neutrality was demonstrated based on the assumption that the employer and employee tax rates remained constant. When the employee's tax rate is higher in the years of deferral than during the years of receipt, deferred compensation is even more tax favored.[42] Due to the steeply progressive nature of the West German tax system, this is likely if the employee defers receipt until his retirement years.[43] Furthermore, the benefit of deferral tends to be greater for high bracket employees.[44]

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40. If the employee receives the $792 currently, the employee pays $396 in taxes and retains $396 for investment. If this is invested at a 3.5 percent after-tax rate of return, it will amount to $454 after taxes at the end of the fifth year. This still compares unfavorably with the $500 the employee would have after taxes if the $1,000 were deferred to the end of the fifth year.

41. *See generally* R. MUSGRAVE & P. MUSGRAVE, PUBLIC FINANCE IN THEORY AND PRACTICE ch. 14 (4th ed. 1984).

42. For example, assume the employee's marginal rate was fifty percent when the employee deferred the compensation and forty percent when the employee received the compensation. Deferring $792 in compensation, which means making an after-tax investment of $396 in order to obtain $1,000 later, yields $600 after taxes, for an after-tax rate of return of 10.9 percent. Had the employee remained in the fifty percent bracket, the after-tax yield would only have been $500, for an after-tax rate of return of six percent.

43. The German marginal tax rate varies from twenty-two percent beginning at a taxable income of 4537 DM to as high as fifty-six percent for taxable income above 130,031 DM. EStG § 32a. Assume that an employee is earning 130,031 DM during the years of deferral and retires at age sixty-five with a pension equal to twenty-five percent of salary (32,508 DM) and has no other income except social security. Assume further that German social security provides the employee with an additional forty percent of salary, which is probably close to a realistic estimate. *See* M. HORLICK, *supra* note 2, at 4. Only twenty-four percent of the social security payments, *i.e.*, 12,579 DM, would be treated as taxable. The first Mark of the pension would therefore be subject to a twenty-two percent marginal rate. The last Mark is subject to a marginal rate of around forty-three percent. If the compensation had not been deferred but instead received during the employee's working years, it would have been subject to a fifty-six percent marginal rate. Thus, deferring income to retirement subjects that income to dramatically lower tax rates.

44. To see this, assume that the employee's marginal rate is thirty-two percent when the compensation is deferred and decreases ten percentage points to twenty-two percent when the compensation is received. Deferring $792 in compensation, which means making an after-tax investment of $538.56 (*i.e.*, sixty-eight percent of $792), earns $780 after taxes, for an after-tax rate of return of 9.7 percent. Yet as shown in note 42, *supra*, a decrease of ten percentage points from a fifty percent to a forty percent marginal rate creates an even higher after-tax rate of return of 10.9 percent.

Even ignoring changes in tax brackets over time, high bracket employees tend to be more interested in deferred compensation. For low-paid employees, the enhanced rate of return generated by a tax favored benefit may not be sufficient to overcome their preference for current consumption or alternative forms of savings. Wolk, *Discrimination Rules for Qualified Retirement Plans: Good Intentions Confront Economic Reality*, 70 VA. L. REV. 419, 430-431 (1984). Thus, these employees might not find a salary reduction of $792 advantageous in return for the promise of $1,000 in the future. For such employees, the propensity to consume is such that they are unwilling to shift from current consumption to savings at "normal" interest rates. For example, assume that an employee in the twenty-two percent bracket would forgo salary only if this forgone consumption could be invested at a before-tax interest rate of twelve percent. To such an employee, the promise of the $1,000 is worth only $699. But since $792 is the true cost to the

The original example above demonstrated that an employer who pays $792 in salary is treated the same as an employer who puts the $792 in a bank account yielding six percent and gives the $1,000 in the account to its employee at the end of year five. Therefore, the West German approach does not appear to provide a direct tax benefit to an employer who decides to provide deferred compensation. What tax benefits there are seem to belong to the employee. Nevertheless, it is possible that a portion of the tax benefit to the employee flows to the employer. Thus, in our example, the promise of $1,000 in the future costs the employer $792 but is worth more than this to the employee. The employee may be willing to accept the deferred compensation in return for a salary reduction in excess of $792. In such a case, the employer receives a portion of the tax benefit in the form of lower labor costs. Exactly how this tax benefit will be divided between the employer and employee cannot be analytically determined.[45] Presumably, some portion of the benefit would have to be retained by the employer to cover the administrative costs of providing the deferred compensation.

Even if there were no direct tax benefit to the employee,[46] it can be shown that the West German approach would still fail to be neutral whenever the employer's actual rate of return differs from the statutorily fixed six percent rate.[47] A higher employer rate of return creates an incentive to defer

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employer of the promise, the employer cannot profitably accept less. In such a case the employer and employee would not agree to the deferred compensation. This rather basic analysis suggests that where employers have the flexibility to set the level of retirement benefits, they will tend to skew the benefits to the highly compensated.

45. *Id.* at 432 n.62.

46. This could occur, for example, if the employee had access to alternative investments with a tax-free rate of return equivalent to that offered by the employer.

47. For example, let us assume that the employer's actual rate of return is nine percent and that the employee had available an investment with an after-tax rate of return of nine percent. To the employee, the $1,000 at the end of year five is equivalent to $708 in cash compensation paid at the end of year one, which is merely the $1,000 discounted at a nine percent rate. However, because the difference between the employer's actual nine percent rate of return and the six percent statutory discount rate accelerates the employer's deductions, from the employer's perspective the $1,000 is equivalent to $699 cash compensation. The employer can reduce the employee's wage in year one by $708 and in return provide deferred compensation at a cost of only $699. In effect, the employer receives a $9 subsidy for making the deferral.

This can be seen from the following table, which is equivalent to Table IV in the text, except that net cash outflow is discounted assuming an after-tax rate of return of 4.5 percent.

Year	Cash Payments	Tax Deduction	Tax Saving	Net Cash Outflow	Discounted Net Cash Outflow
1		792	307	−396	−396
2		48	24	−24	−23
3		50	25	−25	−23
4		53	27	−27	−23
5	1000	57	28	972	815
				Total	350
		Before-tax Cash Equivalent (Total/(1 - tax rate))			699

compensation and a lower employer rate of return creates a corresponding disincentive.[48]

The level of the statutory discount rate is of more than academic interest. An increase in the rate decelerates the employer's tax deductions associated with the deferred compensation, thereby increasing the employer's taxes and the overall cost of deferring compensation. A decrease in the rate has the opposite effect. Thus, by adjusting the statutory rate, it is possible to exercise limited control over the level of the tax benefit received by the employer for deferring compensation. Recognizing this, the West German parliament raised the rate from 5.5 percent to six percent in 1981. The accompanying commentary to the law indicates that the increase was implemented largely for budgetary reasons.[49]

The implications of the West German system's lack of neutrality are explored in Part III of this article. We now turn to a discussion of the dramatically different U.S. system.

II.
THE U.S. SYSTEM

The U.S. tax system distinguishes between qualified pension plans and nonqualified pension plans. Qualified pension plans must be funded[50] and are subject to complex restrictions.[51] Although they are deliberately granted substantial tax advantages[52] in order to encourage widespread pension

48. For example, assume that the employer's actual rate of return is three percent and that the employee could invest in a commercial annuity with a tax-free three percent rate of return. To the employee, the $1,000 at the end of year five is equivalent to $888 of cash compensation paid at the end of year one, which is merely the $1,000 discounted at a three percent rate. However, an analogous computation to that in note 47, *supra*, reveals that to the employer the $1,000 is equivalent to $892 in current compensation. Thus, in this case, there is a disincentive to the employer to defer compensation. The employee will not accept a wage reduction greater than $888 in return for the $1000 of deferred compensation, but the cost to the employer of providing that compensation is actually $892.

49. The relevent statute is Zweite Gesetz zur Verbessurung der Haushaltsstruktur vom 22 Dezember 1981 BGBl I 1523. The commentary is found in *Entwurf eines Zweiten Gesetzes zur Verbesserung der Haushaltstruktur*, BUNDESTAG DRUCKSACHE 9/842, 65-66 (Sept. 28, 1981). The increase in the statutory discount rate was viewed by some as a retreat from the goal of strengthening and expanding pension benefits. *See Ergänzung zum Ersten Bericht des Haushaltsausschusses*, BUNDESTAG DRUCKSACHE 9/985, 13 (Nov. 6, 1981). On the other hand, in the Federal Constitutional Court's view, the reduction was, in effect, an attempt to bring the statutory rate in line with actual rates so that the pension reserves would reflect the actual economic burden. Judgment of November 28, 1984, 1 BVerfG, W. Ger. 68 BVerfGE 287. Thus, the court viewed the increase of the statutory discount rate as a reduction of a tax benefit that could be justified by the government's need to reduce spending and increase revenue. *Id.*

50. I.R.C. § 412 (1986).

51. *Id.* § 401(a).

52. Contributions to the plan are deductible when made. *Id.* § 404(a). Income earned by the retirement fund, generally a trust, is exempt from taxation. *Id.* § 501(a). The employees pay no taxes on plan contributions until the benefits are distributed. *Id.* §§ 402(a)(1), 403(a)(1).

coverage,[53] limitations are imposed to prevent plans from favoring upper echelon employees[54] and to prevent the subsidy of unreasonably high pensions.[55] Nonqualified deferred compensation plans receive no special statutory tax benefit and are generally unfunded because funding would cause the employee to be taxed currently, even though distributions might not occur for many years.[56]

Thus, unfunded deferred compensation plans do have one tax advantage in common with qualified plans: the employee is not taxed until the pension benefits are received. This tax advantage is not a deliberate policy choice, but rather, as more fully discussed below, arises out of the basic approach the tax law takes to the accounting question of when income earned, but not yet paid, is properly taxable to a cash method taxpayer.

A. The Employer's Tax Treatment

The U.S. tax treatment of an employer providing an unfunded pension plan is simple and dramatically different from the West German treatment. Under I.R.C. section 404, a deduction for deferred compensation is allowable only in the taxable year in which the amount is includable in the gross income of the employee.[57] Thus, the employer's deduction must match the employee's income, both as to timing and amount.[58]

B. The Employee's Tax Treatment.

Generally, an employee on the cash-method of accounting will include an amount in income at the time it is "received".[59] A taxable receipt can be constructive[60] and can also be in the form of property[61] or an economic benefit.[62] Although some commentators had argued that the unfunded promise of a solvent employer to pay deferred compensation is taxable currently because

53. *See generally* Wolk, *supra* note 44. *See also* S. REP. NO. 313, 99th Cong., 2d Sess. 578 (1986) "For many years, the committee has supported measures that provide tax incentives designed to encourage employers to provide retirement benefits for rank-and-file employees." *Id.*

54. I.R.C. §§ 401(a)(4) (discrimination rules), 416 (top-heavy plan rules) (1986).

55. Qualified plans are subject to maximum limitations on contributions and benefits. *Id.* § 415.

56. Contributions to a funded nonqualified plan are included in an employee's gross income in accordance with I.R.C. § 83. *Id.* § 402(b). Under section 83, an employee is taxed when the employee's interest in the plan becomes nonforfeitable, *i.e.*, vested.

57. *Id.* § 404(a)(1), (a)(5).

58. This matching requirement was first adopted by the Revenue Act of 1942. Prior to that act, unfunded noncontingent deferred compensation liabilities were deductible by accrual-basis employers, even though it was not actually paid and included in the employee's income until a later year. *See* Globe-Gazette Printing Co. v. Commissioner, 16 B.T.A. 161 (1929), *acq.* 9-1 C.B. 20 (1930).

59. I.R.C. § 451(a) (1986); Treas. Reg. § 1.451-1(a) (as amended in 1978).

60. Treas. Reg. § 1.451-2(a) (as amended in 1979).

61. *Id.* § 1.61-2(d)(1) (as amended in 1979).

62. Under an earlier version of the Internal Revenue Code, the Supreme Court interpreted gross income to include "any economic or financial benefit conferred on the employee as compensation, whatever the form or mode by which it is effected." Commissioner v. Smith, 324 U.S. 177,

it is an economic benefit equivalent to a commercial annuity,[63] this argument was ultimately rejected by the Internal Revenue Service [hereinafter Service]. In Revenue Ruling 60-31,[64] the Service ruled that an employer's unsecured and unfunded promise to pay an amount to an employee in the future is not currently taxable to the employee. This is so even if the employer sets aside funds to provide for benefits[65] or purchases insurance[66] or annuity contracts[67] to fund the benefits. However, if the funds are secured against the employer's creditors, it is the Service's position,[68] and probably that of the courts,[69] that the deferred compensation is currently taxable.

The combined effect of I.R.C. section 404 and Revenue Ruling 60-31 is that the employer receives the deduction for the payment and the employee is taxable on the payment only in the year it is actually paid. Thus, the key difference between the U.S. and West German tax treatment of unfunded plans is that West German law permits accrual of the pension liability by the employer, albeit in the form of discounted liability, while U.S. law does not.

C. *The Economics of the U.S. Approach*

As in the analysis of the West German approach, the basic question regarding the U.S. approach is whether it violates the neutrality principle by creating incentives (or disincentives) to defer compensation. This section examines the economics of the U.S. approach and demonstrates that it is neutral only if the employer and employee are subject to the same tax rate. Because this is not the usual circumstance, in most instances the U.S. approach will not be neutral as to the decision to defer compensation.

Consider the example previously explored: the employer promises, as a part of the employee's compensation for year one, to pay the employee $1,000 at the end of year five. To demonstrate the neutrality of the U.S. tax system in the case of equal tax rates, assume that both employer and employee are subject to a twenty-eight percent tax rate and that the before-tax rate of return for both is six percent. The $1,000 payment at the end of year five costs the employer $720 after his twenty-eight percent deduction. Discounted to the end of year one at an after-tax rate of return of 4.32 percent (.06[1−.28]) the employer's cost is $608. Since the employer is in the twenty-eight percent bracket, this is the same cost as paying $844 in compensation at the end of

181 (1945). The current section 61(a) has been given an equally broad interpretation. *See* Commissioner v. Kowalski, 434 U.S. 77, 82-83 (1977).

63. *See, e.g.*, Note, *Taxation of Deferred Compensation: Some Modest Proposals*, 60 YALE L. J. 169 (1951); *see generally* Blodgett, *Deferred Compensation of Executives*, 6 INST. ON FED. TAX'N 764, 806 (1948); Allison, *Executives' Pensions Without Section 165*, 8 INST. ON FED. TAX'N 451 (1950).

64. 1960-1 C.B. 174.

65. *See* Rev. Rul. 60-31 (Example 2), 1960-1 C.B. 174.

66. *See* Rev. Rul. 68-99, 1968-1 C.B. 193.

67. *See* Rev. Rul. 72-25, 1972-1 C.B. 127.

68. Rev. Rul. 60-31 (Example 4), 1960-1 C.B. 174.

69. *See* Minor v. United States, 772 F.2d 1472, 1474, 85-2 T.C. ¶ 9717 (9th Cir. 1985).

year one. Thus, the employer is indifferent to paying the $844 at the end of year one or $1,000 at the end of year five. The employee is equally indifferent. The deferred compensation of $1,000 is worth $720 after taxes, which discounted to year one at an after-tax rate of 4.32 percent is $608. This is exactly what the employee would have after taxes if cash compensation of $844 were paid at the end of year one.

If both were taxed at an equivalent rate, but not at twenty-eight percent, the numbers would change but the neutrality would remain.[70] As long as the tax rates are identical and the tax system is otherwise neutral, the U.S. approach creates no special incentive (or disincentive) to defer compensation. The decision to defer compensation is purely a financial one. If the employer can offer a marginally higher rate of return than an equivalent investment, then deferred compensation may be a good investment.

However, this neutral treatment of deferred compensation disappears when the employer and employee are taxed at unequal rates. Although the Tax Reform Act of 1986 has brought the U.S. tax system closer to a flat-tax regime, not all taxpayers are subject to the same tax rates and even a given taxpayer's rate may change from year to year. Thus, there remain significant non-neutralities, i.e., incentives or disincentives, in the U.S. system's treatment of deferred compensation. The remaining discussion examines this lack of neutrality under various tax rate assumptions.

When the employee's marginal tax rate is lower than the employer's, there is a disincentive to defer. Under the Tax Reform Act of 1986 this disincentive will be commonplace with respect to highly-compensated employees and profitable corporations. The maximum rate for individuals is twenty-eight percent, but for corporations it is thirty-four percent.[71] Therefore, an employee with a twenty-eight percent tax rate (assuming a six percent before-tax rate of return) would trade $844 in current salary for the $1,000 in the future. But if the employer is in the thirty-four percent bracket, the $1,000 is equivalent to $856 in current salary. An employer who offered to defer compensation would have to reduce employee wages by this amount to keep labor costs unchanged, but this would represent a $12 loss in compensation to the

70. This point can be seen as follows. Assume the marginal tax rate for both is t and the before-tax rate of return is i. To the employer, the $1,000 payment at the end of year five represents an after-tax cash flow of $1,000 $\times$ $(1-t)$, which discounted to the end of year one is $(\$1,000 \times (1-t))/(1+(i \times (1-t)))^4$. Since the employer has a marginal tax rate of t, we simply divide this result by $1-t$ to find the equivalent cash compensation. The result is $\$1,000/(1+(i \times (1-t)))^4$. As for the employee, the $1,000 payment after taxes is worth $1,000 $\times$ $(1-t)$, which discounted to year one is also $(\$1,000 \times (1-t))/(1+(i \times (1-t)))^4$. Since the employee also has a marginal tax rate of t, we again divide this result by $1-t$ to find the equivalent cash compensation. The two results are equal.

71. I.R.C. §§ 1, 11(b) (1986). For taxpayers in certain intermediate income ranges, the marginal rates are currently five percent higher due to the phase out of the lower brackets for both the individual and corporate income taxes. *Id.* §§ 1(g), 11(b). For example, married individuals with taxable income between $71,900 and $149,250 are subject to a thirty-three percent marginal rate.

employee. Employers wishing to retain their employees would not find it advantageous to defer compensation. Another way of looking at this result is that under the U.S. deferral rule, the employee who defers compensation in effect invests this postponed salary in the employer and is taxed at the employer's tax rate. This is not a wise investment if the employer's tax rate is higher than the employee's.

On the other hand, there is a corresponding incentive to defer if the employer's tax rate is lower than the employee's. The employee with a twenty-eight percent tax rate is willing to trade $844 in salary for the $1,000 deferred compensation, whereas an employer in the fifteen percent bracket would find the current cost of the deferred compensation to be only $820. There would be an incentive to defer and the parties could divide the tax savings between them. Prior to the Tax Reform Act of 1986, when the maximum corporate tax rate was forty-six percent and the maximum individual rate was fifty percent, this scenario was quite common. As noted above, at least for profitable corporations, the reverse will now be true.

The greatest incentive to defer occurs when the employer's tax rate is zero. Since the employer pays no taxes, the $1,000 payment at the end of year five is equivalent to only $792 (i.e., $1,000 discounted at a six percent rate) at the end of year one. Thus, the employer could set aside $792 in a bank account earning six percent to cover the deferred compensation. However, as noted above, from the employee's perspective, this deferred salary is equivalent to $844 current salary, assuming the employee is in the twenty-eight percent bracket. Thus, by offering to defer $792 of current salary, the employer can in effect give the employee the equivalent of a $52 pay raise. The tax incentive to defer arises because the employee is not taxed on the accumulating interest of the deferred compensation. It is as if the employee received the $792 from the employer, paid the $222 in tax, and invested the remaining $570 with the employer at a tax free rate of return of six percent. The investment grows to a total of $720 at the end of year five, equaling the amount an employee in the twenty-eight percent bracket has after taxes should he defer compensation.

Analyzing the case of a zero tax bracket employer is more than just an academic exercise. Although it is true that a taxable employer will normally face a positive tax rate, at least over the long term, there is a class of employers whose tax bracket is always zero: state and local governments and non-governmental tax-exempt organizations. The U.S. deferral rule creates a tax-favored form of savings for employees of such entities. In effect, unfunded deferred compensation plans of such entities receive the same tax treatment as qualified plans.

Congress has recognized the tax-favored nature of deferred compensation in this situation and has limited the ability of non-taxable employers to provide these tax benefits. Thus, in the Revenue Act of 1978, Congress added

section 457 to the Code,[72] permitting the usual deferral rule to apply to an unfunded deferred compensation plan of a state or local government only if the plan met certain eligibility requirements. The Tax Reform Act of 1986 tightened these requirements and extended them to non-governmental tax-exempt organizations.[73] The requirements include limitations on the maximum amount deferrable,[74] prohibitions against payments prior to separation from service or "unforeseeable emergency,"[75] and distribution limitations requiring the commencement of benefit payments not be unduly postponed nor spread over an extended period of time.[76] These limitations are similar to those imposed on qualified retirement plans and are designed to assure that the tax subsidy furthers the socially desirable goal of creating retirement savings.[77] If a plan is not eligible, the present value of the compensation[78] is included in the gross income of the participant or beneficiary when there is no substantial risk of forfeiture.[79] The later payment of the deferred compensation is treated as the payment of an annuity.[80] Under U.S. law, a portion of each annuity payment is excluded from income. The underlying principle in establishing the appropriate portion is the desire to tax the interest income but not the return of capital. Thus, gross income does not include the part of

72. Pub. L. No. 95-600, § 131(c), 92 Stat. 2779 (1978). Section 457 was part of a Congressional response to an Internal Revenue Service [hereinafter Service] proposal to apply constructive receipt principles to elective employee deferrals. On February 3, 1978, the Service issued proposed regulations which provided that if payment of part of a taxpayer's fixed, basic, or regular compensation is deferred at the taxpayer's individual election (other than as part of a qualified retirement plan) to a future taxable year, the deferred amount would be treated as received in the earlier year. Prop. Treas. Reg. § 1.61-16, 43 Fed. Reg. 4638 (1978). The proposed regulation applied to all employers, including taxable entities. First, Congress nullified the proposed regulation's applicability to taxable employers by providing that for such employers the taxable year for including deferred compensation shall be determined by the principles in effect on February 1, 1978. Pub. L. No. 95-600, § 132, 92 Stat. 2782 (1978). In Congress' view, the proposed regulations were not necessary since deferral in the case of taxable employers requires the employer to defer the tax deduction, thereby producing "no substantial net change in tax receipts." STAFF OF THE JOINT COMM. ON TAXATION, 96TH CONG., 1ST SESS., GENERAL EXPLANATION OF THE REVENUE ACT OF 1978 75-76 (Comm. Print 1979).

As to employees of state and local governments, Congress was unwilling to completely deny them access to unfunded deferred compensation plans, but instead permitted limited tax-deferral subject to restrictions. As a result, the only class of employees still subject to the proposed regulation were those of non-governmental tax-exempt organizations.

73. Pub. L. No. 99-514, § 1107(a), 100 Stat. 2426 (1986) (effective for tax years beginning after 1988).

74. I.R.C. § 457(b)(2) (1986).

75. *Id.* § 457(b)(5) & (d)(1)(A).

76. *Id.* § 457(d)(2).

77. *See* H.R. REP. No. 426, 99th Cong., 1st Sess. 701 (1985) ". . . the committee believes that more restrictive distribution rules should be imposed on unfunded deferred compensation plans to ensure that tax-favored savings are used primarily for retirement purposes." *Id.* at 700-01.

78. I.R.C. § 457(e)(6) (1986).

79. *Id.* § 457(f)(1)(A).

80. *Id.* § 457(f)(1)(B).

an annuity payment that bears the same ratio to such payment as the investment in the annuity (in this case, the amount previously taxed as compensation) bears to the expected return under the contract.[81]

Even in the case of a taxable employer, there can be an incentive for deferral if marginal tax brackets fluctuate. As already noted in the discussion of the West German approach,[82] shifting income from a current high bracket year to a low bracket year increases the effective rate of return on the deferred compensation. Prior to the Tax Reform Act of 1986, individual marginal tax rates varied from eleven percent to fifty percent, so that for certain taxpayers the benefits of deferral could be substantial. However, since there are now just two brackets, fifteen percent and twenty-eight percent, with the higher bracket beginning at $29,750 for married couples and $17,850 for single individuals, [83] the current law has substantially eliminated the incentive to defer for precisely those employees for whom unfunded plans may be established under ERISA, namely "a select group of management or highly compensated employees."[84]

In summary, the U.S. system of taxing unfunded deferred compensation is neutral only in the limited case where the employer and employee marginal tax rates are equal and remain unchanged between the date of deferral and the date of receipt. Specifically, in the case of a profitable corporate employer (in the thirty-four percent tax bracket) and a highly compensated employee (in either the twenty-eight percent or thirty-three percent bracket and likely to remain there upon retirement), there is an economic disincentive to defer.

III.
COMPARATIVE ANALYSIS

The difference between the West German and U.S. approaches to the taxation of unfunded deferred compensation is dramatic: the West German system permits a current accrued deduction by the employer, while the U.S. system does not. Neither approach is consistent with a neutral tax system, although the U.S. system is only neutral when employer and employee tax rates are equal and unchanged over time. This section examines the significance of the difference in approaches and proposes changes to make both systems more consistent with the principle of neutrality.

The West German treatment is basically equivalent to the favorable tax treatment given to funded qualified plans in the U.S. Yet, the West German

81. *Id.* § 72. Thus, if I.R.C. section 457 applied to our hypothetical deferred compensation of $1,000 and the plan were not eligible, the $1,000 would be taxable to the employee in year one at its present value. If we assume a discount rate of six percent, the employee would have $792 income in year one and an additional $108 income when the $1,000 is received.

82. *See supra* notes 42-44 and accompanying text.

83. There is actually a third bracket of thirty-three percent for taxpayers in certain intermediate income ranges due to the phase out of the fifteen percent bracket. *See supra* note 71.

84. ERISA § 201(2).

tax law lacks the U.S. concept of a "qualified plan," i.e., a lengthy and complex set of requirements which qualify a plan for favorable tax treatment.[85] In effect, all West German pension plans are qualified, even those that skew benefits to highly compensated employees or exclude low paid workers entirely.

West Germany's surprising lack of concern with possible abuse of this apparent tax incentive can be explained in two ways. First, the relationship between financial and tax accounting is much closer in West Germany than in the United States.[86] Since modern financial accounting provides for the accrual of deferred compensation, the tax treatment of balance sheet reserve plans is generally viewed as a proper means of tax accounting, not a subsidy.[87]

Secondly, the West German system's departure from neutrality in connection with unfunded plans is consistent with their tax treatment of another almost identical form of investment, annuities.[88] Most typical long-term annuities[89] receive extraordinarily favorable tax treatment under West German law. The interest which accumulates on the investment in such annuities during the period before payments commence is never taxed.[90] Once payments commence, the interest accumulating thereafter, which is imputed at a statutory rate, becomes taxable.[91] Thus, an annuity which is paid in a lump sum is received tax free. If the employee's tax rate remains constant, this tax treatment of annuities is identical to the tax treatment of deferred compensation.[92]

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85. *See* I.R.C. § 401(a) (1986).

86. The basic West German principle that financial accounting determines tax accounting (Massgeblichkeit der Handelsbilanz) appears to be subject to fewer exceptions than its American counterpart. For a general discussion of the principle, see K. TIPKE, *supra* note 28, at 216-224.

87. P. AHREND, *supra* note 3, at pt. 2, 17.

88. The deferral of compensation is in effect the purchase of an annuity from the employer: instead of making annuity premium payments, the employee accepts a lower salary currently in return for a promise of future payments.

89. Qualifying annuities include all annuities payable in periodic payments where there is no option to receive a lump sum payment or, if there is such an option, where the annuity was purchased by periodic premiums and the option cannot be exercised for the first twelve years of the annuity contract. EStG §§ 10(1)2(b), 20(1)6. For a more complete discussion of the taxation of annuities see H. REUTER, DIE LEBENSVERSICHERUNG IM STEUERRECHT 75-87 (1984).

90. EStG § 20(1)6.

91. *Id.* § 22.

92. As an example, assume that at the beginning of year one the employee purchases by means of yearly premiums an annuity which will pay a lump sum of $20,000 at the end of fifteen years. If we assume that the annuity earns a six percent rate of return, then the employee would need to pay a yearly premium of $811. If the employee is in the forty percent tax bracket, this $811 is equivalent to $1,351 in before-tax compensation. When the employee collects the $20,000 at the end of fifteen years, it is tax free. Note that even though the employee only pays a total premium of $12,165, the German system does not tax any of the $20,000 as income; the U.S. system would tax $7,835 as income. I.R.C. § 72 (1986).

Assuming the employer also has a six percent rate of return, the employer would be indifferent to reducing the employee's salary by $1,351 each year in return for the promise of a pension payment of $33,333 at the end of year fifteen. But since the employee is in the forty percent bracket, this payment is equivalent to $20,000 after taxes, which is what the employee would have after taxes if he purchased the annuity.

Given this tax-favored treatment of annuities, the West German tax system's failure to impose limitations on discrimination in favor of highly compensated employees and on maximum benefits, as the U.S. tax law does for qualified pension plans,[93] is understandable. Such limitations, which under the U.S. system are designed to prevent abuse of a deliberate tax incentive, make little sense when the highly compensated employee can invest as much after-tax salary as desired in a commercial annuity which provides almost the same tax benefits as an unfunded pension plan.[94]

Yet, as noted, annuities and unfunded deferred compensation are equivalent only if the employee's tax rate remains constant.[95] Deferred compensation becomes more tax favored if the deferral occurs in high bracket years and the receipt occurs in low bracket years, a rather common result given the highly progressive West German tax system.[96]

The special tax advantage given to deferred compensation, beyond the normal favored annuity treatment, could be eliminated in two ways. First, the employee could be taxed currently on the present value of the deferred compensation and then be treated as having purchased an annuity from the employer. The actual receipt of the deferred compensation would then be taxed as an annuity under the West German system. This approach has the conceptual advantage of treating deferred compensation consistently with its equivalent transaction: the payment of salary followed by an investment of the salary, after subtracting taxes, in an annuity to be paid by the employer. The main disadvantage of this approach is that it requires the employee to pay tax currently on a benefit without any actual receipt of cash, certainly a politically unappealing result, especially given the widespread use of the balance sheet reserve plan in West Germany.

This first approach is hardly revolutionary in the context of the West German tax system. It would simply treat unfunded employer promises of deferred compensation, which are generally guaranteed by the PSVaG,[97] essentially the same for tax purposes as an employer purchase of insurance (naming the employee as beneficiary) to fund the deferred compensation. This purchase is taxable to the employee, and there seems little justification for such disparate treatment of the two types of benefits.[98] Insurance is just a

93. *Id.* §§ 401(a)(4) (nondiscrimination requirement), 415 (limitation on maximum benefits).

94. The annuity and the unfunded deferred compensation plans are economically equivalent assuming that the employer interest rate is equal to the rate of return offered by the annuity. *See supra* note 92. Given the heavy regulation of insurance companies and the different markets for the two investments, these rates of return are unlikely to be equal. If employer rates of return are higher, there will be an incentive to arrange for deferred compensation rather than to purchase annuities. Under these facts, the absence of limitations on the plans may be costly to the West German fisc.

95. *See supra* note 92.

96. *See supra* notes 42-44 and accompanying text.

97. *See supra* notes 5-8 and accompanying text.

98. *See supra* notes 32-33 and accompanying text.

means of funding the deferred compensation which shifts the mortality and investment return risks from the employer to an insurance company. In West Germany, large employers are more likely to use unfunded plans and to absorb these costs internally, while smaller employers find it worthwhile to pay an insurance company to bear the risk. Taxing employees on the present value of deferred compensation would make the taxation of unfunded plans consistent with the treatment of both annuities and insurance plans.[99]

A second approach would be to retain the basic structure of the present system, but eliminate the benefits of shifting income to low bracket years by taxing the receipt of deferred compensation at a tax rate equal to the tax rate in the year of deferral. Since deferral normally occurs over many years, some averaging scheme would be necessary. This would eliminate the main disadvantage of the first approach, i.e., taxing the accrued benefit long before its actual receipt, at some modest cost in increased complexity.[100] The U.S. Congress once seriously considered adopting this approach to taxing unfunded plans, since the main advantage of such plans in the U.S. is the ability to shift income from high bracket years to low bracket years.[101]

It should be noted that neither proposed approach to improving the neutrality of the West German system involves any change in the treatment of the employer. Yet, it is precisely the treatment of the employer that distinguishes the U.S. and West German systems. Since modern financial accounting provides for an accrued deduction to the employer comparable to the West German tax treatment and economists generally agree that an accrual method of determining income is appropriate,[102] is the U.S. approach somehow wrong?

The answer is that the U.S. approach attempts to achieve tax neutrality through the use of compensating errors.[103] The employer's deduction is

99. The West German legislature would have to decide whether the special tax treatment for life insurance premiums paid by employers should be extended to unfunded plans or repealed. *See supra* note 33. The general goal of neutrality would argue for repeal, but the goal of encouraging pension coverage might tempt one to retain some tax incentive for establishing pension plans. However, it has been argued that within the U.S. tax system, tax incentives cannot efficiently achieve the goal of widespread pension coverage. *See* Wolk, *supra* note 44. The same analysis applies to the West German tax system.

100. One could, in principle, narrow the range of affected employees by applying the computed rate only to deferred compensation above certain amounts.

101. The House version of the 1969 Tax Reform Act would have taxed the receipt of deferred compensation in excess of $10,000 as if it had been received in prior years using a complex averaging formula. *See* H.R. REP. NO. 413, 91st Cong., 1st Sess. 89-91, *reprinted in* 1969 U.S. CODE CONG. & AD. NEWS 1645, 1738. The Senate Finance Committee deleted the provision on the basis of a Treasury Department recommendation that further study was needed. S. REP. NO. 552, 91st Cong., 1st Sess. 306-07, *reprinted in* 1969 U.S. CODE CONG. & AD. NEWS 2027, 2346.

102. *See, e.g.*, Sunley, *Summary of Conference Discussion*, in COMPREHENSIVE INCOME TAXATION 262 (J. Pechman ed. 1977).

103. The general concept of compensating errors in the context of premature accruals is thoughtfully discussed in Cunningham, *A Theoretical Analysis of the Tax Treatment of Future Costs*, 40 TAX L. REV. 577, 610-615 (1985).

deferred until the employee includes the compensation in income. As demonstrated in Part II of this article, if the employer and employee tax rates are equal, the two errors cancel each other making the approach consistent with a neutral tax system. The approach is inadequate when employer and employee tax rates diverge.

Adoption of the West German system, as modified by the first approach suggested above, would make the U.S. system neutral as to the choice between employer annuities and other annuities, regardless of the respective tax rates. The employer would be allowed a current deduction while the employee would be taxed on the present value of the future compensation which is properly allocable to the tax year in which the services are performed. The payment of the deferred compensation would then be taxed as an annuity under the U.S. system.[104]

In fact, Congress has actually chosen this method of taxing the employee in the case of certain unfunded deferred compensation plans of tax-exempt entities as well as of state and local governments.[105] Recall that the U.S.

104. For example, if our hypothetical deferred compensation was $1,000, the $1,000 would be taxable to the employee in year one at its discounted present value. Assuming a discount rate of six percent, the present value of $1,000 in year one would be $792.

The West German and U.S. treatment of annuities diverge in that in the year of payment the additional $208 would be tax-free under the West German system but taxable under the U.S. system. Even though the $208 is ultimately taxed under the U.S. system, the annuity is still tax-favored since this gain, which represents accumulated interest, was not taxed as it accumulated over the years.

Although Presidents Carter and Reagan proposed legislation to tax annuity holders during the accumulation period on the interest earned in that period, *see* U.S. TREAS. DEPT., THE PRESIDENT'S 1978 TAX PROGRAM, 180-192 (1978); U.S. TREAS. DEPT., TAX REFORM FOR FAIRNESS, SIMPLICITY, AND ECONOMIC GROWTH—GENERAL EXPLANATION 266 (1984); U.S. TREAS. DEPT., THE PRESIDENT'S TAX PROPOSALS TO THE CONGRESS FOR FAIRNESS, GROWTH, AND SIMPLICITY 259-60 (1985), the basic policy of deferral has been retained, at least as to annuities held by natural persons. Under new I.R.C. section 72(u), added by the Tax Reform Act of 1986, if an annuity is held by a person who is not a natural person (such as a corporation), then apart from some limited exceptions the contract is not treated as an annuity contract for tax purposes and the "income on the contract" during any taxable year is treated as ordinary income received by the holder during the taxable year. Income on the contract is defined to mean the excess of (1) the sum of the net surrender value of the contract as of the time of the taxable year and any amounts distributed under the contract for all years, over (2) the total of net premiums paid under the contract plus amounts previously includable in gross income with respect to the contract. I.R.C. § 72(u)(2)(A) (1986).

In 1982, Congress responded to the life insurance industry's increased marketing of annuities as "tax shelters" by imposing a five percent penalty on distributions from deferred annuity contracts prior to age fifty-nine and one half. *Id.* § 72(q), added by Tax Equity and Fiscal Responsibility Act of 1982, Pub. L. No. 97-248, § 265(b)(1), 95 Stat. 278. In 1986, this was raised to ten percent by the Tax Reform Act. Tax Reform Act of 1986, Pub. L. No. 99-514, § 1123(b)(1), 100 Stat. 2558. In a sense, Congress is limiting the full tax benefit of annuities only to those used for retirement saving, which is somewhat analogous to the West German limitation of the special tax benefit to long term annuities. There are significant exceptions to the penalty, including an exception for distributions which are "a part of a series of substantially equal periodic payments (not less frequently than annually) made for the life (or life expectancy) of the taxpayer or the joint lives (or joint life expectancies) of such taxpayer and his beneficiary." I.R.C. § 72(q)(2) (1986).

105. *See supra* notes 72-80 and accompanying text.

deferral rule created substantial tax incentives for unfunded plans of zero bracket employers, but that Congress has restricted the tax incentive to those plans it has determined are deserving of a tax subsidy.

In considering possible modifications to both systems, we cannot ignore the fact that unfunded deferred compensation plays dramatically different roles in each system. In the U.S., such plans are limited in scope, covering only select groups of employees. The main instrument for private retirement savings in the U.S. is the qualified plan, which receives substantial tax advantages. In West Germany, on the other hand, the main instrument for private retirement savings is the unfunded plan.

By analogy to the U.S. qualified plan, one might well ask whether the social goal of encouraging retirement savings justifies the retention of whatever special tax advantages exist for West German unfunded plans. This is a complex topic well beyond the scope of this article, but one important point should be made. If the social goal is retirement savings, the immediate question is whose savings should be encouraged. A system of tax advantages designed to encourage retirement plans must make distinctions between plans based on which individuals are benefited and on the cost of the subsidy. Since concern for the adequacy of retirement saving normally focuses on low paid workers, tax incentives which are not targeted to encourage plans for such workers waste tax revenues. Yet, the present tax advantages of unfunded plans in West Germany depend on the value of tax deferral, a tax benefit of only slight interest to low bracket employees. It may therefore be appropriate to add restrictions to the West German system similar to the U.S. discrimination, maximum benefit, and top-heavy plan rules. However, these rules are blunt instruments at best, and it may simply be that the social goal of increased retirement saving for lower paid workers through the use of tax incentives cannot be achieved efficiently.[106]

CONCLUSION

The main difference between the U.S. and West German systems of taxing unfunded deferred compensation is that the West German employer receives a current discounted deduction for the future payment, while the U.S. employer can only deduct the compensation upon actual payment. Neither system taxes the employee until payments are actually received. The West German approach to the tax treatment of the employer is consistent both with generally accepted U.S. financial accounting principles and with a neutral tax system. The defect in the system lies in its failure to tax the employee currently on the deferred income.

The U.S. rule deferring the employer's deduction is a response to this defect and leads to a neutral system whenever the employer and employee tax

106. *See* Wolk, *supra* note 44 (suggesting this is the case for the U.S. system).

rates are equal. In this case, the employee's advantage is offset by an employer disadvantage which eliminates much of the incentive to defer. However, since employer and employee rates will rarely be equal, the U.S. system is not neutral and may often provide unfavorable treatment of unfunded deferred compensation.

Although a comparison of the two systems would seem to indicate that unfunded deferred compensation receives more favorable tax treatment in West Germany than in the United States, this treatment is shown to be largely consistent with the very favorable (by U.S. standards) West German treatment of the taxation of long-term annuities in general. Thus, what appears to be a special tax subsidy is actually a manifestation of a more widespread departure from a neutral tax system.

Both systems are shown to lead to inappropriate results when the employee's tax bracket changes over time. In particular, both systems create tax incentives to defer compensation if the employee expects to be in a lower tax bracket when the compensation is ultimately received. This problem, as well as the remaining problems in the U.S. system due to differences in employer and employee tax rates, could be resolved by adopting the West German treatment of the employer, but requiring the employee to be taxed on the present value of the future compensation. The payment of the deferred compensation would then be taxed as an annuity.

Since U.S. tax rates have become less progressive and employer rates will generally be higher than employee rates, there is little incentive to create unfunded plans in the United States. Due to this situation and the fact that unfunded plans play less of a role in the U.S. system than in the West German system, reform of the U.S. system is not an urgent fiscal matter. In contrast, because of West Germany's highly progressive tax rates, which reward the shifting income to low bracket retirement years, and the pervasive role of unfunded plans, reform is a far more significant issue.