RECORD OF SOCIETY OF ACTUARIES
1986 VOL. 12 NO. 1

DEFERRED COMPENSATION ARRANGEMENTS--A PRIMER

Moderator: JON D. SUTCLIFFE
Panelists: ROBERT L. PAWELKO*
ROBERT E. SHOR**
RANDALL J. TOMASSI***
Recorder: STANLEY B. ROSSMAN

Deferred compensation arrangements:

- o Why are they established?
- o Funded versus unfunded programs
- o Supplemental Executive Retirement Plans (SERPs)

MR. JON D. SUTCLIFFE: The purpose of the next 90 minutes or so will be to share with you some of our ideas on the major elements involved in designing and implementing an effective deferred compensation arrangement.

Ever since the Congress passed the 16th Amendment to the Constitution, which legalized income taxes, people have spent a lot of time figuring out the best way to reduce their tax bill. Today, the Internal Revenue code seems to get the same kind of scholarly attention devoted only to the Holy Scriptures. Everything from race horses to religion has been used as a way to reduce people's tax bills.

* Mr. Pawelko, not a member of the Society, is a Consulting Principal with A. S. Hansen, Inc., in Deerfield, Illinois.

** Mr. Shor, not a member of the Society, is President of The Benefits Group, Inc., in Los Angeles, California.

*** Mr. Tomassi, not a member of the Society, is a Consultant with A. S. Hansen, Inc., in Deerfield, Illinois.

PANEL DISCUSSION

Deferred Compensation arrangements originally were developed primarily for their tax advantages to the individual. But today there are a number of other business purposes for which deferred compensation arrangements are used.

The two major categories of deferred compensation arrangements are, of course, the qualified plans, such as pension plans and profit sharing arrangements, and non-qualified plans. Today, we will focus almost exclusively on the non-qualified arrangements.

I. Introduction and Overview

A. Increased Importance of Non-Qualified Deferred Compensation Plans

1. In General. Non-qualified deferred compensation plans have always been viewed as playing a secondary role to qualified retirement plans in compensation and retirement planning. However, for a number of reasons, non-qualified deferred compensation plans are playing a much more important role in providing retirement income as well as capital accumulation.

2. Statutory and Regulatory Coverage. Non-qualified deferred compensation plans have proven to be quite advantageous for employers. There are two primary reasons for this: (a) the absence of the antidiscrimination rules of the Internal Revenue Code ("Code"), and (b) the limited applicability of the burdensome rules of the Employee Retirement Income Security Act of 1974 ("ERISA").

3. TEFRA. With the enactment of the Tax Equity and Fiscal Responsibility Act of 1982 ("TEFRA"), non-qualified deferred compensation plans have become a much more important retirement planning device. TEFRA lowered the contribution limits applicable to qualified defined contribution plans from $45,475 to $30,000 and the benefit limits applicable to qualified defined benefit plans from $136,425 to $90,000. TEFRA also imposed other burdensome requirements on qualified plans, including the top-heavy provisions and the restrictions on certain distributions.

4. DEFRA. The Deficit Reduction Act of 1984 ("DEFRA") further restricted the amount of contributions to and benefits payable from qualified plans by freezing the cost-of-living adjustments under Code Section 415 until 1988.

5. REA. The Retirement Equity Act of 1984 ("REA") imposed additional restrictions on qualified plans, including restricting the rights of married participants to determine how and when their benefits are to be paid.

6. Proposed Legislative Changes. In addition to the restrictions imposed by TEFRA, DEFRA, and REA, it is certain that pending legislation will continue to restrict the benefits available under tax-qualified retirement plans and eliminate the favorable tax treatment currently afforded distributions from such plans.

7. Conclusion. The cumulative effects of both past and future legislation will serve to make non-qualified deferred compensation plans an attractive source of retirement income. In fact, these plans could eventually become the primary source of retirement income for top executives. However, when considering the implementation of a non-qualified deferred compensation plan, it is important to consider the advantages and disadvantages from the perspective of both the employer and the employees.

8. Other Issues. While the definition of "funded" or "unfunded" is clearly the most significant current issue from an ERISA standpoint, a number of other issues exist.

   a. Top-Hat Plan -- Select Group of Management or Highly Compensated Employees. In order to qualify as a Top-Hat Plan, a non-qualified deferred compensation plan must be maintained for a "select group of management or highly compensated employees." While some guidance exists, there is no clearly defined way of determining what is a "select group of management or highly compensated employees."

i. DOL View. The Department of Labor has issued several advisory opinion letters addressing this question. However, because these are factual in nature and a number of years old, they do not provide much guidance. These advisory opinion letters are 75-63 (July 22, 1975), 75-64 (August 1, 1975). 75-48 (December 23, 1975) and 76-100 (November 15, 1976). Furthermore, the DOL has concluded that because the question of whether employees are highly compensated or not is a question of fact, it will not rule on this issue. Revenue Procedure 76-1.

ii. Case Law. In *Belka v. Rowe Furniture Corp.*, the court concluded that the plan in question covered only a "select group of management or highly compensated employees." As with the DOL advisory opinion letters, this determination was entirely factual. The court indicated, without explanation, that several tests may be used. Among these are the high-25 rule of the Code, a facts and circumstances test, a straight dollar test, a functional and dollar test, and a percentage test. Note that the court concluded that some of the covered employees could be either management employees or highly compensated employees. Thus, some employees covered by the Top Hat Plan may be non-management employees while others may not be highly compensated employees.

iii. Conclusion. As the dollar limits applicable to qualified plans are continually lowered, it is likely that more and more employees will be covered by non-qualified deferred compensation plans. It is imperative that careful consideration be given to this issue so as to qualify the plan as a Top-Hat Plan. Based on the above information, the following guidelines should be followed:

- Plan participants should be key employees and should be designated as such by the Board of Directors or Compensation Committee.

- o A minimum salary level for participation should be established which limits actual participation to those considered "highly compensated."

b. Excess Benefit Plans -- "Solely" Requirement. In order to qualify as an Excess Benefit Plan, a non-qualified deferred compensation plan must be maintained by an employer "solely" for the purpose of providing benefits in excess of the limitations on contributions and benefits imposed by Code Section 415. In the case of *Catacosinos v. Applied Data Systems* No. CV 84-2477 (E.D.N.Y. 1984), a plan was held not to be an Excess Benefit Plan because it was providing benefits to employees who were not receiving maximum benefits under the employer's tax-qualified plans.

c. Existence of a Plan, Fund, or Program. In order to be covered by ERISA. a non-qualified deferred compensation plan must be a "plan, fund, or program." If the non-qualified deferred compensation plan is an individual arrangement between an employer and an employee it may be exempt from ERISA.

i. Case Law. In *Donovan v. Dillingham.* 688 F.2d 1367 (11th Cir. 1982), the court stated that whether an arrangement constitutes a plan, fund, or program depends upon all the facts and circumstances. The court concluded that at a minimum those terms imply the existence of intended benefits, beneficiaries, a source of financing and a procedure to apply for and collect benefits.

ii. DOL View. The Department of Labor has issued several advisory opinion letters holding that certain individual arrangements are not ERISA covered pension plans. These advisory opinion letters are 76-79 (May 25, 1976) and 76-110 (September 28, 1976). In a third advisory opinion letter, the DOL held to the contrary. This is advisory opinion letter 79-115 (October 29, 1976).

iii. Conclusion. As indicated in the *Dillingham* case, it is a matter of facts and circumstances whether a plan, fund, or program exists. However, it is likely that a group of individual arrangements providing similar benefits will be considered a plan, fund, or program.

With that as a general introduction to the subject, let me talk about what we're going to be covering today. First, Randy Tomassi, a consultant with A.S. Hansen in its Deerfield, Illinois, office, will provide a general discussion of the various kinds of deferred compensation arrangements, and when and how they are used. Then, Bob Pawelko will discuss the major legal requirements and the issues involved in setting up a deferred compensation arrangement. Finally, Rob Shor will talk about the use of life insurance and other devices in funding these plans.

MR. RANDALL J. TOMASSI: We want to talk today about the increasing importance of non-qualified deferred compensation plans. Generally, these types of plans have been considered a second source of income for executives. We are now seeing them play a bigger role.

II. Types of Non-Qualified Deferred Compensation Plans

Although the term "non-qualified deferred compensation plan" is a very general term and may refer to a variety of deferral arrangements, there are basically four different types of non-qualified deferred compensation plans:

- Supplemental Executive Retirement Plans ("SERPs").
- Top-Hat Plans.
- Excess Benefit Plans.
- Voluntary Deferred Compensation Plans.

A. Supplemental Executive Retirement Plans.

1. Definition. A Supplemental Executive Retirement Plan is a retirement plan which provides any type of non-qualified

supplemental retirement income, typically in a form similar to a tax-qualified defined benefit pension plan (i.e., an annual pension to the executive with a survivor pension to the executive's spouse). Frequently the benefits payable under a SERP are reduced by the benefits payable under the tax-qualified retirement plan of the employer and the benefits payable under the Social Security system.

2. Common Uses. A SERP is quite flexible and may be used to:

   a. Provide retirement benefits based upon all of the executive's compensation, including amounts that are not taken into account under the benefit formula of the employer's tax-qualified retirement plan (e.g., amounts deferred under a deferral arrangement, bonus payments or income recognized upon exercise of stock options).

   b. Compensate an executive who forfeits retirement benefits under a previous employer's tax-qualified plan. This problem may also arise in intra-company transfers and promotions.

   c. Provide a greater level of retirement benefits to certain key employees. This is particularly valuable as the limits on qualified benefits continue to be reduced.

   d. Protect an executive against forfeiting retirement benefits as a result of an involuntary termination of employment (e.g., a reduction in work force or hostile takeover).

   e. Provide special early retirement window benefits to an executive as opposed to an involuntary layoff. This is attractive since many tax-qualified retirement plans reduce benefits which begin before normal retirement. The SERP can make up the difference between a reduced early retirement benefit and an unreduced normal pension.

B. Top-Hat Plans

1. Definition. A Top-Hat Plan is a plan which is unfunded and maintained by an employer primarily for the purpose of providing deferred compensation for a select group of management or highly compensated employees.

2. Common Uses. A Top-Hat Plan is quite similar to a SERP. However, its purpose is to provide non-retirement type benefits such as:

   a. To protect the company against raids by competitors by conditioning benefits on the executive's ability to keep all trade secrets, know-how, and customer lists confidential; to limit competition with the company; or to render consulting services after retirement.

   b. To attract competent executives.

   c. To provide more liberal amounts or standards for payment of death or disability benefits.

   d. To serve as "golden handcuffs" by causing the executive to forfeit significant benefits if the executive voluntarily terminates employment prior to retirement.

C. Excess Benefit Plans

1. Definition. An Excess Benefit Plan is a plan that is designed solely to provide benefits in excess of the maximum amount permitted under tax-qualified retirement plans (i.e., $90,000 annual benefit under a defined benefit plan and $30,000 "annual addition" under a defined contribution plan).

2. Common Uses. Because of the narrow definition of an Excess Benefit Plan it serves a very limited but important purpose. An

Excess Benefit Plan may only provide benefits to employees who are receiving maximum benefits from the employer's tax-qualified plans.

D. Voluntary Deferred Compensation Plans

A Voluntary Deferred Compensation Plan involves the executive's election to defer a portion of his salary or a bonus. Payment of the deferred amount is typically postponed to termination of employment or retirement. Deferred amounts are typically credited with a stated rate of interest or other measure of earnings. A voluntary deferred compensation plan can reward a key executive in a tax efficient way by deferring the receipt of a taxable raise or bonus plan payment. The executive may accumulate a significantly greater amount than if the raise or bonus were received currently due to tax-free accumulation. Furthermore, the executive may be in a lower tax bracket when the amounts are actually received.

MR. SUTCLIFFE: Let me introduce Bob Pawelko,a consulting Principal with A. S. Hansen in the Deerfield, Illinois, office. He has extensive experience in all areas of employee benefits. He is responsible for some of Hansen's most important and sensitive relationships.

MR. ROBERT L. PAWELKO: My topic is the legal issues surrounding non-qualified deferred compensation plans.

III. ERISA Considerations

A. Applicability of ERISA in General

1. General Rule. ERISA defines an "employee pension benefit plan" as:

> "any plan, fund, or program. . .to the extent that by its express terms or as a result of surrounding circumstances such plan, fund, or program. . .

a. provides retirement income to employees, or

b. results in a deferral of income by employees for periods extending to the termination of covered employment or beyond,

regardless of the method of calculating the contributions made to the plan, the method of calculating the benefits under the plan or the method of distributing benefits from the plan." ERISA Section 3(2)(A).

It is clear from this definition that virtually all non-qualified deferred compensation plans are subject to the requirements of ERISA. However, the extent to which the requirements of ERISA apply depends upon the classification of the particular non-qualified deferred compensation plan.

2. Classification of Plans. For purposes of ERISA, all non-qualified deferred compensation plans fall within one of two classifications:

   a. Excess Benefit Plans. An "Excess Benefit Plan" is a plan maintained solely for the purpose of providing benefits in excess of the limits set forth in Code Section 415. ERISA Section 3(36).

   b. Top-Hat Plans. A "Top-Hat Plan" is an unfunded plan maintained by an employer primarily for the purpose of providing deferred compensation for a select group of management or highly compensated employees. ERISA Sections 201(2), 301(a)(3) and 401(a)(1). Included within this definition are Supplemental Executive Retirement Plans (SERPs) and voluntary non-qualified deferred compensation plans.

3. Funded vs. Unfunded Plans. It is extremely important to identify the type of plan in order to determine precisely the applicable ERISA requirements. In this regard, it is important to determine whether

the non-qualified deferred compensation plan is funded or unfunded. Note here that the concept of "funding" for ERISA purposes may be different than for tax purposes. Thus, it is unwise to presume a plan that is considered unfunded for tax purposes is also unfunded for ERISA purposes.

a. Legislative History. ERISA itself does not define either "funded" or "unfunded." However, the ERISA Conference Report states that "...the labor fiduciary rules do not apply to an unfunded plan primarily devoted to providing deferred compensation for a select group of management or highly compensated employees. For example, if a 'phantom stock' or 'shadow stock' plan were to be established solely for officers of the corporation, it would not be covered by the labor fiduciary rules." H. Rep. 93-1280 at p.296.

b. Case Law. Two important cases have addressed the issue of funding for ERISA purposes.

   i. *Dependahl v. Falstaff Brewing Corp.* 491 F. Supp. 1188 (E.D. Mo. 1980). In this case, the employer's plan provided death benefits to the beneficiaries of certain executives. The plan specifically identified life insurance policies, owned and paid for by the employer, under which benefits were to be provided. The executives were aware of the policies and looked to the policies for the payment of their benefits. The court concluded that the plan was funded, because there was property set apart from the employer's general assets to which the executives could look for payment of benefits.

   ii. *Belka v. Rowe Furniture Corp.* 571 F. Supp. 1249 (D. Md. 1983). In this case, a non-qualified deferred compensation plan utilizing life insurance policies was not considered "funded" for ERISA purposes. The court concluded this way because even though the policies were maintained on the lives of the executives, the policies were held by the employer in its own name, and the employer was the named beneficiary. In addition, the employer would pay benefits upon termination of employment or death. Thus, because the policies would be of no help to the employer in making payments upon termination of employment, the court concluded the plan was unfunded. The executives looked solely to the employer for payment of benefits upon termination of employment.

c. DOL View. The Department of Labor has yet to directly address the issue of what constitutes a "funded" plan for ERISA purposes. However, the DOL has provided some guidance in making this determination.

i. Proposed Plan Asset Regulations. In August of 1979, the DOL issued proposed regulations addressing the issue of "funded" plans. The regulations provided that if the property used to fund benefits under a non-qualified deferred compensation plan was that of the employer sponsoring the plan and (1) the employer represented to the plan participants or beneficiaries that the property would be used only to provide plan benefits or (2) if the property constituted an identified portion less than the whole of the assets of the employer and under the terms of the plan the property constituted the sole source of contributions to the plan by the employer, then the property would be deemed a plan asset, and the plan would be considered funded. Note, however, that these proposed regulations were withdrawn in January of 1985.

ii. Advisory Opinion 81-11A. In response to the *Dependahl* case, the DOL issued Advisory Opinion 81-11A, which sets forth certain criteria with respect to non-qualified deferred compensation plans funded through the purchase of life insurance. If these criteria are met, the plan is considered unfunded:

- o The insurance proceeds are payable only to the employer, as named beneficiary.

- o The employer has all rights of ownership under the policies, which would be subject to the claims of the employer's creditors.

- o Neither the plan nor any participant or beneficiary has any preferred claim against the policies or any beneficial ownership interest in the policies.

- o There is no representation to any participant or beneficiary that the policies will be used only to provide plan benefits, or that they in any way represent security for the payment of benefits.

- o Plan benefits are not limited to, or governed in any way by, the amount of insurance proceeds received by the employer.

- o The plan neither requires nor allows employee contributions.

d. Conclusion. While no clear guidelines exist in determining whether or not a plan is "funded" for ERISA purposes, the standard that appears to have developed is whether specific assets have been segregated or otherwise identified to participants as being the source of benefit payments. Thus, at least with respect to the purchase of life insurance policies, benefits should not be paid directly by the insurance company, and the participants should not be given any indication that the insurance policies are the source of funds to pay benefits.

B. ERISA Rules

1. Title I Requirements. Title I of ERISA imposes various requirements on "employee pension benefit plans":

   a. Reporting and Disclosure. The provisions of Part 1 impose various reporting (e.g., Form 5500) and disclosure (e.g., summary plan description) requirements upon employers.

   b. Minimum Participation and Vesting. The provisions of Part 2 impose various participation (e.g., the age 21 and one year of service rule) and vesting (e.g., nonforfeitability of benefits) requirements upon the plan.

   c. Minimum Funding Standards. The provisions of Part 3 impose certain minimum funding standards upon employers (e.g., the employer must currently fund the plan's normal cost and amortize its past service liability).

   d. Fiduciary Responsibility. The provisions of Part 4 impose certain standards of conduct upon individuals having a fiduciary relationship with the plan (e.g., the exclusive benefit rule and prohibited transaction provisions).

   e. Administration and Enforcement. The provisions of Part 5 give the participants certain rights (e.g., the right to an administrative review of the denial of benefit claims and the right to bring a lawsuit to enforce their rights under the plan).

C. Applicability of ERISA to Specific Types of Plans. The applicability of Title I of ERISA to non-qualified deferred compensation plans depends upon the type of plan and whether or not the plan is funded.

1. Excess Benefit Plans.

a. Unfunded. An unfunded Excess Benefit Plan is completely exempt from ERISA. ERISA Section 4(b)(5).

b. Funded. A funded Excess Benefit Plan is exempt from several provisions of Title I:

i. Minimum Participation and Vesting. ERISA Section 201(7).

ii. Minimum Funding Standards. ERISA Section 301(a)(9).

2. Top-Hat Plans.

a. Unfunded. An unfunded Top-Hat Plan is exempt from several provisions of Title I:

i. Minimum Participating and Vesting. ERISA Section 201(2).

ii. Minimum Funding Standards. ERISA Section 301(a)(3).

iii. Fiduciary Responsibility. ERISA Section 401(a)(1).

iv. Reporting and Disclosure. Labor Regulations Section 2520.104.23(a) exempts unfunded Top-Hat Plans from all but a minimal reporting obligation. The plan must file a simple statement with the DOL within 120 days after the plan is established.

b. Funded. A funded Top-Hat Plan is subject to all provisions of Title I.

IV. Income Tax Considerations

A. Income to Employees

1. General Rule. The primary objective sought in establishing a non-qualified deferred compensation plan is the deferral of income taxes

until the deferred compensation is actually received. However, the deferral of income taxes in the context of a non-qualified deferred compensation plan is not automatic. Generally, as long as the plan is "unfunded" for tax purposes, the deferred compensation will not be taxable until actually received. In this regard, Revenue Ruling 60-31 provides that an employer's unfunded and unsecured promise to pay compensation in the future does not create taxable income to an employee until the employee actually receives the compensation.

2. Possible theories of taxation. While the general rule noted above will apply to most non-qualified deferred compensation plans and result in a deferral of taxation, the IRS may seek to currently tax employees on deferred compensation under one or more of the following doctrines and statutes:

   a. Constructive Receipt Doctrine. The constructive receipt doctrine is designed to prevent an employee from turning his back on income he is entitled to receive. The constructive receipt doctrine provides that "income although not actually reduced to a taxpayer's possession is constructively received by him in the taxable year during which it is credited to his account, set apart for him, or otherwise made available so that he may draw upon it at any time, or so that he 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." Treasury Regulations Section 1.451-2(a).

   b. Economic Benefit Doctrine. Although frequently confused with the constructive receipt doctrine, the economic benefit doctrine is distinctly different. Whereas the constructive receipt doctrine deals with when cash or property should be included in an employee's income, the economic benefit doctrine deals with what property or rights actually received by a taxpayer should be subject to immediate taxation. The economic benefit doctrine provides that the creation by an obligor of a fund in which the taxpayer has vested rights will result in immediate inclusion by the taxpayer of the amount funded. A "fund" is created when an account is irrevocably placed with a third party, and a taxpayer's interest in such fund is "vested" if it is nonforfeitable. General Counsel Memorandum 39230 (January 20, 1984).

c. Cash Equivalency Doctrine. The cash equivalency doctrine is essentially a narrower statement of the economic benefit doctrine and provides that an employee is taxable not only on the receipt of cash, but also on the receipt of rights that constitute cash equivalents. The cash equivalency doctrine provides that "if a promise to pay of a solvent obligor is unconditional and assignable, not subject to set-offs and is of the kind that is frequently transferred to lenders or investors at a discount not substantially greater than the generally prevailing premium for use of money, such promise is the equivalent of cash and taxable in like manner had it been received by the taxpayer rather than the obligation." *Cowden v. Commissioner*, 289 F. 2d 50 (5th Cir. 1961).

d. Code Section 83. In general, an employee recognizes compensation income in the year in which property is transferred to him or for his benefit in connection with the performance of services, unless the employee's rights to the property are subject to a "substantial risk of forfeiture" and such risk of forfeiture applies to the property in the hands of any transferee. Code Section 83(a).

e. Code Section 402(b). If an employer makes a contribution to a trust which is not part of a qualified plan under Code Section 401(a), the employee is taxed on the value of his interest in the trust in accordance with Code Section 83 except that the value of the employee's interest in the trust shall be substituted for the fair market value of the property for purposes of applying Code Section 83. Code Section 402(b).

3. Application to Non-Qualified Deferred Compensation Plans.

   a. Constructive Receipt Doctrine. The constructive receipt doctrine can be avoided by having the employee enter into an irrevocable agreement to defer compensation to a date certain, or until the occurrence of an event that is not within the employee's control (in other words, imposing substantial limitations or restrictions on the employee's right to receive the deferred compensation).

   b. Economic Benefit Doctrine. The economic benefit doctrine does not apply to an employer's unfunded or unsecured promise to pay. If funds are set aside, the economic benefit doctrine will not apply provided the funds remain part of the employer's general assets and subject to the claims of the employer's creditors.

   c. Cash Equivalency Doctrine. The cash equivalency doctrine can be avoided by not evidencing the promise to pay deferred compensation with a promissory note or other evidence of indebtedness; by prohibiting the employee from assigning, alienating, pledging, or otherwise transferring his interest under the agreement; and by applying spendthrift trust provisions to the employee's rights which preclude attachment by the employee's creditors.

   d. Code Section 83. Code Section 83 will only apply if funds (i.e., "property") are set aside. However, even if funds are set aside to pay the deferred compensation, Code Section 83 will not apply if the funds remain part of the employer's general assets and are subject to the employer's creditors.

   e. Code Section 402(b). Generally speaking, if there is no transfer of property to which Code Section 83 applies, Code Section 402(b) will not apply.

4. Application of Tax Rules to Specific Funding Devices. Recently, attention has been focused on a number of so-called "security" or

"quasi-funding" devices. These devices are designed to provide the employees with a degree of assurance that funds will be available to pay deferred compensation when that compensation is due. The closer these devices come to insulating an employee from the credit or business risks of the employer, the more likely a taxable event will occur.

a. Rabbi Trusts. The most well-known of these devices is the rabbi trust. The rabbi trust is simply an irrevocable trust arrangement into which funds are placed to provide benefits to employees. Under a rabbi trust, the assets contributed always remain subject to the creditors of the employer. A rabbi trust provides a degree of security in that the assets placed in trust are beyond the reach of the employer and may be reached only by the employer's creditors in the event of insolvency or bankruptcy. The IRS has ruled (and apparently will continue to rule) that as long as the assets of the trust remain subject to the claims of the employer's creditors, there are no immediate tax consequences to the employees resulting from the funding of the trust.

b. Escrow Arrangements. An escrow arrangement is simply an arrangement with a bank establishing an escrow account to which funds are contributed by the employer. An escrow arrangement operates much like a rabbi trust in providing security to the employees. The IRS has ruled that as long as the assets contributed to the escrow arrangement remain part of the employer's general assets and subject to the claims of the employer's creditors, there are no immediate tax consequences to the employee resulting from the funding of the escrow account.

c. Third Party Guarantees. Under a third party guarantee arrangement, the employer promises to pay deferred compensation from its general assets and obtains a guarantee from a third party to pay the employees in the event the employer defaults on its payment obligation to the employees. The guarantee might be from a related corporation, a shareholder, or a letter of credit from a bank. The IRS has ruled (and apparently will continue to rule) that as long as no assets are set aside to fund the guarantee, there are no immediate tax consequences to the employees.

d. Surety Bonds. Under a surety bond arrangement, an executive purchases a financial surety bond from an independent insurance company to protect his interest in the non-qualified deferred compensation plan. The surety bond insures payment under the plan if, for any reason, the employer is unable to make payment. Although the IRS originally approved the use of a surety bond, it will no longer approve of this device due to the degree of employer involvement. Apparently, the insurance companies require the employer to indemnify them in the event of default. The IRS believes that this involvement confers a taxable economic benefit on the employee.

e. Vesting Trusts. A vesting trust is a revocable trust established for the benefit of the employees participating in the non-qualified deferred compensation plan. Under a vesting trust, the employee's interest will become vested upon the occurrence of a specified event. Typical events precipitating full vesting include termination of employment, attainment of a specified age, or a change in the control of the employer. If the vesting trust is revocable and the assets remain subject to the employer's creditors, the employees are not taxed until benefits are received from the trust. On the other hand, if the assets of the trust are to be used only to provide benefits under the non-qualified deferred compensation plan, the employees will be taxed when their interests in the trust become vested.

f. Life Insurance. Corporate-owned life insurance is a popular method of funding non-qualified deferred compensation plans. The employer purchases life insurance policies on the lives of the employees. The employer is owner and beneficiary of the policies. The cash values in the contracts remain part of the employer's general assets. The cash values are frequently used as the source of payments prior to retirement, and the face amount of the insurance is the source of funds to make payments in the event of an employee's death. As long as the contracts remain part of the general assets of the employer and subject to the employer's creditors, this method of funding will not result in current taxation to the employees.

B. Deduction to Employer

1. General Rule. A deduction with respect to an employer's contribution to a non-qualified deferred compensation plan will be allowed in the taxable year in which the amount is includible in the employee's income. Code Section 404(a)(5).

a. The deduction is allowed when the compensation is includible rather then when actually included. Treasury Regulations Section 1.404(a)-12(b)(1).

b. The amount deductible may differ depending upon whether or not the plan is funded.

i. Funded Plan. The amount deductible is limited to the actual contribution or premium paid by the employer. Treasury Regulations Section 1.404(a)(12)(b). Thus, the amount deductible may not equal the amount includible due to investment gains and losses of the funding vehicle.

ii. Unfunded Plan. The employer may generally deduct the entire amount (including interest) paid to the employees.

2. Special Rules. There are several circumstances under which the employer's deduction may be disallowed.

a. In the case of a funded plan, the employer's deduction may be disallowed unless separate accounts are maintained for each employee under the plan. Code Section 404(a)(5).

b. In order for compensation to be deductible it must be "ordinary" and "necessary" in carrying on a trade or business and must be "a reasonable allowance for...personal services actually rendered." Code Sections 162 and 212.

c. No deduction is allowed for "excess parachute payments." Code Section 280G. An "excess parachute payment" is a payment in the nature of compensation to an officer, shareholder or highly compensated employee which is contingent upon a change in the ownership or effective control of the employer which exceeds three times the employee's average annual compensation over the five-year period preceding the year in which the change in ownership occurs.

MR. SUTCLIFFE: I might mention that in addition to FASB 87 and 88, there's a new bulletin 85-4 which covers accounting for life insurance. You may wish to review it.

Our final speaker, Robert E. Shor, is the President of The Benefits Group, a Los Angeles firm specializing in developing funding arrangements for deferred compensation plans and other benefit programs. Rob is a graduate of UCLA, a CLU, and lifetime member of the Million Dollar Round Table and Top of the Table.

MR. ROBERT E. SHOR: I'll be talking about the mechanisms which have been developed to fund various non-qualified plans. We'll talk about the pay-as-you-go method, the book reserve method, the annuity investment method, the non-qualified trust, and my favorite, corporate-owned life insurance. The last turns out to be the least expensive method. (See Chart 1 on pp. 194-95.)

V. Funding of Executive Supplemental Benefits With Corporate-Owned Life Insurance

DEFERRED COMPENSATION ARRANGEMENTS--A PRIMER

A. Introduction

Before describing how the life insurance policies work to produce a high rate of return, two important points should be made:

1. The plan of benefits for the executives (Deferred Compensation or Supplemental Executive Retirement Plan, etc.) *must* be carefully separated from the funding of the plan. Each should be analyzed separately to avoid confusion:

   o First, the company should evaluate what plan of benefits to offer, and the "cost" of such benefits,

   o Second, the company should decide whether or how to fund for the benefits granted.

2. The life insurance policies should be considered purely as an investment of the corporation. They should be evaluated as pure investments by the company and compared against other investments available to the company for its cash, both in terms of the rate of return and the inherent risk of the investment and return.

   The policies do not provide security to the executive since the corporation owns all rights including the death benefits. In case of bankruptcy or takeover, the policies are general assets of the corporation available for any purpose. The executives cannot be vested in the insurance without suffering immediate adverse tax consequences.

B. Pay-as-you-go

Benefit expense is recognized only when benefit payments are made to retired executives. There is no accounting accrual or cash outlay until benefit payments actually commence. The expense is then charged to operations in the year in which the benefit is paid.

This method creates the least amount of recordkeeping and the lowest initial expense requirement. The drawback to this approach, however, is the rapidly increasing benefit expense. In effect, the benefit expense for currently employed executives is charged against future earnings rather than current earnings. This method is not in accordance with generally accepted accounting principles.

C. Book Reserve

The plan is operated on a nonfunded basis; however, contribution amounts are calculated as if the plan were to be funded. These contributions are carried as reserves on the books of the employer, and the annual accrual is charged to current earnings. When members terminate or retire, their benefits are paid from company assets and credited against these book reserve amounts.

The book reserve approach is attractive if the employer does not want to dedicate current cash flow to fund the plan.

A drawback to this approach is that, according to generally accepted accounting principles, the annual accrual will impact current earnings. Moreover, there is no offsetting asset available to recover plan costs.

D. Unallocated Annuity Plan

This is a group annuity which may be used to pre-fund benefit liabilities. It is an investment contract in which interest is credited at new money rates which are sometimes guaranteed for periods of five or ten years. It provides for a tax deferred rate of return. Treasury II proposals and the tax bill passed by the House of Representatives may curtail the use of this vehicle.

The unallocated annuity offers considerable flexibility:

- o Deposits and withdrawals are made when deemed appropriate in accordance with the terms of the plan,

- o Monies on deposit are not allocated to any individual, a feature which is especially useful as participants may come and go over the life of the plan, and

- o Cash withdrawals and annuity income options are available for benefit payments to participants.

In addition to the flexibility, interest payments are guaranteed for a specific number of years and are tax deferred to the time of withdrawal.

The primary disadvantage of this approach is that the employer would have to advance all monies without the opportunity to recapture its benefit costs for those executives who die or retire under the plan.

E. The Non-qualified Trust

A non-qualified trust has exactly the same tax and cost consequences to the employer and the employee as does the book reserve method, assuming the after-tax earnings of the trust are equal to those on capital reinvested in the business. If, however, the trustee cannot earn as much on those funds, the actual cost of a non-qualified trust funding approach may be higher than the book reserve method.

The non-qualified trust method permits the employer to pre-fund for benefits. Also interest income earned on trust assets will reduce required employer contributions. The non-qualified trust also provides the employees with the comfort of knowing that assets have been segregated to fund their benefits which are not available to a "take over" company, although they are subject to the claims of the employer's general creditors.

The non-qualified trust, however, contains several major disadvantages:

- o Contributions are not tax deductible unless and until the employee is vested,

- o The employee, when vested, is in receipt of income on contributions and investment income that is currently taxable, even though payment of these amounts is deferred until retirement,

- o Investment income with respect to assets for nonvested participants is passed through to the employer.

This method does not provide the opportunity for recapture of benefit costs.

ASSUMPTIONS

Corporate Marginal Tax Bracket	50%
Corporate Cost of Capital:	14% Pre-Tax 7% After-Tax
Salary Scale:	8%
Benefit:	$68,967 Joint + 50% Survivor
Unallocated Deposit Account:	
o Guaranteed Rate (10 Years)	11.9%
o Assumed Nonguaranteed Rate	10%
o Average Asset Management Charge	.75%
o Initial Contract/Sales Charge	2%
Nonqualified Trust:	
Interest Rate:	11% Pre-Tax 5.5% After Tax
Book Reserve:	Provided by Actuary
Life Insurance:	
Policy Loan Interest Rate:	Moody's Seasoned Bond Yield Index: 12.75%

F. Corporate-owned Life Insurance

This is a method of funding whereby the employer purchases individual life insurance policies on each plan participant. The advantage of this method is that it takes into account the cost of plan benefits, premiums paid, and cost of money, and is designed to recover all plan costs.

The disadvantage of the corporate-owned life insurance method is that it requires a current cash outlay.

G. Operation of the Policies

With that introduction, how does funding with life insurance work? Without going through all the mechanics, the concept is:

1. The corporation is owner and beneficiary of life insurance policies insuring the lives of a group of executives who have been promised a retirement benefit or deferred compensation. The positive cash flow from the combination of tax deductions and policy loans throughout the life of the policy and death benefits at the end will be enough in the aggregate to fund the promised payments in future years.

2. The corporation must pay four out of the first seven annual premiums, as required by IRS regulations, in order to be eligible for a deduction for interest paid on policy loans. Depending on the particular policy and insurance company, the employer would normally pay premiums in years 1, 5, 6 and 7. The goal is to be as fully leveraged as possible within the confines of the IRS guidelines and the insurance contract. The premiums are *not* tax deductible to the corporation, since the corporation owns the policy and is the beneficiary.

3. After the first seven years, when four premiums have been paid, no further premiums or cash need be invested in the insurance policy. Each subsequent year, a mechanism is set up so that the maximum amount of cash value is borrowed out of the policy ("stripped out")

-- enough to pay the annual premium and net interest. In addition, cash is returned to the corporation in the form of reduced taxes. The combination of the policy loan taken out and the cash saved from the tax benefits is more than enough to pay the annual premium and interest on the policy loans, and to provide a positive cash flow.

4. Upon the death of the executive covered, the death benefit is paid to the corporation and received tax-free (since premiums were not tax deductible when paid).

5. Present value analysis of these policies takes into account the time value of money and illustrates the gains to be derived from corporate-owned life insurance.

6. The high rate of return of these arrangements is obtained from the tax leverage the corporation gets from the favorable tax treatment given to life insurance policies. In particular:

   a. the cash value build-up of the policy -- i.e., the interest credited to the cash value fund each year -- is not taxed to the corporation.

   b. the total amount of the death benefit is also not taxed upon receipt.

   c. the interest on policy loans is tax deductible (subject to potential restrictions inherent in XYZ's investment in tax exempt securities).

H. *Simplified Example*

To illustrate simply how the tax leveraging works, take as an example a policy that has been in force for about 10 years.

Current Cash Value	$50,000
Policy Loan Outstanding	$45,000
Annual Expense Charge	$ 400

In a typical policy, the insurance company credits interest on the cash value at Moody's corporate bond rate less 3/4%. At the same time, the insurance company charges interest on policy loans at the full Moody's rate. The 3/4% is referred to as the "spread," and it, together with mortality gain, is how the insurance company makes money.

If, for example, Moody's is 8%:

Interest Credited on Cash Value:	
.0800 - .0075 = .0725 x $50,000 =	$ 3,625
Interest Charged on Policy Loan:	
.0800 x $45,000 =	
	$ 3,600
Tax Savings from Interest Deduction:	
.46 x $3,600 =	$ 1,656
Net Return for Year:	
Interest Earned	$ 3,625 (tax free)
- Expenses	- 400
- Interest Paid	- 3,600
+ Tax Savings	+ 1,656
Net Gain	$ 1,281

Actual returns on a given policy will vary depending on many factors: the Moody's rate, expense provisions, mortality, etc. In particular:

- as the Moody's rate increases, so does the rate of return on the policy, assuming the spread remains the same.

- the expenses for some policies are quite high in the first year of the policy, for installation expense, commissions, etc. Some carriers have products with high early cash values and have reduced expenses to improve results for the policyowner.

If life insurance is selected as the funding vehicle, the following issues must be addressed:

1. A significant amount of cash is required to be invested in the first few years of the policy with no net cash required after the seventh year (after considering tax benefits). The significant returns will not materialize unless the policies are kept in force -- and all tax conditions remain relatively the same.

2. The policies should not be terminated or cashed out by the company for any reason in the early years, because this would substantially lower the investment returns. Note, however, that if an executive terminates and is replaced, the new participant may replace the terminated one on the policy with an adjustment to policy values because of any age differences.

3. If the company tax bracket drops to some lower rate, the rate of return on the policies drops also. Occasional years of zero taxes will impact the net rate of returns but should not significantly impair the results. If an employer is not paying any taxes, insurance is a poor investment unless other expenses can be used as offsets to the current premium costs.

4. If Congress lowers the corporate tax rate, returns available from life insurance would be affected. Marginal tax rates much below 30% in the current interest rate environment would make these policies less attractive.

5. If Congress at any point eliminates the favorable tax treatment afforded life insurance policies (either the removal of tax deductions of policy loan interest, or taxation of the interest build-up on cash values), then life insurance may no longer be a viable investment vehicle. Policies in force at the time of legislation would probably be grandfathered and would probably retain the favorable tax treatment.

6. Interest rates must remain relatively high; if long term rates fall well below 8% (say 5% - 6%), the return on the policies declines substantially. Some policies provide a floor rate of 8%.

I. Summary

Under the proper conditions -- now and into the future -- life insurance can be a very good investment. After-tax returns of 20% or more over the lifetime of a policy have been verified. The most important qualification is that the policies and conditions be permanent.

IF:

- o The policies are cashed in early,
- o The company stops paying taxes,
- o Congress eliminates the very favorable tax treatment of life insurance,
- o Congress lowers the corporate pre-tax rates substantially,
- o Interest rates drop substantially, (assuming no floor rate),

THEN, it is doubtful whether life insurance would be as good an investment. As stated above, the longer the policies are kept in force and the longer tax conditions remain unchanged, the higher the net rate of return on the policies. These policies are used to fund death and retirement benefits, which are usually of lifetime duration. Therefore, it is reasonable to expect that the policies would remain in force until the benefits terminate with the death of the insured executive.

MR. PAWELKO: I spent about 5 years as Chief Actuary of the Illinois Insurance Department. I spent a lot of time studying these kinds of contracts. I suggest that you use your logic and your actuarial background and study these contracts very carefully. Otherwise, I suggest that you sell your house, sell your stocks and go buy one of these policies, because they all generate a lot of return: 28%, 30%. The more you buy, the better the return. Look at them carefully. If you do the job right, please let me know. I get all tangled every time I try to dig these things out. It gets very confusing.

CHART 1

SUPPLEMENTAL EXECUTIVE BENEFIT PLAN

FOR: SAMPLE EXECUTIVE

YEAR	PAY- AS- YOU- GO		BOOK RESERVE (9%)		UNALLOCATED ANNUITY PLAN		NON-QUALIFIED TRUST (11%)		CORPORATE OWNED LIFE INSURANCE (INS. & BENEFITS)			
	ACTUAL COST	P.V. @ 7.00%	ACTUAL COST	P.V. @ 7.00%	ACTUAL COST	P.V. @ 7.00%	ACTUAL COST	P.V. @ 7.00%	ACTUAL COST	P.V. @ 7.00%	CASH VALUE	PV @7.00% OF C.V.
	(1)	(2)	(3)	(4)	(5)	(6)	(7)	(8)	(9)	(10)	(11)	(12)
1	0	0	(5,064)	(5,064)	(13,200)	(13,200)	(25,135)	(25,135)	(8,890)	(8,890)	5,151	5,151
2	0	0	(5,520)	(5,159)	(13,200)	(12,336)	(25,135)	(23,491)	0	0		
3	0	0	(6,017)	(5,255)	(13,200)	(11,529)	(25,135)	(21,954)	(566)	(494)		
4	0	0	(6,558)	(5,353)	(13,200)	(10,775)	(25,135)	(20,518)	(1,133)	(925)		
5	0	0	(7,148)	(5,453)	(13,200)	(10,070)	(25,135)	(19,175)	(10,590)	(8,079)		
SUBTOTAL	0	0	(30,307)	(26,284)	(66,000)	(57,911)	(125,675)	(110,273)	(21,179)	(18,388)	19,586	14,942
6	0	0	(7,792)	(5,555)	(13,200)	(9,411)	(25,135)	(17,921)	(10,590)	(7,551)		
7	0	0	(8,493)	(5,659)	(13,200)	(8,796)	(25,135)	(16,749)	(10,590)	(7,057)		
8	0	0	(9,257)	(5,765)	(13,200)	(8,220)	(25,135)	(15,653)	38,449	23,944		
9	0	0	(10,090)	(5,873)	(13,200)	(7,683)	(25,135)	(14,629)	1,395	812		
10	0	0	(10,998)	(5,982)	(13,200)	(7,180)	(25,135)	(13,672)	2,326	1,265		
SUBTOTAL	0	0	(76,937)	(55,119)	(132,000)	(99,201)	(251,350)	(188,895)	(189)	(6,974)	23,903	13,002
11	0	0	(11,988)	(6,094)	(13,200)	(6,710)	(25,135)	(12,777)	2,369	1,204		
12	0	0	(13,067)	(6,208)	(13,200)	(6,271)	(25,135)	(11,941)	3,064	1,456		
13	0	0	(14,243)	(6,324)	(13,200)	(5,861)	(25,135)	(11,160)	3,805	1,689		
14	0	0	(15,525)	(6,442)	(13,200)	(5,478)	(25,135)	(10,430)	4,613	1,914		
15	0	0	(16,923)	(6,563)	(13,200)	(5,119)	(25,135)	(9,748)	5,127	1,988		
SUBTOTAL	0	0	(148,684)	(86,751)	(198,000)	(128,640)	(377,025)	(244,952)	18,789	1,278	49,532	19,209
16	0	0	(18,446)	(6,686)	(13,200)	(4,784)	(25,135)	(9,110)	6,103	2,212		
17	0	0	(20,106)	(6,810)	(13,200)	(4,471)	(25,135)	(8,514)	7,149	2,422		
18	(34,484)	(10,917)	0	0	0	0	0	0	(26,383)	(8,352)		
19	(34,484)	(10,203)	0	0	0	0	0	0	(25,522)	(7,551)		
20	(34,484)	(9,535)	0	0	0	0	0	0	(24,189)	(6,688)		
SUBTOTAL	(103,452)	(30,654)	(187,235)	(100,247)	(224,400)	(137,896)	(427,295)	(262,577)	(44,053)	(16,680)	90,321	24,975

ASSUMED AGE OF DEATH: AGE 80

CHART 1 CONTINUED

SUPPLEMENTAL EXECUTIVE BENEFIT PLAN

FOR: SAMPLE EXECUTIVE

(continued)

	PAY- AS- YOU- GO		BOOK RESERVE (9%)		UNALLOCATED ANNUITY PLAN		NON-QUALIFIED TRUST (11%)		CORPORATE OWNED LIFE INSURANCE (INS. & BENEFITS)			
YEAR	ACTUAL COST	P.V. @ 7.00%	ACTUAL COST	P.V. @ 7.00%	ACTUAL COST	P.V. @ 7.00%	ACTUAL COST	P.V. @ 7.00%	ACTUAL COST	P.V. @ 7.00%	CASH VALUE	PV @7.00% OF C.V.
	(1)	(2)	(3)	(4)	(5)	(6)	(7)	(8)	(9)	(10)	(11)	(12)
21	(34,484)	(8,911)	0	0	0	0	0	0	(22,962)	(5,934)		
22	(34,484)	(8,328)	0	0	0	0	0	0	(21,821)	(5,270)		
23	(34,484)	(7,783)	0	0	0	0	0	0	(20,196)	(4,559)		
24	(34,484)	(7,274)	0	0	0	0	0	0	(19,022)	(4,013)		
25	(34,484)	(6,798)	0	0	0	0	0	0	(17,130)	(3,377)		
SUBTOTAL	(275,872)	(69,750)	(187,235)	(100,247)	(224,400)	(137,896)	(427,295)	(262,577)	(145,184)	(39,832)	153,604	30,283
26	(34,484)	(6,354)	0	0	0	0	0	0	(15,463)	(2,849)		
27	(34,484)	(5,938)	0	0	0	0	0	0	(13,207)	(2,274)		
28	(34,484)	(5,550)	0	0	0	0	0	0	(11,134)	(1,792)		
29	(34,484)	(5,186)	0	0	0	0	0	0	(8,294)	(1,247)		
30	(34,484)	(4,847)	0	0	0	0	0	0	(6,036)	(848)		
SUBTOTAL	(448,292)	(97,625)	(187,235)	(100,247)	(224,400)	(137,896)	(427,295)	(262,577)	(199,318)	(40,843)	252,019	35,425
31	(34,484)	(4,530)	0	0	0	0	0	0	(3,416)	(449)		
32	(34,484)	(4,234)	0	0	0	0	0	0	689,193	84,614		
33	(17,242)	(1,978)	0	0	0	0	0	0	(17,242)	(1,978)		
34	(17,242)	(1,849)	0	0	0	0	0	0	(17,242)	(1,849)		
35	(17,242)	(1,728)	0	0	0	0	0	0	(17,242)	(1,728)		
SUBTOTAL	(568,986)	(111,944)	(187,235)	(100,247)	(224,400)	(137,896)	(427,295)	(262,577)	434,733	29,767	0	0
36	(17,242)	(1,615)	0	0	0	0	0	0	(17,242)	(1,615)		
37	(17,242)	(1,509)	0	0	0	0	0	0	(17,242)	(1,509)		
38	(17,242)	(1,411)	0	0	0	0	0	0	(17,242)	(1,411)		
LIFE OF PLAN	(620,712)	(116,479)	(187,235)	(100,247)	(224,400)	(137,896)	(427,295)	(262,577)	383,007	25,232	0	0

ASSUMED AGE OF DEATH: AGE 80

Now, I don't deny that life insurance has valid applications in certain situations. These deferred compensation plans hinge upon tax laws that are always changing. The policies hang upon many projection, and that's my business. I do a lot of projections. I can make a projection make anything look good if I pick the assumptions just right. I think you all know that. Be careful with them. There are many companies that have them. I've been involved with many purchases, and I always end up backing away from them because something doesn't smell right. A life insurance company is investing in the United States equity markets. It buys stocks and bonds. Take a look at the average net rate of investment return of a life insurance company. These companies don't make something out of nothing. They can't give you more than they actually earn. Anybody who thinks they can, long term, is deluded. Please look at them.

MR. SHOR: The observations that Bob made are correct. You do need to look at the policies carefully. You need to look at the assumptions. You do need to look at the source. You need to get involved with the carrier that's finally selected and look at its assumptions.

The one place I significantly differ from Bob is this issue of rate of return. Carriers are returning 8-9% on their basic book of business; 10% if they are very good. But that's not what you're investing in. The new contracts use a concept called "direct recognition." Direct recognition means that if you pay the carrier on your policy loan 10%, it will credit a net 9.25% to 9.75%. So you are paying 10%, which is 5% after taxes in a 50% tax bracket. You are getting 9.25%. That spread boosts the yield from the carrier's portfolio book rate of return up to these outrageous numbers that you hear about and see. Now if you apply expected mortality rates partially to these yields, you will see 28% internal rates of return. But that's only one method of computing internal rate of return. There are modified methods which drop the yield to 12%. I think the latter is a more accurate method. The normal method assumption is that one the cash outflows, you are getting the same rate of return as on the cash inflows, and that you are able to re-invest at 25%. No so! You will re-invest the insurance cash inflows at your own corporate rate of return. When you apply those numbers, you'll find internal rates of return of 12% net after taxes.

MR. SAMUEL S. STANLEY: I have a question about "non-qualified plans" that are set up to cover rank-and-file employees. I've become aware of several situations where a defined benefit plan is terminated and the benefits are rolled over to a defined contribution plan. It's a concern of management that some of the older employees might have their benefits reduced as a result of these events. So it sets up a non-qualified plan to replace these lost benefits to a limited group of the affected employees. The corporation then gets a legal opinion from in-house counsel that this is a non-qualified plan not covered by ERISA. I'm not a lawyer, but ERISA does mention criminal penalties. I'd like to know what the panel has to say about this situation.

MR. SUTCLIFFE: My guess is that unless the group is a highly paid one, it should be subject to ERISA -- funding, for instance. Any comments, Bob?

MR. PAWELKO: I agree.

MR. STANLEY: I've had this come up a lot in my office. I don't know how to deal with it.

MR. PAWELKO: All you can do is tell your clients, by letter, that you have some concern. Suggest to your clients that they get outside opinion. It's their decision, not yours. All I'd do is warn them.

MR. DUANE BOND: Mr. Shor, your handout stresses the effect of the marginal tax rate on investments. Now, I agree with Mr. Pawelko, that a client in the year 2012 would have to have had $500,000,000 of taxable income in order to make a profit. Can you just tell as a general guideline what sort of profitability there is, because as Bob Pawelko said, "the more you buy, the better off you are." What's the limit?

MR. SHOR: Duane, I think your question addresses the issue of the amount of net profit an employer has against which it can write-off interest on one of these policies. The answer is you don't want to buy an insurance policy that projects out to have a pre-tax interest charge in the future that is greater than the expected profit. We test that. We have a utility, for example, that had $10,000,000 of insurance premium that it was about to approve. I had forgotten to test the profit issue, so I went up to Revenue and asked it what its current profits were. It said $2,000,000,000. I asked it what its future profit might be, and it said $10,000,000,000. Well, our interest expense in the same time frame as the $10,000,000,000 was $800,000,000. So you want to have an environment in which you are matching your interest pre-tax with the expected profit. It's a very important test.

MR. ROBERT DUGAN: The comments made so far have taken for granted that nonqualified deferred compensation plans will be covered by FASB 87. I would like to explore that a little bit further. As I read FASB 87, it covers any type of pension benefit provided by an employer. A pension benefit is anything provided through a pension plan. Conversely, FASB 87 considers a pension plan to be anything that provides pension benefits, without really giving a definition. If you look back further before FASB 87 (everyone knows about APB#8)), there was also APB#12, which gave guidance on deferred compensation arrangements. APB#12 said that if you have enough of these deferred arrangements that could constitute a plan, then they're accounted for under APB#8. Otherwise, they are *not* subject to pension expensing rules, but are expensed under any reasonable method that expenses the benefits over the working lifetime of the employee. FASB 87 supersedes APB#8, but does not affect APB#12. A nonqualified plan of this nature is not a "plan," and is not subject to all of FASB 87. This puts us back to APB#12 to determine pension expense. Any comments?

MR. SUTCLIFFE: My reaction is that a SERP would clearly be covered by FASB 87. A deferred compensation arrangement may not necessarily be covered by FASB 87. What do you think, Bob or Randy?

MR. PAWELKO; My experience with Big 8 accounting firms is that they look upon deferred compensation arrangements as plans. My definition of a pension benefit is "a stream of income after an employee leaves."