RECORD OF SOCIETY OF ACTUARIES
1991 VOL. 17 NO. 3B

ARE NONQUALIFIED PLANS THE PLANS OF THE FUTURE?

Moderator: SILVIO INGUI
Panelist: SAUL BEN-MEYER*
Recorder: SILVIO INGUI

The panel will address concerns that government regulations are discouraging the utilization of qualified plans. Topics which will be addressed include:

- The effect of funding limits
- Maximum benefit and contribution limits
- Nondiscrimination
- Plan sponsor objectives
- Taxation of benefits

MR. SILVIO INGUI: I'm an actuary and a principal in the firm of Milliman & Robertson. We will be discussing nonqualified deferred-compensation plans. What are they? Why and when should a company consider using them? Why are they gaining popularity? What are some of the tax and other legislative issues? By the end of our presentation, we hope that we will have answered the question, "Are nonqualified plans the plans of the future?"

Our panel consists of myself and Saul Ben-Meyer. Saul is a partner in the New York City law firm of Walter, Conston, Alexander & Green, P.C. He has a JD degree from New York Law, and an LLM in taxation from New York University. He practices in the area of employee benefits and executive compensation and has been doing this since 1980.

I will first cover the issues of the growing importance of nonqualified plans, and discuss the three most common types of nonqualified deferred-compensation plans. Saul will then present the taxation issues, including constructive receipt and the applicability of ERISA. I will then provide a brief review on some of the more common funding vehicles and some of the accounting rules. Finally, we hope to address any questions that the audience may have.

What are the reasons for the growing importance and utilization of nonqualified deferred-compensation plans? The reasons for the growing importance of nonqualified plans can be categorized into four areas: legislative changes, the growing shift to defined-contribution plans, attraction and retention of key employees, and tax-sheltered capital accumulation.

The Tax Reform Act of 1986 (TRA), in many ways, made qualified plans less attractive. The first is in the area of plan flexibility. The new rules under TRA that deal with vesting, coverage, participation, social security integration, the definition of compensation, and general nondiscrimination are all aimed at providing lower benefits to higher paid employees. Many companies have discovered that the changes that

* Mr. Ben-Meyer, not a member of the sponsoring organizations, is a Partner with Walter, Conston, Alexander & Green in New York, New York.

would be required to bring their plans into compliance with TRA and still maintain pre-TRA benefit levels for their executives would be too costly. Thus, an approach to deal with this problem is to change the qualified plan to comply with TRA, and maintain pre-TRA benefit levels for the lower and middle level management employees. A nonqualified plan would then be introduced to make up any losses incurred among the higher paid employees.

The second blow delivered by TRA was greater restrictions in the contribution and benefit limits under Section 415. Defined-contribution plans are frozen at the $30,000 contribution limit, until the defined-benefit limit reaches $120,000. Now, to put this in perspective you need to recall that prior to TEFRA, which took effect in 1984, the defined-contribution limit had reached approximately $45,000. TEFRA reduced it to $30,000 and TRA has kept it there and is going to keep it there until the defined-benefit limit reaches $120,000. And at that point, the defined-contribution limit will equal 25% of defined-benefit limit. In the past, it had been 1/3 of the defined-benefit limit. In addition, the definition of "annual additions," for purposes of the $30,000 limit, was changed. Prior to TRA, after-tax contributions were basically only considered if they exceeded 6%. Now they are considered in full.

Under defined-benefit plans, the $90,000 cap on annual benefits is no longer applicable at age 62-65, but at an individual's Social Security retirement age, which is between age 65 and age 67. Furthermore, the reductions for early retirement are fully reduced from the Social Security retirement age with no floor, whereas the prior law put a floor of $75,000 on the benefit.

Under 401(k) plans, deferrals were limited to $7,000, indexed for inflation. More restrictive average deferral percentage tests were introduced which basically made it more difficult for highly compensated people to defer. Furthermore, 401(m) tests on after-tax and matching contributions were also implemented. Finally, the definition of highly compensated employees was substituted for the top paid one-third group in the average deferral percentage test. This causes the highly-compensated group to be smaller. Finally, TRA put a $200,000 cap on compensation.

When all the dust settled, it was very clear the TRA had taken its toll on the qualified benefits for senior management. By way of an editorial comment, I also believe that TRA backfired in some respect. Yes, it did accomplish its goal of reducing benefit levels for senior employees. However, I believe many lower paid and middle management will be hurt because many companies have and will discontinue their defined-benefit plans.

This brings me to the second reason for the growing importance of nonqualified plans, and that is the shift to defined-contribution plans. Many companies have terminated their defined-benefit plans. In addition, companies that don't have a qualified plan but are considering one tend to lean toward defined-contribution plans. The shift to defined-contribution plan is a reason that many of you may not have considered as a reason for the growing importance of nonqualified plans. However, I believe that this will be an important reason. Defined-contribution plans tend to produce inadequate benefits for older employees, and in many instances, the senior management are amongst the older employees. Many defined-contribution plans are profit sharing plans with no fixed commitment on contributions. Many of them are 401(k) plans

with the only benefit being a matching employer contribution; thus, employees who don't contribute don't receive any benefits. Furthermore, highly-compensated employees under a 401(k) plan may be limited even below the $7,000 deferral limit if there is low participation among the nonhighly compensated employees. Finally, the deferral limits are generally inadequate for executives – $7,000 even with a 50% match, is unlikely to provide a sufficient accumulation for a senior executive to retire on.

The jury is still out on defined-contribution plans. Only time will tell if they will provide adequate retirement income. Or will companies wake up some day and find that senior management cannot afford to retire? Furthermore, the Age Discrimination and Employment Act (ADEA) currently requires that in order to force a senior management employee to retire, a company must provide at least $44,000 in annual pension. It's questionable whether an accumulation under a 401(k) plan, if that's the only retirement plan that the executive has, will be able to provide an annual pension of $44,000.

The third reason that I list for the growing importance of nonqualified plans is the attraction and retention of employees. In many instances, a company's qualified plan may not be adequate for key employees. A key employee may be older and the company's defined-benefit plan may not produce sufficient benefits or the company may only have a 401(k) plan or a minimal profit sharing plan. To attract a key employee he may want to be kept whole, especially if he's older and he is coming from a company that has a very good retirement program, or he may be forfeiting some valuable early retirement subsidies. The key employee may want a minimum benefit such as 50% of pay after 10 years.

Benefit and compensation limits may restrict the companies from meeting the needs or the desires of these key executives through their qualified plans. And even if they could, it may be too cost prohibitive because to make the changes to meet their needs would only mean enriching benefits for the rest of the employees.

What are some other ways that nonqualified plans can be used? Qualified plans sometimes just aren't flexible enough in a certain situation, especially under the new nondiscrimination rules. Through a nonqualified plan, you can tailor the needs of a specific key employee. You can include special features, such as early retirement subsidies, that are not in the qualified plan. A fully subsidized surviving spouse benefit may be provided. Another way to use a nonqualified plan is to design the qualified plan to be nonintegrated. Under the new integration rules, if your plan has any substantial early retirement subsidies, the amount of disparity that you will be allowed to provide may be very small. It may be so small that it may not be worth the effort. So some companies would prefer to just adopt a base qualified plan that is nonintegrated, and then introduce in their nonqualified plan the integration that they had lost due to TRA. Furthermore, you can be much more flexible in defining compensation. Section 414(s) is very specific that the definition of compensation in a qualified plan cannot discriminate. Many executives want to know that their bonuses and their stock options will be included in their pension benefits. In most instances, that may be difficult under the pension plan. A way of handling this is to have the same formula in the nonqualified plan and the qualified plan; the only difference being the definition of compensation in determining the benefits.

The final reason for the growing importance of nonqualified plan is tax-sheltered capital accumulation. As I discussed earlier, a senior employee's ability to defer compensation under a qualified plan has been significantly restricted by TRA. A 401(k) plan doesn't provide a vehicle to substantially defer income. Furthermore, certain key employees may wish to defer cash compensation such as bonuses. Even directors may wish to defer some of their directors' fees. Currently the only vehicle available to handle this is through a nonqualified arrangement.

Having discussed the reasons for the growing importance and use of nonqualified plans, let's now look at some of the common types. These include excess benefit plans, top hat plans or supplemental executive retirement plans (SERPs). There are other types of nonqualified deferred-compensation plans such as golden parachutes, stock appreciation rights, and fathom stock, but we are not going to discuss these other plans during this session. In fact, the excess and top hat plans are probably the ones that most of you are really interested in because these are the two types of nonqualified plans that are typically used to compliment a qualified plan in providing additional retirement income to key executives.

What is an excess benefit plan? This is defined under Section 3(36) of ERISA, as a plan maintained by an employer solely for the purpose of providing benefits for certain employees in excess of the limitations on contributions and benefits imposed by Section 415 of the Code. This plan does not have to cover a select group of employees. However, it is quite rare that excess plans cover anything but highly paid employees because it is very rare that other than highly paid employees are affected by 415 limits. Excess plans are exempt from the reporting and disclosure requirements, the coverage requirements, the vesting requirements, funding, and fiduciary responsibility requirements of ERISA. In addition, they are not subject to the nondiscrimination rules.

The second, and probably the most common, type of nonqualified deferred-compensation plan is a top hat plan or SERP. This is typically 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. It can provide benefits beyond those restricted by Section 415. For example, the $200,000 compensation limit is not a restriction under Section 415. Thus, if you want to implement just an excess plan, the $200,000 compensation limit would still apply because it's not a 415 limitation. If you want to expand the plan to include compensation in excess of the $200,000 limitation, you have to create a SERP. SERPs are growing in their use, not just because of the compensation limit, but also they are beginning to be used more frequently for 401(k) deferrals. Many executives want to defer more than the $7,000 and are using nonqualified plans to defer the monies they would have been able to defer had the limitations under Section 401(k) not been in effect.

When we discuss SERPs, we have to be very careful to ensure that the plan only covers a select group in order to avoid ERISA coverage. In addition, careful design of a SERP is important to avoid constructive receipt issues. I'm not going to get into these two topics because Saul will review the issues of ERISA coverage and constructive receipt. Finally, a SERP does require a one-time reporting requirement with the Department of Labor, which is not required for an ERISA excess plan.

Another common type of nonqualified deferred-compensation plan is not specifically designed to provide a pension supplement. It's really just a simple salary deferral plan. I mention this because one of the reasons for the growth in nonqualified plans is to provide executives the opportunity to defer some income and have some tax-deferred capital accumulation. Sometimes the best way to do this is just through a simple salary deferral plan. This allows a select group to defer receipt of all or a portion of its compensation. They tend to be very simple. A common form would provide for an executive to defer a bonus to a later date.

At this time, Saul will discuss some of the tax issues, and also review the ERISA implications if your nonqualified plans are not properly designed.

MR. SAUL BEN-MEYER: As Silvio explained, I'll be reviewing the taxation of nonqualified deferred-compensation plans as well as the applicability of ERISA. We'll be covering a great deal of material in a very short period of time. In essence, I've condensed what was previously a two-day seminar into a short review.

I'd like you to get a general overview that will alert you to the tax and ERISA issues that come up in the context of nonqualified deferred-compensation plans, in particular in the design and drafting and implementation of these plans. As Silvio discussed, nonqualified plans serve many functions and achieve goals that are unattainable under qualified plans. The primary advantage of a nonqualified plan over a qualified plan is the ability to achieve tax deferral and tax-free accumulation for a limited group of highly paid executives, without regard to coverage and discrimination requirements that are imposed on qualified plans.

You've got to be very careful in the design of a nonqualified plan to ensure that you avoid the premature taxation of the benefits under that plan. If you run into some of the problems I discuss such as economic benefit and constructive receipt, you could be in a situation where the benefits become taxable before they're paid and you're going to have a very unhappy client at that point. Not surprisingly, Congress and the Treasury have imposed some restrictions on these plans. First, in general no deduction is available to the employer until the compensation is included in the employee's income. Second, the employee must generally rely on the unsecured promise of the employer to pay the amount due.

Basically, I've broken down the discussion into four questions: What is a nonqualified deferred-compensation plan? Is the nonqualified plan funded or unfunded? (This determination is critical for purposes of determining the tax treatment of the plan and ERISA coverage.) How are nonqualified plans taxed? (We'll look at income taxes, social security taxes and briefly, the state and gift taxes.) And finally, are nonqualified plans subject to ERISA and if so, what are the consequences?

The first key question is: What is a nonqualified deferred-compensation plan? It has to be nonqualified; that is, it's not subject to the requirements of Code Section 401(a). There are approximately 28 requirements set forth in 401(a)(1-30) that are necessary for a plan to be treated as a qualified plan. Nonqualified plans are not subject to these requirements. Does it involve the deferral of compensation? Generally, any compensation or benefit that is received more than a brief period of time following the end of the employer's taxable year in which the services are

performed, is treated as deferred compensation. For example, if you had a simple bonus plan where the bonus was paid within 2.5 months after the end of the year, generally that would not be treated as deferred compensation. However, if the bonus was deferred to some point beyond the 2.5-month period, the IRS would typically impose a presumption that this is a nonqualified deferred-compensation plan. Finally, does it constitute a plan? Any plan, method or arrangement, however characterized, providing for deferred benefits for employees, their spouses or dependents, are essentially treated as plans for this purpose. I'll talk about this a little bit more under the ERISA requirements of a plan in the area of ERISA coverage, where there is an issue as to whether an individually negotiated employment contract arises to the status of a plan.

The second key question is: Is the nonqualified plan unfunded or funded? This is important because the issue of funding determines the tax treatment of both the employer and the employee, as well as the applicability of ERISA. Since the IRS sets forth rules for tax purposes while the Department of Labor is responsible for the ERISA rules, the determination of whether a plan is funded or not theoretically can be different for both purposes. You have to be careful of that although it usually is not a problem. Most nonqualified plans are unfunded for both tax law and ERISA purposes primarily to avoid the immediate taxation and ERISA coverage. You have to be careful in using the terms *funded plans* and *unfunded plans*. When I speak of funded plans, I'm talking about a plan that is truly funded with a separate trust or corpus that sets aside specifically earmarked funds and is devoted to the payment of benefits. The term is often used casually for purposes of describing situations where life insurance is purchased by the employer or other assets are purchased by the employer to assist in satisfying this obligation with no real obligation to use those particular assets for satisfying the benefits. I usually refer to that as quasi-funding.

Although the definition of funding can vary, generally for both ERISA and tax purposes, a plan will not be considered as funded for either purpose if it constitutes a mere unsecured promise to pay some amount in the future. Any assets that are earmarked or set aside for that purpose, must remain subject to the claims of the employer's general creditors. Although the employee may have fully vested rights to payment under the terms of the plan, he or she cannot have any right to the earmarked assets themselves above those of the general creditors of the company. What all this boils down to is the employee remains an unsecured creditor of the employer. This is one of the primary disadvantages of nonqualified plans compared with qualified plans.

On the other hand, a nonqualified plan will be treated as a funded plan if assets are set aside or segregated as an identifiable fund which the employee may look to enforce his claims under the plan. The assets are outside the reach of the employer's general creditors, similar to the assets held under a qualified plan, and it's usually set up in the form of a trust, an annuity contract or an escrow account which is either owned by the employee or under which the employee is the main beneficiary. Although this basically solves the security problem for the executive, funded plans, as I'll discuss later, are subject to adverse tax rules.

Before we get into the taxation of funded and unfunded plans, I'd like to just review quickly the tax treatment of qualified plans for comparison purposes. Under a

qualified plan, the employer gets an immediate tax deduction for contributions to the plan and the employee only has taxable income upon actual receipt of those benefits, at some future time, even if they're made available to him through the opportunity of distributions or withdrawals at an earlier time. There's no concept of constructive receipt in qualified plans. Under a nonqualified plan in comparison, there is no deduction for the employer until there's income to the employee upon actual receipt. But there are circumstances in which the income can be accelerated prior to actual receipt under the concepts and doctrines of economic benefit and constructive receipt, which I'll discuss later. Qualified plans also provide for the tax-deferred accumulation of assets for both the employer and employee. On the other hand, under a nonqualified plan, if it's unfunded, then any income accumulated on the assets are basically taxed to the employer, unless the assets happen to be in the nature of a vehicle that's already tax free, such as a municipal bond or insurance contract.

In a funded plan, the assets would be taxable either to the trust or to others, depending upon how the trust is designed.

There's also favorable tax treatment available to qualifying plan distributions. You're all familiar with those. There are five- and ten-year averaging, the deferral of net unrealized appreciation on employer securities, as well as the accelerated tax-free recovery of voluntary after-tax contributions for accumulations as of December 31, 1986. Generally, none of these special rules will apply to nonqualified plans and, if some of our congressmen have their way in the form of pension simplification bills that are currently pending, there's a good chance we may lose the special averaging and net unrealized appreciation as well on the qualified plans.

There are also tax penalties that are imposed on distributions in qualified plans. You're all familiar with the 10% additional tax on premature distributions, the 15% excise tax on excess distributions, and the companion 15% additional estate tax on excess accumulations of death, and finally the 50% excise tax on insufficient or late distributions. Essentially, the laws require you to create a corridor in time and amount through which distributions must fall, which is not applicable to nonqualified plans.

The third question is, how are nonqualified deferred-compensation plans taxed? We'll look at the income taxes, deduction to employer which I mentioned, income to employee, social security taxes and estate and gift taxes.

The statutory basis for the deduction to the employer is set forth in Code Section 404(a)(5) with references to 162 and 212. Essentially, the deduction is allowed in the taxable year when the amount is included in the employee's income. The timing of the deduction rule is the same for both funded and unfunded plans since it's tied to the timing of the inclusion which we'll get to later. But the timing of the inclusion will depend upon whether the plan is funded or unfunded; so it becomes important. The amount of the deduction also depends upon whether the plan is funded or unfunded. In an unfunded plan, the entire amount that is included in the employee's income is deductible to the employer. That includes any deemed earnings or growth on the deferred amounts. On the other hand, in the funded plan, the employer is only entitled to a deduction of the value of the original contributions and not for any of the earnings that are credited to that amount.

There are six situations, which I'll go through relatively quickly under which the employer's deduction can be lost, delayed or accelerated: the separate account rule, the failure to withhold income taxes, ordinary necessary business expense rule, reasonable compensation, and the contest of asset acquisitions and golden parachutes. The separate account rule applies only to funded plans with more than a single participant, and it generally requires that separate accounts be maintained for each employee in such a funded nonqualified plan. It's not required to establish a separate trust, but merely set up a separate bookkeeping account to which earnings and income are separately allocated. Although this is a relatively simple requirement for defined-contribution plans due to the separate account nature of those plans, it can become a problem for a funded defined-benefit type nonqualified plan, and this is the reason most of these types of plans are done on an unfunded basis.

The deduction can also be lost in certain circumstances when the employer fails to withhold income taxes on the amount paid. This generally applies again to funded plans and also to transfer of property in connection with the performance of services where the participant is an employee. These are the rules that are governed under Section 83 of the Code and I'll get into them a little bit more in detail when we talk about economic benefit and the taxation of funded plans. The employer must withhold income taxes from the distribution in order to receive the deduction, but there are several exceptions to this rule under proposed regulations under Section 83 which you should take a look at before assuming you have to withhold.

The deferred compensation also must constitute an ordinary and necessary business expense in order to be deductible. It must be ordinary and necessary in carrying on a trade or business. There are some applications of this in case law. One example was where an employer set up a benefit for the spouse of a particular employee and because of the wording of the resolutions, it was solely for purposes of benefitting the widow. There was deemed to be no valid business purpose. I think in that particular case, it was just a problem of poor counsel and poor drafting. If the resolutions had stated some business purpose such as retention of the employee or something, it might have gone the other way. Two specific applications of this rule though come up in the area of reasonable compensation and also in the context of asset acquisitions. Basically, compensation must not be in excess of a reasonable allowance for personal services actually rendered. The IRS generally raises this issue in the context of shareholders of closely held companies where they try to recharacterize deductible compensation into a nondeductible dividend, and you should be aware of it in those circumstances.

Nonqualified deferred compensation is considered in combination with all other compensation paid to the employee to determine its reasonableness, and some of the factors that the IRS and courts will look at include the employee's qualifications, the nature, extent and scope of the work, size and complexity of the business, the prevailing economic conditions, compensation of comparable employees in comparable businesses, and the adequacy of past consideration. This last factor is an important one that is very useful, usually in the context of a closely held company, especially a start-up company. You can argue that in the early years, the owner did not take out a full amount of compensation basically for the benefit of the growth of the business, and that this deferred compensation is essentially to compensate him for those early years in the start-up phase.

A problem also comes up in the context of an asset acquisition where one company is buying the assets and business of another, and the purchaser of the assets agrees to assume a nonqualified plan where, in one particular situation, it was providing a death benefit to the widow of a former employee of the company they were buying. This was basically presented in the *David R. Webb* case where they held that the amounts payable were not deductible but rather had to be added to the basis of the assets acquired and depreciated over time. Originally there was some concern that this concept would be applied to qualified plans as well, but so far that hasn't materialized and it also doesn't seem to be a problem in stock deals where the identity of the employer continues. It's basically based on the premise that there was no legitimate business reason for assuming those payments.

I just want to touch briefly on golden parachutes. We come across these quite a bit these days. No deduction is allowed for what's called an "excess parachute payment" under Section 280(g) of the Code. These are essentially payments that are made to certain officers, shareholders or employees that are contingent upon a change in ownership and control of the employer, and where the current value of those benefits equals or exceeds three times the average annual compensation of the employee over the five-year period preceding the year of change in control. The average annual compensation is referred to as the base amount. To the extent that you do make a payment in excess of three times the base amount, then all compensation in excess of one times the base amount will be nondeductible to the employer and there will also be a 20% excise tax on that amount to the employee. In essence there is a threshold, and once you go one dollar above that three-times base amount, then it's not just the one dollar that's not deductible, but it's everything above the base amount.

Those are the basic rules governing the deduction to the employer. Now I'd like to talk a little bit about the income tax treatment of the employee. The statutory basis for the income tax treatments under Sections 61 and 451 of the Code generally provides that gross income includes all income from whatever source derived, including compensation for services, whether in cash or property. We'll look at income from unfunded plans as well as funded plans, since the distinction is important for determining the timing of the income to the employee, and ultimately the timing of the deduction to the employer.

First we'll look at the timing of the income under unfunded plans. In general, cash is not taxable to a cash-basis employee until actual receipt. To the extent that property is transferred in connection with the performance of services, it's taxable when it's first transferrable by the employer and is no longer subject to a substantial risk of forfeiture. I'll discuss that further when I cover the doctrine of economic benefit. That leads into the treatment of funded plans. Nonqualified deferred compensation constitutes wages that are subject to withholding under Sections 3402 or 3405 of the Code and most state and local income tax laws. Although, generally, the cash compensation under a nonqualified plan is not taxable until actual receipt, it can become taxable prior to actual receipt under either the doctrines of economic benefit or constructive receipt, which are the two basic weapons that the IRS uses in accelerating income under nonqualified plans.

Under the doctrine of economic benefit, an employee is taxed on the value of any economic benefit or cash equivalent provided to him or her. This is the underlying concept for the taxation of property transferred in connection with the performance of services. An example of this is where the employee can assign his or her rights to property not yet actually or constructively received. This comes up in the situation where the employer sets up a bank account in the name of the employee or purchases an annuity contract or life insurance contract in the name of the employee, even though there's no direct access to it, he hasn't received it, and he has no right to receive it. It's an assignable economic benefit essentially, at the point that it's vested. And at that point when it's no longer subject to a substantial risk of forfeiture it will be taxed. These rules have been codified in Sections 83 and 402(b) of the Code that deal with the funded plan taxation.

The doctrine of constructive receipt which is much more important in the context of unfunded plans provides primarily that a cash basis employee receives income when it is actually or constructively received by him. Income is constructively received when it is made available without a substantial limitation or restriction. The underlying concept is that an employee may not simply turn his back on income and refuse to accept it, merely to defer the income to a future date, if it's otherwise freely available to him. The classic example is the employee who receives his paycheck on December 31 and thinks that by holding it until January and then depositing it, he can defer his income to the following year. That's generally not the case. However if the banks happen to be closed on December 31 – it's not a great example – but theoretically that would be a restriction on his access to the money, and it might lead to a proper deferral. Constructive receipt is one of the most important factors in designing a nonqualified plan since it imposes limitations on the flexibility available to employees in electing the time and form of benefit payments.

There are four basic areas of plan design in which the application of constructive receipt could apply and which you have to watch out for. The first is: Who makes the decision to defer? Is initiation of the agreement by the employee sufficient to cause constructive receipt? You have to look at the timing of the deferral election. When must the employee make the election to defer relative to when the services are performed? You also need to look at the so-called deemed investments of the deferred amounts, or to what extent can assets be earmarked under the plan to measure the value of the deferred compensation without causing constructive receipt. Finally one of the most important issues is the acceleration or postponement of the payment. Under what circumstances can subsequent elections be made to postpone, accelerate or change the form of the benefit to be paid?

The first design issue is: Who makes the decision to defer? Generally the IRS and the courts have held uniformly that it's immaterial whether it's the employer or the employee who initiates the decision to defer, provided the agreement is a bona fide agreement. The one exception that arises is in the context of corporate control where a constructive receipt may be found where a controlling shareholder is responsible for entering into the agreement. The employee's control of the employer may be enough to cause constructive receipt since there may be no real restriction on the employee's access to the money. As a result of this issue, the IRS has issued a revenue procedure that it will not issue rulings on deferred compensation elected by majority shareholders. That 1987 ruling was updated this year. It's now Revenue Procedure

91-3. The court decisions in this area, however, are split, with some cases fighting constructive receipt in these situations and others not.

The second design issue is the timing of the deferral election. When must the election to defer be made? We generally look at three periods. Does it have to be before any of the services are actually performed, or is it sufficient to be prior to the time that the amount deferred is ascertainable? And finally, is it possible to just make the election prior to the time the amount is paid and still have an effective election? The IRS ruling in this area is extremely restrictive and is set forth in Revenue Procedure 71-19. Because of the restrictions, very few plans, that I've run across, actually comply with these requirements, and therefore, employers don't bother to apply for a ruling. The ruling basically covers the election of the amount of the deferral, the timing of the payment and the form of the payment. The ruling provides that all of these elections need to be made prior to the beginning of the period of service for which the compensation is payable. They don't talk about what they mean by the beginning of the period of service in the ruling, but subsequent private letter rulings that have been issued to individuals, and which cannot be relied on as precedent and are only binding to the individuals issued, generally provide that the period of service is the employee's taxable year. So that in a bonus deferral arrangement, the election must be made prior to December 31 of the year preceding the year for which the services, that will result in the bonus, are paid. Subsequent elections to defer the receipt or change the form of payment, for example from a lump sum distribution to an annuity, would be permitted only if the benefits under the plan remain subject to a substantial risk of forfeiture throughout the entire deferral period. Whether a substantial risk of forfeiture exists is basically a facts and circumstances test, but it usually requires the performance of future significant services by the employee. The IRS has taken the position that a simple noncomplete provision or a consulting obligation are generally not sufficient to constitute substantial risk of forfeiture and could lead to immediate taxation. Understandably, employees are generally unwilling to subject themselves to a substantial risk of forfeiture for the entire period of the pay-out, unless they are very close to retirement. Therefore, the plan must limit the ability to make these subsequent elections or has to go forward on the basis of some of the more liberal interpretations of the case law, which I'll get into.

Two exceptions that the IRS does make however, are for new plans and new participants. Generally you have a new participant or new plan as long as the election is made within 30 days of the effective date of the plan or within 30 days of the participant's eligibility. Then you'll have a valid deferral. However, there is some question as to whether or not the deferral must be limited to services subsequent to the election.

The case law in applying the doctrine of constructive receipt is significantly more liberal than the IRS position. The two cases that are most often cited are the *Veit I* and *Veit II* cases. In the *Veit I* case, the court permitted the extension of an original deferral period as long as that election to extend was made prior to the time the amount deferred was ascertainable. This was a bonus deferral plan and the election was made before the profits were in, and the formula was applied, and the amount was ascertained. The Internal Revenue Service acquiesced in that decision, although based on the Revenue Ruling 71-19 position, it will not rule on it individually. A couple years later, Veit came back to the employer and requested a subsequent

deferral. This was after the amounts had been ascertainable but before the extension period expired. So the amounts were not yet payable to him. He requested a subsequent deferral of a few years. The IRS challenged that saying there was constructive receipt. They went to court, and the court upheld the deferral on the basis that it was a bona fide agreement. He did not have the right to receive the compensation at the time the election was made and it was a valid deferral. I'd caution however, that these are 1940 cases, and the IRS position since these cases has pretty consistently been that elections to defer, in order to get a ruling from them, which is their blessing, must be made prior to the performance of the services covered.

So what does the advisor do? Well, you've got to determine how much risk the employer is willing to accept to accommodate the employee's desire for flexibility in the design of the plan and the availability of the funds. The more flexibility that's built into a plan, the greater the risk of constructive receipt. One of the common provisions that I've seen put forth in plans is where an employer permits a change in the election at some time prior to the period the amounts are payable, but usually within a significant fixed period of time before that date. It's usually one or two years. So if it's one or two years before the deferral expires, there is some basis for arguing that it's an effective deferral under some old IRS revenue rulings. However, you will not get a ruling on this.

The third design issue is the issue of the investment or deemed investment in the deferred amounts. Generally, in a nonqualified plan, the plan provides for an amount of deemed interest or earnings to be credited to the amount of the deferred compensation until paid. This can be either at a fixed rate such as 9%, or it can be tied into a variable rate such as an index fund or Moody's long-term bond index. The IRS has held that this deemed interest is basically treated as additional deferred compensation rather than actual interest; so there's no tax deduction available to the employer for this amount of extra additional compensation that's actually paid out. In some cases, the employer will take the second step of actually going out and purchasing the actual investment that underlies the commitment to pay the interest, such as a CD or an interest in a long-term bond fund, basically to hedge its obligation to make the payments. Some plans go as far as to permit the employee to select the deemed investment fund, such as a choice of several mutual funds out of a family of mutual funds, to measure the rate of return or interest credited to the deferred compensation. Then the employer goes out and purchases that asset to hedge its obligation. Generally the IRS has provided that these provisions will not result in taxation either as an economic benefit or constructive receipt, or cause the plan to be deemed "funded," as long as there's no obligation on the employer's part to buy the assets and as long as they remain part of the general assets of the employer and subject to the claims of its creditors.

The final design issue is the ability to accelerate or postpone the payment. Based on IRS Revenue Ruling 71-19, no subsequent elections can be made unless a substantial risk of forfeiture exists throughout the entire deferral period. There are a couple of exceptions however, where the IRS will permit acceleration of all or part of the deferred compensation. The first one is in the case of a financial hardship. However, the hardship definition here is significantly stricter than the one you're familiar with under 401(k) plans. It must constitute an unanticipated financial emergency beyond

the control of the employee or the beneficiary which would otherwise result in severe financial hardship. So utilizing nonqualified plans to save for the purchase of a primary residence or to provide for your child's education will not work, because those will not constitute hardship distributions. The courts, on the other hand, have permitted acceleration or postponement in other situations including where that acceleration is the sole decision of the employer. The problem here is that the employer must exercise independent judgment and be careful not to just rubber stamp the request of every executive, since that would result in constructive receipt and immediate taxation to all of the employees under the plan. Other areas where acceleration has been approved by the IRS is in connection with a change in control of the employer, a termination of the plan, and a liquidation of the employer.

We're now going to be talking about the determination of income to employees under funded plans. Basically, under funded plans, the tax rules to the employer are determined under Sections 402(b) and 83 of the Code which is the codification of the economic benefit rule we've been talking about. The taxation of contributions to the trust is determined under Section 83 which determines the taxation of property transferred in connection with the performance of services. Under this rule, the value of the employee's entire interest in the trust is taxable when it's first transferrable or no longer subject to substantial risk of forfeiture, or vested. While the full interest is taxed to the employee as I discussed before, the employer would only get a deduction for the amount of the initial contribution.

Distributions from the trust are taxed under the annuity rules under Section 72, regardless of whether the contributions were taxed or not. However, it does provide for the tax-free return of after-tax contributions in any amounts that were previously taxed under Section 83 at the time of contribution. The taxation of trust earnings depends upon the terms of the trust, and generally, the tax can be applied to the trust itself, the employer, if it happens to be a grantor trust, or the employee if it constitutes a current economic benefit or if the interest is passed through.

I'll talk very briefly about Social Security taxes. Nonqualified deferred compensation are wages for Federal Insurance Contributions Act (FICA) or Federal Unemployment Tax Act (FUTA) in the later of the year in which the services are performed or when the amounts are vested. Since most employees are vested in their deferred compensation, the income is usually subjected to FICA in the year the services were performed. This was generally not an issue prior to 1991 when employees' base salaries plus bonuses were generally, in excess of the taxable wage base. So they paid their full FICA taxes on their salaries and there was no additional income that was subject to FICA. The problem is that in 1991, the 1.45% Medicare portion of FICA on salary, bonus and vested nonqualified deferred compensation was extended to $125,000. So employees with salary and bonus in excess of the taxable wage base of $53,400 in 1991 but below $125,000 will owe an additional 1.45% on the amount of vested nonqualified deferred compensation up to $125,000 attributable to that period of time. It's not a financial issue; it's really more of an administration issue. How do you identify the amount, particularly in the case of a defined-benefit plan, that's attributable to that year of service?

I won't go into the details of the estate and gift taxes. I just want you to know that it's there. Essentially death benefits are included in the estate of the employee. The

IRS takes a position that if there's a "death-benefit-only plan," there could be a taxable gift, and any payments after death, whether they're made to the beneficiary or the estate are taxable income to the beneficiary or estate, not the descendant. There is a deduction available however, for the amount of estate tax attributable to that income and there's also a $5,000 income tax exclusion if you qualify for it.

The final question we'll look at is: Are nonqualified deferred-compensation plans subject to ERISA? This is an important determination that's often overlooked by practitioners. If it is subject to ERISA, then the plan will be subject to some or all of the ERISA requirements under Title I. We're going to look at the extent to which ERISA applies to excess benefit plans, top hat plans and funded plans. The ERISA requirements under Title I that you're mostly all familiar with, include the reporting disclosure requirements, which include the summary plan description (SPD), 5500 annual reports, summary annual reports and the provision of benefit statements. It includes the eligibility and participation requirements (age 21 and one year of service), the vesting requirements including the joint-and-survivor annuity and spousal consent requirements, the minimum benefit accrual rate provisions, minimum funding provisions, the fiduciary responsibility provisions which include prudence, diversification and the trust requirements that the assets be held in trust (this would cause a plan subject to these rules to be a funded plan), and the prohibited transaction limitations on transactions between the plan and certain interested parties. It also covers the claims procedure and enforcement procedures, which in some cases covers basically the access to federal district courts and also preemption of state law if ERISA applies. This is kind of a sleeper in the sense that in many cases these requirements can be extremely favorable to the employer. It protects the employer against the application of various state laws that may provide for punitive damages and may provide for all sorts of equitable actions for wrongful termination that often arise in connection with ERISA claims. By limiting it to federal court and to the application of ERISA law, you can protect employers from a lot of the problems that come up in state courts.

Unless a specific exemption applies, all of the requirements of Title I of ERISA will apply to a funded pension plan. So the threshold is to ask the following three basic questions: Is there a plan? ERISA defines a plan to include any plan, fund or program. However, there are a lot of cases holding that certain individually negotiated employment agreements, which include the deferral of compensation are not plans and therefore are not subject to ERISA. However, there are some splits in the cases and the Department of Labor advisory opinions in this area are also split. So you have to be very careful when you're dealing with an arrangement for one particular individual. You can't just assume it's not a plan. It may very well constitute a plan.

If it is a plan, is it a pension plan? Section 32 of ERISA defines a pension plan as a plan established or maintained by an employer that either provides retirement income to the employees or results in the deferral of income for periods extending to the termination of covered employment or beyond. Since most of the nonqualified plans we've talked about will constitute pension plans, if they're not otherwise covered under exemption, then they will be subject to the requirements of Title I of ERISA.

Finally, the determination that needs to be made under ERISA is whether the plan is funded. Generally, this determination is the same for tax and ERISA purposes, but risks do exist that the Department of Labor or the courts, in the application of the

rules, could find a funded plan in a situation for ERISA purposes where it's not funded for tax purposes.

The determination of funding will determine whether any of the exemptions we talk about are applicable to the plan. One important exemption from all or part of the Title I requirements is for excess benefit plans, which Silvio explained is a plan that is solely to provide benefits in excess of the 415 limits. But you need to still make the distinction and determination of whether it's a funded or unfunded excess plan. If it's an unfunded excess plan, then it's exempt from all the ERISA requirements and it will not be taxable until the actual receipt, even if the employee is vested, unless the benefits are made available sooner under the constructive receipt rules. If the excess plan is funded, on the other hand, then it's only a partial exemption and it will still be subject to the reporting and disclosure rules, the fiduciary responsibility rules including the trust requirement that is consistent with the funded plan, as well as ERISA enforcement, which isn't such a bad result. If it's also funded for tax purposes, then it may be taxed immediately when the employee is vested.

The second exception to the full ERISA coverage under Title I is the top hat plan exemption. And as Silvio explained, a top hat plan is basically an unfunded plan maintained primarily to provide deferred compensation to a select group of management or highly compensated employees. The first element that we have to look at in determining whether the plan satisfies the top hat exemption is whether the plan is unfunded. Again, this is a facts and circumstances test similar to the rules we previously discussed.

The second element is that this plan can only cover a select group of management or highly-compensated employees. This is really the critical element of the top hat plan since the Department of Labor has not yet issued any rulings or guidance on what constitutes a "select group." However, over the past year or so, it released a couple of trial balloons to sort of get the public's reaction to a few ideas. I guess the one that was shot down pretty quickly is a requirement that the employee earn three times the Social Security wage base. That would bring it up to over $160,000 in order to qualify. It also has informally made it clear that it is not going to tie the definition into the definition of "highly compensated employee" for purposes of the tax code, and that somebody who is a highly compensated employee for purposes of the tax code still may not rise to the level of the select group.

Finally, it informally released the idea of possibly applying the standard under the Age Discrimination Employment Act which permits employers to compulsorily retire employees at 65, and that provides that they must be an executive or high policy-making employee. The problem with this is that it really doesn't add any clarity at all. There are just as many questions under that definition as there are under the select group definition.

The current issue in this area appears to be: What is the effect of having a plan with one employee who fails to satisfy the definition of select group? Will that kill your whole plan? There was a recent case called *Belko* vs. *Roe* in 1983 that held that the word *primarily* in the definition modifies select group of management or highly-compensated employees. So as long as the plan covers a group that's primarily composed of highly compensated and management employees, it will be okay.

However, the Department of Labor has rejected that approach, and its position is that *primarily* modifies deferred compensation. I don't really know what that means . . . that the plan primarily provides deferred compensation. Maybe there are plans that provide other types of benefits. I guess a death benefit might be one that they have in mind there.

So the issue is what do you do if you have a large group of employees that you want to cover? One approach that I've been using is to establish two plans, even if the provisions are identical; one to cover the employees that you feel very comfortable with as being part of the select group, and one to cover the employees that are questionable. This way, if there is ever a challenge or problem with the lower-paid plan, it won't affect the plan covering the higher-paid employees. The lower-paid plan can provide a fail-safe provision that provides if any amounts are deemed to be taxable or found to be taxable, then benefits will be immediately paid out and distributed so that the funds will be there to pay the taxes.

If the plan does qualify for the top hat exemption, at that point it is subject only to the Department of Labor simple notice requirement, under which you must identify the number of participants and agree to make the documents constituting the plan available if requested. That has to be filed within 120 days after the effective date. It's also subject to the ERISA enforcement provisions but not to any of the other provisions under ERISA. These provisions are essentially self-enforcing and the reason a challenge comes up in the case of a top hat plan is the circumstances where you have a disgruntled employee who's been terminated, and because of a non-compete provision or a bad boy clause, the employer has forfeited his benefit. At that point the employee comes back and says, "But I'm not a select employee and I'm entitled to the protection of ERISA and therefore, this plan has to be funded and I'm vested because I've been here for five years. You owe me my money." That's basically how it comes up. You have to be very careful because sometimes the people you're talking to in designing these plans are the very executives who are going to be the ones suing for benefits under them. They're often going to encourage you to put in all sorts of flexible access provisions and provisions that may come back to haunt you one day. So it can sometimes be a very difficult position to be in.

Finally, are funded plans subject to ERISA? The answer there is easy. If the plan is found to be funded, it is subject to all of the ERISA requirements unless it happens to satisfy the excess-benefit plan exemption. Now at that point, the plan has probably failed its intended purpose and will be discontinued and taxed.

This is just a summary of the ERISA coverage. We talked about unfunded excess benefit plans where ERISA is entirely exempt, funded excess benefit plans where only the reporting disclosure or fiduciary duty and enforcement provisions apply, unfunded top hat plans where there's a simple notice requirement and the enforcement provisions apply, and finally a top hat plan that's found to be funded or defective or other nonexempt plans where all the provisions of ERISA are applicable.

MR. INGUI: At this point, I will briefly discuss three types of vehicles for – I use the word loosely – funding nonqualified deferred-compensation plans. This does not mean, as Saul pointed out, that by using these vehicles you create a "funded"

deferred-compensation plan. I guess a better word is "securing" the benefits. These three vehicles are basically rabbi trusts, secular trusts and insurance vehicles.

Segregating funds for nonqualified deferred-compensation plans, was not always common. However in recent years, it has become more common and I believe it will continue to become more common, basically for two reasons. The first reason is the increased activity in the takeover area and the concern of change of management. Executives are becoming more fearful that a takeover or change of management, either hostile or otherwise, could result at a loss of their nonqualified deferred-compensation benefits. The second reason that these vehicles are being used or being considered is that, with the limitations in qualified plans, it is not uncommon for an executive to receive more of his pension from the nonqualified plan than his qualified plan. You may have heard of Roger Smith, former CEO of General Motors. It was publicized that he was going to be retiring with over a $1 million pension. Well, you can be sure that over $900,000 of that is coming from a nonqualified plan because he can't receive it from his qualified plan. Thus, it is not uncommon for a senior executive to have a nonqualified benefit equal to three or four times his or her qualified benefit.

Probably the most common vehicle considered is the rabbi trust. A rabbi trust gets its name because it was first used when a congregation created a trust for its rabbi. It's an irrevocable trust for the benefit of the covered employees. What makes a rabbi trust and what prevents a rabbi trust from creating constructive receipt is that the trust is still subject to the general creditors of the corporation. Thus, there is a substantial risk of forfeiture. Rabbi trusts are becoming much more common, as I mentioned, because they are being used predominantly to protect against corporate takeovers.

The second type of vehicle is the secular trust. This goes beyond what a rabbi trust does. It also protects against the general creditors. However, under a secular trust, the employer contributions and the trust earnings are immediately taxable to the employee. If a secular trust is also deemed a pension plan for Title I purposes, it will be subject to all the requirements of Title I of ERISA. In my experience, secular trusts have not yet become too popular. They're being discussed a lot, but I have not seen too many actually being implemented. For one thing, the tax on the trust earnings and contributions can be quite significant, which can add additional cost to the program, if the employer compensates the employee for the tax.

Insurance vehicles have been a very common approach to fund nonqualified deferred-compensation plans. However I understand that the tax laws are getting tighter and they are closing some of the loopholes that allow these type of vehicles to become attractive. Some of the types are key persons, split dollar, nonqualified annuities, etc.

Finally, the issue comes up about accounting for nonqualified plans. Traditionally these plans were not funded. Yet, in 1987 Statement of Financial Accounting Standards (SFAS) No. 87 was passed. It stipulates that even though you are not systematically segregating funds for a nonqualified deferred-compensation plan, you still have to expense for it on the corporate income statement. You determine a SFAS No. 87 expense just like you would for a qualified plan. That expense is a charge to income. Typically, if a contribution has not been made to cover that

expense, you end up with an accrued pension expense that appears as a liability on the balance sheet. Thus, during a period where a nonqualified deferred-compensation plan is not paying out any real benefits, there is an accumulation of a liability on the books through the annual SFAS No. 87 expense, and that liability does not get written down until contributions are actually made to pay benefits. At that point, the contributions will act to reduce the accrued liability on the books.

This ends our discussion on nonqualified plans. In closing, I would like to say that nonqualified plans can present a lot of challenge and opportunities to actuaries. I find that it allows me to be more creative and provides me with a powerful tool to solve many of my client's problems. However, I cannot overly stress the importance of competent legal counsel in setting up these plans. The rules and regulations are just not that clear, and you really need someone to guide you through some of the case laws and the issues on constructive receipt. As to whether nonqualified plans are the plans of the future, well, I'll let all of you reach your own conclusions and answer that question yourselves.

MR. WILLIAM E. NEAL: Would a definition of a select group consist of those whose benefits would exceed Section 415 limits? Do you think that would qualify as a select group?

MR. BEN-MEYER: I don't think that would work because the definition of a select group is management employees, for one, and it's possible that somebody who exceeds the 415 limitations is not a management employee or highly compensated. That's really where the play is, what is meant by highly compensated. I don't think the benefit that the particular participant has achieved is relevant. I think that's more relevant to the formula under the plan in how rich the plan is possibly more than how highly compensated the employee is. I guess you could design a plan that's rich enough so that some relatively low-paid people might be up against those 415 limitations. I think that's what the problem is with that.

MR. MITCHELL I. SEROTA: If a nonqualified plan is being, shall we say secured rather than funded by a life insurance policy, is that also subject to SFAS No. 87?

MR. INGUI: The issue of how it's funded or secured really has nothing to do with whether it's subject to SFAS No. 87. With SFAS No. 87, you have to determine the expense. What will happen is if you go through the process of SFAS No. 87, there are six components to expense. One of them is return on assets. If you have a plan that has no funds segregated, that component in SFAS No. 87 is zero. There is a service cost and an interest cost because you have a projected benefit obligation (PBO), but because there are no assets set aside you have no return on asset. So if you do introduce some kind of securing vehicle, where now you have funds, like a rabbi trust or an insurance vehicle that may have cash values, my interpretation would be yes, you can now look at that as an asset and say, "What is my expected return?" And that becomes a credit. So it affects maybe the result, but it doesn't affect whether you are subject to SFAS No. 87. All nonqualified deferred-compensation plans are subject to SFAS No. 87. The only time I have seen an accountants say, "We can ignore it," is if they felt it was so immaterial it was just irrelevant. For instance, it just covered one employee of a major corporation and the expense amounted to $50,000 in a company that has hundreds of millions of dollars

on its income statement. There, they may write it off for immateriality purposes, even though the plan is subject to SFAS No. 87.

MR. SEROTA: So immateriality is in the eyes of the accountant rather than of the actuary, right?

MR. INGUI: Well, it's in our eyes, too, but I think they have the final call as to whether or not they want it. You can argue.

MR. SEROTA: I'm thinking in particular when you have a 401(k) plan as opposed to a defined-benefit plan that's the base plan for the employees of the corporation. Then you just have a small, or maybe not so small, nonqualified plan for the top executives; then maybe it will be regarded as being immaterial.

MR. INGUI: It's possible. You've got to really look at the numbers, and it's going to vary by accounting firm. I'm sure if you lined up five different accountants, whether in the same accounting firm or different, they would give you different opinions. I've heard 5% as a threshold thrown around, but others will many times ask you to go through the exercise. Give them the number and then they'll make the determination.

MR. MICHAEL ROBERT RAHN: I just take a little exception with the last part of what you said there. If you buy insurance or set up a fund and you use that as a credit in your SFAS No. 87 expense, then you no longer have a secured plan. You have a funded plan. And in my way of thinking, you would then be subject to all the ERISA requirements. I think you can buy insurance and have it as a credit on the books. I mean, if you look at the books in total, you have your FASB liability and then somewhere else you have your insurance as a credit to kind of balance the books. But you cannot use it in the FASB calculations as a secured arrangement. If you use it in the FASB calculations, you have a funded arrangement.

MR. BEN-MEYER: I think there's probably a serious risk of that because you're really then identifying a particular asset as being specifically earmarked for satisfying a specific obligation under the plan. When you cross that step, even outside the accounting rules, you have a problem.

MR. RAHN: Well, in effect, you earmark it, but it's just like an investment of the company. It's an asset of a company on the books.

MR. BEN-MEYER: Right. But from the Department of Labor's point of view, this goes beyond what you're suggesting, but say you went to an employee and told him even off the record, "We're holding this life insurance policy to fund your benefit. And we will use the assets to pay for your benefits." There has been case law and the Department of Labor's position is that, in the Tandy Advisory Opinion letter, that alone could result in the plan being funded. You have to be very careful when you're dealing with life insurance.

MR. RAHN: I don't deny that you have to be careful in how you word it, but it can be done. Because I know there are arrangements that exist.

MR. NEAL: Are you suggesting that specific assets earmarked for covered deferred compensation or a SERP arrangement would make that a funded plan? For example, employees know that they're going to buy Mutual Fund A with these deferred compensations.

MR. BEN-MEYER: No. Just to clarify it, a very common arrangement now is where the employer will allow the employee to select one or two funds from a family of funds, almost like a 401(k) plan, and say, "this month I want my account in my deferred-compensation plan credited as if it were invested in these particular mutual funds." You can pick up the paper every day and see what that interest rate is or what those earnings are, and you can keep track of what the value of the account is growing to. Just by linking them up conceptually doesn't quite do it; as long as the employer has no obligation to actually go out and buy the funds even though he may do it voluntarily as a hedge. As long as the assets or the ownership of those funds remain the general asset of the company and are subject to the claims of the general creditors, then you don't have a fund under basic principles.

MR. INGUI: I'm going to ask one last question because we did not discuss Section 457 plans. I'm going to ask Saul to give us a statement on Section 457 plans. They are what was substituted for tax-exempt organizations when TRA basically eliminated the use of typical nonqualified arrangements for tax-exempt organizations, unless it came under one of the grandfathering provisions.

MR. BEN-MEYER: It's a complicated area. But essentially, prior to TRA, Section 457 applied only to governmental plans, state and local plans. During that period of time, there was always some very small murmur of dispute as to how nonqualified deferred-compensation plans of tax-exempt organizations would be treated. There was somewhat a distinction between the treatment of nonqualified plans for tax exempts and for private companies. The rules were slightly different, and there was always a question whether the Internal Revenue Service would ultimately finalize some early proposed regulations as they would apply to tax exempts, which essentially would knock out elective deferred compensation for tax exempts. At one point they had a proposed ruling position that would have knocked those particular plans out. Then in 1978, Congress passed legislation that basically froze the interpretation of these rules as of that date, but they only froze it as to private company plans and not tax-exempt plans.

That uncertainty was resolved with TRA when Congress solved the problem by just extending the coverage of Section 457 to tax-exempt organizations as well as to governmental organizations. Section 457 basically requires that the only way to provide deferred compensation to an employee of a tax-exempt organization, if it's going to be an "eligible 457 plan," is on an unfunded arrangement that would be subject to severe limitations including a $7500 aggregate annual contribution limitation. For that purpose, they took other contributions into other plans into account. It was also subject to other qualified-plan-type limitation such as the 401(a)(9) minimum distribution rules and had several other limitations that made it very unattractive. However, it solved the constructive receipt problem in effect by saying that the amounts would not be taxable until actually paid, even if the employee was vested.

If you put in a plan that is "ineligible" under 457 and doesn't satisfy the rules, that was truly very much like a funded plan and the employee would be taxed as soon as the benefit was vested or no longer subject to a substantial risk of forfeiture. The real problem or limitation on these plans is that they must be unfunded. So in order to avoid ERISA coverage, you have to come in under the top hat exception which means that you're limited to covering only a select group of highly compensated and management employees. So these plans cannot be readily used any more for providing deferred compensation to tax-exempt organizations. That's about all I have on it.