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NONQUALIFIED-PLAN ISSUES

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- Funding
- Secular Trusts
- Rabbi Trusts
- Trends in plan design
- ERISA excess plans: Why can't they include compensation in excess of the IRC 417(-) limits?
- Who can have them?

MR. DONALD J. SEGAL: We have two guest speakers. Jim Naida is an attorney with Deloitte & Touche in Detroit. He's been in the business for 12 1/2 years and describes himself as a frequent speaker on deferred compensation, ERISA, and other mundane topics. Garth Gartrell is an ERISA partner with Pillsbury, Madison & Sutro. Garth, in addition to being a top-notch ERISA attorney, is chair of the California State Bar Tax Section and appears in the 1993-94 volume of the *Best Lawyers in America*; only ten ERISA lawyers from California made that list.

MR. P. GARTH GARTRELL: I would have sworn that Jim was an actuary because I got stuck with the obligatory, boring job of running through some of the basics and doing a basic discussion; then he's going to kick off the fun, with more incident-by-incident issues.

Let's start with the basics and look at a qualified plan. I know that's way below the basic level for most of you, but the great thing about a qualified plan from a tax-planning standpoint and from a tax lawyer or accountant standpoint is that there's a unique timing mismatch that occurs with qualified plans that very rarely occurs in the Internal Revenue Code (IRC). That timing mismatch is that the employer can make a contribution to a plan and receive an immediate deduction. So, you have an immediate deduction, but there's no income recognition for the employee until actual distribution of the qualified plan benefit many years down the road. This disconnection provides one of the most efficient tax shelters because tax shelters are very rarely devices to totally avoid the payment of taxes. They almost invariably involve playing with the timing of income; it is among the most efficient vehicles for disconnecting those sequences that exist in the code, and it can happen over a period that spans generations. They're certainly designed to be in existence for decades, running into five or six decades. As powerful as this disconnection is, though, it pales in comparison to the power of the trust to accumulate tax-free, and this is certainly a powerful thing to present about qualified plans to employee groups, especially if it's a 401(k)

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plan that has a match because you can, in effect, count the match as part of the return on the employee's investment. If you ignore the match, or if you were to simply take a periodic contribution to a retirement plan and let that accumulate without deducting taxes from the income every year, you can find over the span of 20-25 years that the return simply from the qualified plan may yield a return that's five or six times greater than that under the much slower and cumbersome taxable trust. As you know, there is a very high price for these tax benefits.

The code has numerous limits on aggregate and individual contributions that can be made to plans. There are limits on what the plan can be invested in so that the plan cannot be backed up by certain collectibles. There are complex rules designed to prohibit an employer from blurring the lines between permissible and impermissible investments by being privy to transaction rules which simply declare certain investments between certain persons as completely out of bounds and impermissible. There are severe limits on the ability to use plan assets in certain ways that might generate income that should be taxed, and there are unrelated business taxable income rules, obviously the 10% penalty for early distribution. Pension plans are prohibited from making distribution prior to termination of employment. Ancient incidental death benefit rules have been the rules that require distribution by the age of 70 1/2. The 15% excise taxes can apply at various levels. That's by no means the body; the entire body of the rules are pale in comparison to the rules regarding nondiscrimination: 401(k) testing, 401(m), 402(g) limits.

Well, the IRC has its set of rules that deal primarily with only one relationship, and that is the relationship between the government or the Federal Treasury and the taxpayer. Now, with a qualified plan you have several different taxpayers including sometimes the employer and usually the employee. The reason I say sometimes is that you may encounter a plan of a state government or some other tax-exempt entity, and the notion of a taxpayer becomes a little more tangential. There are things that the code does not do. The code does not regulate the relationship between the employer and the employee, so if a vesting schedule violated that, it is permissible under the code; it really doesn't do a participant much good. There's no mechanism within the IRC for that individual to step forward and address what wrong may have happened. This leads to Title I of ERISA.

Now, there are a few things that you have to keep in mind when you're thinking about ERISA. First, it doesn't force any employer to offer any specific benefit or any specific level of benefit, per se. It does attempt to ensure that the promise made to an employee is kept and that it is a promise that an employee can monitor; that's what Title I is all about. It really is a process of making a plan participant a little deputy attorney general who can have the tools to police the plan and enforce any violations of the plan or ERISA that might have occurred. There are two types of plans that are governed by ERISA: pension plans and welfare plans. A welfare plan covers a lot of nonpension-type benefits including health and welfare, disability, life insurance, some vacation, some severance. It does not cover things like malpractice coverage, even though that may extend to a broad base of employees, and, of course, pension plans. It's important to note that the distinction between a pension plan under ERISA and a pension plan under the IRC is significant. They're not similar at all. Even something that might be a qualified retirement plan under the IRC actually might not be a plan subject to ERISA, and vice-versa. A pension plan under ERISA might not be subject to regulation under the IRC, and that's particularly applicable in the case of nonqualified plans.

The definition of a pension plan under ERISA is a plan that provides retirement income or defers receipt of income to periods extending to the termination of employment or beyond. Now, we'll come back to that. That's a very broad definition. There are important statutory exceptions to ERISA. There's a very broad statutory exception for plans that are established or maintained by governmental employers. Also, among the important exceptions from ERISA is the exception for unfunded plans solely to provide benefits in excess of the 415 limits.

I want to first run through a few of ERISA's requirements because they are important in constructing a nonqualified plan. Then I'll talk about some exceptions to ERISA applicability that significantly affect nonqualified plans. The first set of requirements under Title I of ERISA are those dealing with reporting and disclosure. They provide a comprehensive mechanism, such as a plan audit in many cases, elaborate disclosure of terms of the plan, and information reported to the government that must be reported to participants. Substantial sanctions are in place for the failure to comply with those provisions including ERISA's only criminal sanctions. So, this is the network that starts this process of crosschecking that permits participants to, in effect, be deputy attorneys. Lawyers get used to the fact that there's very little in the way of a private right of action under most federal statutes. ERISA is one significant exception, and I certainly would say that the exceptions have become more and more common throughout the years, but a structure like ERISA is actually a fairly rare creature under federal statute. There are only limited occasions where individual citizens and participants have a right to bring a private cause of action. So, that's why I say that participants are, in effect, little deputy attorneys. They have all sorts of policing powers, and that was very much a fundamental part of ERISA when it was passed.

ERISA also provides rules that make sure that the promise made by an employer is not illusory, and that's where the minimum vesting and benefit accrual rules, which are like those in the code, now find their place in ERISA. So, the fact that the vesting provisions under ERISA are the same as the code is meant to harmonize the two statutes that have completely different purposes. In fact, if the code vesting statute is violated, there's a good chance that it also will have violated the ERISA statute for vesting and provide a means of relief through ERISA's private right of action sections for that participant. Rules requiring adequate funding, are rules that, when you think about violating the provisions of ERISA for a nonqualified plan, become the scariest for individuals who might be considered fiduciaries.

What if you had a duty to see that deferred compensation assets made it into a trust, but you didn't primarily because you thought the plan wasn't subject to ERISA? If the plan and eventually the company goes belly-up at some time, the only person that participants could look for to claim benefits from might be the fiduciary, and that fiduciary liability could be personal and could follow him or her for many years. Companies very rarely have fiduciary liability coverage. Instead, they rely on indemnity from the company. Now, if the company goes belly-up, and you're a fiduciary looking to be reimbursed for any losses you might suffer in connection with any plan that you might be involved in, your indemnity is worthless. Without fiduciary liability insurance you could be faced with significant future liability if the employer ultimately does not make it. I think I heard something like 60-70% of all American businesses eventually fail. So, it's an event that is likely to occur. It's probably going to occur with most employers. It just depends, I guess, on your timing.

While the reporting and disclosure rules apply at least to some extent to all plans subject to ERISA, the participation, vesting, funding and fiduciary rules apply only to certain plans; thus the welfare plans are not subject to participation, vesting, and funding. More importantly, for our purposes, unfunded plans maintained primarily for the purpose of providing deferred compensation for a select group of highly-compensated employees are exempt from ERISA's fiduciary, participation, vesting, and funding rules. Now, all these rules are backed up by this intricate and expansive private right of action section, actually one of the other great benefits of ERISA.

There was a Viet Nam War hero, Jeremiah A. Denton, Jr. What I remember about him was the Vietnamese paraded him in front of TV and had a script for him to read about how the war was immoral. While he was reading this script, he blinked in Morse Code the word torture for the American news media to capture. Jeremiah A. Denton, Jr. was in Congress at the time ERISA was passed, and he refers to the preemption provisions of ERISA as its crowning achievement, and that is the second great thing that ERISA did. On the one hand, it was designed to deputize employees. On the other hand, it was designed to provide an incentive for employers to establish employee benefit plans. We've kind of gotten out of the notion of thinking that the government wants to motivate employers to set up pension plans. But, in order to do that, when ERISA was passed, the government felt it was very important to eliminate the need for companies, and especially conglomerates in many states, from having to deal with 50 different jurisdictional problems that might exist in the various states. So, it completely preempted all of state law applicability and replaced it with one federal scheme that was supposed to develop on its own. It has, by and large, developed on its own, and certainly the preemption provisions have worked pretty true to form.

The Supreme Court has been relentless in denying the application of state law, although various exceptions have been made prior to the Retirement Equity Act of 1984. There was a divorce exception made. Certain exceptions have been made for purely procedural devices to permit the payment of a remedy using state garnishment laws. Those are strictly procedural laws. Everything else has been completely preempted, and the Supreme Court has been very protective of that provision. The end result is that the sole mechanism for enforcement of employee plan issues now flows through ERISA. That wiped out not only a wide variety of state laws, but it also took out the ability to use state law remedies to enforce certain punitive damage and other extracontractual damage awards that could leak into any particular suit. Because the Supreme Court, on a completely different front, provided that ERISA itself has no punitive damage potential, you actually have a situation where employers, despite the intricate provisions of ERISA, actually prefer to be in ERISA because it completely wipes out the ability to have a punitive damage award assessed against an employer that may sponsor a retirement plan.

I mention this because Part V of ERISA, which has the enforcement and preemption provisions, is not among those provisions of ERISA that are carved out from coverage for most nonqualified plans. Now, we need to make an important distinction. If the plan is a top-hat plan, that is, it's a plan providing benefits to a select group of highly compensated or management employees, it is covered by the preemption provisions and the Part V provisions regarding the private right of action section. If the plan is, however, let's say, a governmental plan or a plan that is providing benefits in excess of those available under the 415 limits, it's not an ERISA plan at all and is not one that would be protected by the ERISA preemption provision. Employers like to design a plan so that it fits within ERISA. What that means is they avoid all of Part II, the vesting and benefit accrual. They avoid all of Part III, the funding. They avoid all of Part IV, the fiduciary rules. They get the benefit of Part V, but going back to Part I, if you do it right, you have only the smallest of reporting obligations to the government and to employees. So, you actually find, with respect to nonqualified plans, most employers who are thinking about the issue try as often as possible to come within the framework of ERISA.

Well, nonqualified plans obviously have become popular and are becoming increasingly popular because of the limitations that have been put on qualified plans which, as you know, have only pyramided through the last ten years, and it's likely to continue. As you know, the 417 definition of compensation indexed up in the $230-235,000 range -- is likely to come down if any version of tax revision happens. I've heard various figures. I think the latest is $150,000. And that certainly will accelerate the drive toward nonqualified plans. There are a number of really fine outlines for the tax effects of nonqualified plans. One was prepared by one of my partners, John Ocker. Another is prepared by George Bostick. If any of you would like a copy of those outlines, feel free to contact me.

Let's run through a couple of preliminary issues for the taxation of nonqualified plans. Nonqualified plans, by their very definition, involve future receipt of the benefit. When you're deferring the income into the future, the question always is, can the employee be taxed on that deferral even though the money is not payable for many years, and does the employer get the deduction? Well, we don't have actual income. So, we can't look to the typical method of taxing individuals, which is the cash receipt method, right? No matter what you promise, individuals are not typically taxed until we actually have cash in hand. Well, we don't have cash in hand. So, do we escape taxation? Well, the next level we have to go to is the rule of constructive receipt. The rule of constructive receipt says you could walk up to the pay window and simply by asking, receive the money; then you have constructively received it for tax purposes and will be taxed on it. You may not have actually walked up to the window and asked for payment. However, under the constructive receipt rule, if that payment is contingent upon some substantial limit or restriction, you're not taxed on it at least at that time. A typical, substantial risk of forfeiture would be if you had to quit to get the money. Now, I think most people would agree that a severe penalty would be if one condition of receiving the money is that you have to quit.

Other plan design features may be relevant. An example of a stock appreciation right feature is one in which an employee has a stock option. A stock option permits the employee to hold an option and at some later point in time tender that option along with the option price and receive, in return, shares which obviously will be valued at the fair market value at the time that the option is exercised. A stock appreciation right feature permits the employee, instead of tendering the cash and receiving the shares, to simply identify that it's time to exercise the option. But instead of tendering the price, the employee only receives the difference between what the option price is and what the fair market value is. Well, suppose you have an option that says you can do that at any point in time. What risk of forfeiture do you incur? Well, the Internal Revenue Service (IRS) has always been pretty good on this particular kind of feature and has said what you lose is the opportunity to share in the future appreciation of the stock. Stock in itself is a valuable right, and if you receive stock equal to the spread, even though you're receiving stock, you're not receiving as much stock as you could have gotten under the option, and so you are foregoing a valuable right. So, the IRS has rarely attempted to tax an employee in that situation.

I have to caution you, though, with respect to a plan that looks a little like that; this situation often comes up with respect to phantom stock option plans. Phantom stock option plans often involve not the award of stock for the payment of cash but often reflect certain performance bonuses that mirror the appreciation in the stock. Often there's no price required or there can certainly be no price required in exchange for the award. It's just payable at some future point. Now, in that case, let's suppose the employee has the right to receive the value of ten shares at whatever their value is five years from now, and after five years, the employee decides not to exercise. Well, there seems like there's been the potential for constructive receipt, but we have to ask, do we have the summary annual report (SAR) kind of issue? Is a valuable right being forfeited? The IRS would say no in that case because what the employee could do, at least in the right company, is take the cash, go out and buy exactly that number of shares equal to that fair market value on that day and, in effect, have no risk of forfeiture. You can replace the phantom shares with actual shares. You actually do have the ability to walk in with no forfeiture available; there's a private letter ruling to that effect. It's Private Letter Ruling 8829070, and you might also want to note a later case, *Martin vs. Commissioner*. It's still an unreported tax court decision. Its case is Court Docket Number 1632-88. It seems to say that the IRS is not quite right on that theory, although I'm not as convinced as others that it's a complete repudiation by the tax court of that principal, and I certainly would be very careful with any phantom stock plan of that particular design.

The tire really meets the road with respect to executive compensation with the notion of the economic benefit doctrine, and that is shorthand for Section 83. The basic principle behind Section 83 is that suppose I didn't have constructive receipt, but money was put into trust or somehow locked up airtight for ten years, and there's no chance I could get at the money. There's no opportunity during those ten years for constructive receipt to apply, but if you have it in such an airtight vehicle that there's almost absolute certainty that it will be paid, a person theoretically could walk out and take a promise to receive a $100 plus income ten years from now for maybe $80. Some might be willing to buy that promise if it's locked up so airtight. If you have your taxes prepared by H&R Block, they'll give you an advance on a payment that they feel comfortable is going to be coming to you if they prepared your return. Well, that's where the economic benefit doctrine kicks in, and that's what Section 83 tries to capture. Section 83 simply provides that at the time property is transferred to another individual and is no longer subject to a substantial risk of forfeiture, then the person who performed the services, not the person receiving the property, is subject to tax equal to the difference between the fair market value on the date the property's transferred and whatever the individual might pay for that property.

Certain things aren't subject to Section 83, I guess the most important of which is an unsecured promise to pay money, assuming we don't have a constructive receipt issue. If all you have from an employer is the unsecured promise to receive something in the future, I think it's only fair, don't you? If it's true that 60% of all American businesses fail, and there's a substantial likelihood that promise won't be paid, it would be a little unfair to tax that promise, and so that's not captured within Section 83. That's probably the norm for a high-flying executive to eventually have a falling out with management, and in that case you might have an invitation to file a lawsuit; no real assurance that you'll ever really get paid.

Now, another important exception from Section 83 is the grant of most employee stock options. We take off the table stock options that are traded on an established exchange -- they're different animals completely -- but most stock options are not -- you take that particular stock option. The grant itself is not subject to Section 83. That becomes important when we take a look at the Section 83(b) election and how that can apply not so much with respect to stock options but with respect to restricted stock for which the employee pays by giving a nonrecourse note. Section 83(b) permits the service provider to accelerate the tax consequences to the date that the services are actually performed. Section 83(b) in its most opportune circumstance would work something like this: Let's say there are a lot of companies in San Diego that have become very successful from start-ups. Perhaps there are a lot of companies that have not produced a product yet, or have not come close to making a profit, but they have great promise. Well, when those companies are started they aren't worth a dime, and their stock isn't worth a whole lot and it doesn't trade for much. It might trade for pennies, but the expectation is that the stock will become very successful.

Let's say an employee is awarded shares, and those shares are worth a penny. Let's also say that those shares are subject to a restriction, and that restriction is, let's say, that you have to work five years. If you quit after four years, you have to give back the shares for a penny each. Well, in that case the stock doesn't vest permanently in the hands of the participant until five years pass, but in that circumstance, the participant could use Section 83(b) to accelerate the tax consequences. Now, the tax consequences, because there's that risk of forfeiture, otherwise wouldn't occur till year five, but the employee says he is going to take it in year one and elect on the 1,000 shares to recognize income at the date of grant equal to a penny for each of those shares. He gives his Section 83(b) election which has to be done within 30 days. So, the transfer has to be filed with the IRS and filed with the company; you just cannot miss that date. Well, assume that the employee still owns those shares in year five. The company went public in year three, and those shares are, let's say, selling at $22-23 a share. I mean that's certainly not an unusual example. If the employee had not made the Section 83(b) election, that employee would have taxable income at $23 a share. If there are a thousand shares, that employee would have taxable income in year five equal to $23,000, whereas back in year one, making the Section 83(b) election, the income was $10. So, that's the impact, and usually we're talking about share awards that are $50,000. The numbers can be absolutely astronomical. So, it's critical to do an 83(b) election, especially in start-up companies.

MR. SEGAL: Garth, what if he made that election in the first year and then quits in the fourth?

FROM THE FLOOR: He loses it.

MR. GARTRELL: He loses it. You do have the opportunity, don't you, to offset the long-term loss?

FROM THE FLOOR: Long-term capital.

MR. GARTRELL: Long-term capital loss has to be matched with long-term capital gains. It's not something that completely disappears, but it's a gamble.

MR. SEGAL: There is a gamble.

MR. GARTRELL: It sounds like the IRS is being nice to not tax you on an option on the date of grant, but really the option is already involved. You don't exercise an option until you've seen that the company has succeeded. You never exercise an underwater option. If an employee could make an 83(b) election on something that already involves no potential for loss, the government is in a complete no-win situation. There's no risk to the employee in that situation. So, an option does not trigger income, and I think it was primarily for the benefit of the Federal Treasury.

Now, the real reason I go through all this is to go back to the restricted stock example. Whatever the purchase price is, the employee tenders a note rather than cash for the purchase price. Now, the important thing to remember is that if the note is nonrecourse, and by nonrecourse I mean that the only way that the company can enforce the note is to take back the stock, it can't sue the individual personally. If the note is nonrecourse, then what have you got? You essentially have an option. It's the exact same economic circumstances, ignoring dividends, that an option would hold; no Section 83(b) election could be made at the time that the note is signed. It would have to be made when the employee decides to take the shares and actually pay on the note. Now, most situations aren't that clean. You may have an employee with a requirement to pay 20% of the note price and then give a note on the remaining 80%. You're in a gray area, and it's difficult to give you a whole lot of guidance about whether or not you have option treatment or not. It's an absolutely critical thing if you come across it and spot it, and I would say that is often overlooked. I know good tax lawyers who don't spot that issue, and it's not unusual to find a company that has options sitting out there with that particular problem.

In nonqualified plans the deduction is not disconnected like it is in qualified plans. The deduction is available to the employer only at the time the employee recognizes income. Social security is very much an issue. Let me just say one thing about social security. I believe one of the items on the table for Clinton's reform package would be to remove the $125,000 indexed cap for Medicare.

It's $135,200 now. Most nonqualified deferred compensation plans don't have to worry about Medicare or social security. It's just a timing problem. If you get income above that threshold, then the rest escapes taxation. Most plans for highly compensated executives, when added to current compensation, get above that, so we really haven't had to worry too much about it.

Under Clinton's reform package it would be subject to it. That all of a sudden raises a new layer of tax that would apply to nonqualified plans. I haven't thought about any planning potential for that. There probably is some – I don't know – but that's an issue that is on the table if that cap gets removed.

MR. JAMES D. NAIDA: What I wanted to do is go through a few of the basic issues and then give you some real life examples of problems that I've had over the past several years. I'll list some opportunities of some things you can do with nonqualified deferred compensation. The particular area that I'm going to emphasize is tax exempts because some of the worst problems and some of the hardest planning situations involve tax exempts because of Section 457. I'm going to get into that after I go through some of the basic stuff first, and I think I'm going to leave the rabbi and secular trusts for Garth since I don't really want to talk about that.

One of the basic things to think about whenever you're doing deferred compensation is if you have a closely held company. In most instances, it really doesn't make much sense to have deferred compensation for the owner because it's the owner's money, and a promise to pay him or herself money in the future is really irrelevant because he or she is not getting a tax deduction. The owner is not getting anything. The only time it makes sense is if you have a situation where owners are planning on selling the company, and they want to create an enforceable postretirement income to themselves. So, usually what you're dealing with in nonqualified deferred compensation is either nonowners in closely held companies or executives at publicly traded companies. A lot of the different issues come up in those situations.

The first thing I wanted to talk about is some of the miscellaneous issues. The first one is the Federal Insurance Contributions Act (FICA) tax and Medicare tax under Section 3121(v) of the code. I normally refuse to quote code sections whenever I'm speaking to a group, but, believe it or not, this is a code section that's actually readable – I think it was written before any of the current congressional staffers were around because it's written in English, and it's actually understandable. It says that deferred compensation is subject to payroll taxes at the later of when the services are performed or when there is no longer risk of forfeiture. So, in your typical deferred compensation plan all of the deferred compensation is FICA taxable on the last day of employment because that's typically when the risk of forfeiture goes away. So, as Garth was saying, no one's ever really worried about FICA or Medicare tax on deferred compensation. It just usually isn't hit unless somebody retired in the first month of the year or first two months of the year – they'd typically be over the wage base, and it wouldn't be an issue.

Now two things impact this: One is the talk about lifting the cap off the Medicare tax base; the other one that impacts deferred compensation a lot is the proposed $1 million cap on compensation deductibility. It's going to force more people to think about putting it into deferred compensation. On the other hand, when they're getting pushed to put it in deferred compensation because of the million dollar cap, they're getting pushed to not vest it because of the Medicare lack of a cap. So, you get into a situation where you're more likely going to have deferred compensation that is subject to risks of forfeiture based on postretirement consulting.

The other area that we've dealt with is postretirement covenants designed not to compete, which clearly, under Section 83, involve a risk of forfeiture if they're meaningful. The question is, would that be subject to FICA if it's payable under a noncompete? I don't know the answer to that, but I think it's maybe one way to get around a lot of the FICA and Medicare issues.

The reporting of the payments under the deferred compensation is a real big issue, too, and this is where I see a lot of problems. After the person retires and they're receiving their deferred compensation, whether it's under a supplemental executive retirement plan (SERP) or a top-hat plan or an excess plan (whatever type of nonqualified deferred compensation), the payments to that individual should be reported on a W-2. Typically, I see more than 50% of the payments being reported on a 1099 which causes a problem because then the individual possibly will put that 1099 onto a Schedule C and trigger an SE tax that he or she shouldn't be paying because the nonqualified deferred compensation is not subject to FICA when paid. It was subject to FICA when earned. So, right there you can be hurting the individual. But from the company's standpoint, you haven't cost it anything. You've possibly cost the individual, and if they put the 1099 onto the other income line on their return, they're not paying an SE tax. Where I see a lot of problems come up is where they report it on a W-2. They put the whole amount in Box 10 where they're supposed to, and then they also report it as social security wages under Box 16 and take the FICA tax out which causes three problems. You've cost the company the FICA tax which they shouldn't have paid, you cost the individual the FICA tax which he or she shouldn't have paid, and the individual is then going to get a notice from social security saying you made more than the earnings tests. You're going to lose part of your social security.

I had one client that would mess this up year after year. They had about 10 or 12 people on deferred compensation. In October of every year they could count on getting 10 or 12 nasty letters from former executives saying, "You messed up again. How come I got this notice?" I'd ask them what's going on? They said, "Well, we reported it." But I finally asked them to show me how they reported it, and what came up was they weren't taking the social security tax out; instead they were reporting it in Box 16 as earned wages. The simple solution was to not report it in Box 16. A W-2 may look weird when it has something in Box 10 and nothing in Box 16, but that's the whole idea. That is nonqualified deferred compensation. That's the purpose. That's how you report it. A lot of times your FICA tax and your taxable wages don't necessarily match because of a 401(k) or a 403(b) or a lot of reasons. So, there's no reason it can't be smaller. So, an area in which I see a lot of problems is the reporting in the taxation under 3121.

The next major area I want to talk about, and then I'll get into specific cases that I've dealt with, is just some of the special Section 457 problems. If you work for any tax exempt, ask the person who handles either their tax department or their human resources department how he or she deals with Section 457? I guarantee you that if you do enough work with tax exempts, you're going to have at least some of them say what is Section 457? I had a very large tax exempt that had annual revenues of about $700 or $800 million, that when I asked the head of their tax department how they dealt with Section 457, he looked at me like I'd just come from Mars. That was a real problem because they had a lot of nonqualified deferred compensation, and they had never addressed the 457 issues.

Here is the two-minute description of 457: (this covers both state and local governments and tax exempts) for the tax exempts, it says that to have a nonqualified deferred compensation plan that won't be taxable, it either has to be an eligible plan or it has to have a risk of forfeiture under 457(f). An eligible plan limits the deferral amount to $7,500 a year, and that $7,500 works in tandem with the 403(b) limit of $9,500. So, most larger tax exempts, because they maintain 403(b) plans are not going to be able to have an eligible 457 plan because no one would put money in a 457 plan if they have the ability to put it in a 403(b). The 403(b) is absolutely secure from creditors. Typically, it's very similar to a qualified plan. A 457 plan is subject to the creditors of the employer, and it's not funded. So, there's no reason to have a 457 plan if you have a 403(b) plan. So, for most large tax exempts, I think you can assume that any nonqualified deferred compensation they will have won't be an eligible plan.

Then you have to look to what should they do? A lot of them have grandfathered 457 plans. This is a pre-August 16, 1986 solution, and I think that date comes from one of the trigger dates of the Tax Reform Act of 1986. I'm not sure if that was when either the Senate or the House Committee Report came out. If they were entered into before that date, you can continue deferring under that agreement regardless of the amount or the percentage. Anything goes, and it doesn't impact your 403(b) amount. The problem is that you can't touch this agreement at all, other than to apply the percentage that's being deferred to a new compensation amount. So, if the individual says take 10% of my compensation and put it into the deferred compensation, and their compensation goes up, you can take a bigger amount because it's the same percentage, but you can't change any of the deferral aspects of the deferred compensation arrangement.

There's some question as to how you can change the payout provisions of it. Some people take the approach that the employer can unilaterally change the payout provisions and it doesn't impact it. Others say that as long as you're not delaying, and as you enter into the change far enough ahead of when it would otherwise be paid, you can change them, too. I think there's an unknown amount of risk involved if you make those kind of changes.

I'll give you an example of a situation I had a few years ago. A local tax exempt had a grandfathered 457 plan. To digress for a second, 457 also applies to nonqualified defined-benefit plans, and the hard part is figuring out what the annual deferral is, and it applies to an employer-provided benefit. It doesn't have to be a voluntary deferral. It can be an employer-provided deferred compensation plan. It's still subject to 457. A tax exempt had a very high-profile chief executive. To persuade this person to leave his prior employer, they had to give him some good perks. One of them was a nonqualified defined-benefit plan upon his retirement. It was entered into, I think, in 1983. So, it was grandfathered. There's no problem. And it had a decent benefit in it.

In 1987 or 1988, he realized that he really needed more than this for retirement. It wasn't enough. So, they went to their attorneys and their actuaries, which were both very reputable and very good, and they said, amend this deferred compensation plan and change the defined-benefit formula. By doing that they triggered an immediate tax on the whole amount at retirement. The day this individual retired he would be taxed on the whole amount of the deferred compensation, the actuarial present value of the deferred compensation, and it was about $185,000 in the old deferred compensation, the original agreement. All they added was a present value of about $35,000, but by adding the present value of about $35,000, they triggered the tax on the entire $220,000. The solution we came up with which was interesting was that the agreement hadn't really been formally approved by the board of directors. So, we immediately contacted the board of directors and told them whatever you do, don't approve this plan. Say that the old one has not been changed. It will never be changed. And set up a separate side agreement for the additional amount. It wasn't clear whether it would or wouldn't be an eligible plan, but it didn't matter because at least then they protected the old grandfathered amount. We got to it quick enough where it hadn't been approved by the directors, but if it had been approved by the directors, they would have been sunk, and this individual would have had a bad tax situation when he retired.

FROM THE FLOOR: This suggests that any nonqualified plan, whether it's connected to a Rabbi Trust or not should have a provision, at least from the employee's perspective, that if, for any reason, the tax consequences become accelerated, then the distribution also becomes accelerated. I think that's an important thing to have. You may, again, have a trustee literally applying the terms of the plan that calls for certain payment dates, and if you have a less-than-friendly atmosphere between the former executive and the company, the trustee may not be able to have the authority to amend the terms of the trust or the plan, or maybe the company would say that the investment isn't designed that way, so we're not going to pay you in advance. I think you want to make sure that kind of protective provision is in there for the employee.

Typically, you're put in a qualified plan. This plan is subject to receiving approval from the IRS as a properly qualified plan. You can get back any contributions made, if it doesn't pass. Can you write something into an unqualified plan saying that if this doesn't match up to all of the nonqualified rules that we're trying to adhere to, then it's basically null and void and never existed?

MR. NAIDA: I think you can do it. The problem isn't so much that the organization doesn't have the ability to fund it all at the date of retirement. Whether they have the ability to fund it or not is irrelevant because it's still going to be taxable because that's not a substantial risk of forfeiture. A substantial risk of forfeiture has to be that it's conditioned on future performance of services. If they go bankrupt, that's a different situation, but if they do have the ability to pay it but into the future, it's still going to be income. That gets into a lot of the Rabbi Trust issues in the informal funding. That's why it is important to make sure they have the ability to pay it in case they need to accelerate it.

Another interesting situation with a 457, is that it's not a replacement for a 401(k) plan for a tax exempt, because tax exempts are subject to Title I. State and local governments aren't, but tax exempts are. So, if you have a deferred-compensation plan that covers someone other than a select group of highly compensated or management employees, we're not really sure what it means. I guess it's kind of like obscenity – you know it when you see it but if you put in an obscenity restriction for everybody, clearly that's not a select group. It's obvious sometimes when you don't have the select group, and I've had clients try to put in a 457 plan as a substitute for 401(k). It doesn't work because ERISA will say you have to fund it, and if you fund it, then it doesn't fall under 457 because it's not an unfunded plan, and it becomes immediately taxable to everybody. A lot of tax exempts make that mistake, especially the small ones.

The second situation I had was bizarre. A very large tax exempt had a CEO who was about to retire, and they wanted to nudge him into retirement. They didn't want to fire him, but, on the other hand, they weren't going to be heartbroken if he left. So, they wanted to give him an incentive. They cut a deal with him that they would give him a consulting arrangement for three years at some good money and give him a 100% joint survivor nonqualified annuity. Unfortunately, this occurred in 1989. This individual happened to have our tax department do his individual tax return. When he came in fortunately the tax person who was doing it had heard something about Section 457. Unfortunately, he had this annuity which was nonqualified and it wasn't one he could cash in either, it was just a plain, old joint and survivor annuity they'd actually gone out and bought. He had a $400,000 taxable event with $40,000 of cash to pay about $120,000 of tax.

We devised some panic solutions. We talked to the organization which felt bad about it. The consulting firm that had told them to do it felt even worse. That's another story all together. They loaned the former executive the money to pay the tax, then bumped up his consulting amount enough each year so that he could pay back the loan. It reduced the future annuity because now that he has paid the tax, his annuity has an exclusion ratio. Each time he gets a payment, part of it's taxable, part of it's nontaxable. They'd intended for x amount to be fully taxable so he'd have x minus the tax as his annuity. Well, now what we had to do is back in with a bunch of circular formulas so that the after-tax amount from this now-partially taxable annuity was going to equal the former taxable amount of the full annuity which meant that they had to pay him less each year. So, instead of paying him, say, $50,000 a year, they only had to pay him $38,000 or $39,000. It took an awful long time to figure this all out. In the end, it ended up costing the hospital about $60,000 or $70,000. They went back to the consulting firm that had done this and told them if you ever expect any work from us in the future, you'll cover the cost, and the firm did, although I think they fired them anyway. They probably should have let them sue. At least they would have had their day in court.

I'm going to go through some of the other basic problem areas and a few more opportunities. The one issue I had with the restricted stock is the timing. We had a savings and loan that went public, and contrary to a lot of other states, savings and loans in Michigan are generally very sound and actually are solvent; in fact, several of them qualify as commercial banks. So, from that standpoint Michigan's a very strange state. This S&L put in some incentive stock options (ISOs), nonqualified options, and a restricted stock package for about four of their executives, and the restricted stock was going to vest in six months. They also had the 16(b) restrictions which staggered out a little longer, but I can't remember the exact details. Nobody ever told these people about an 83(b) election. When they granted them the stock it was about six dollars a share. The restrictions lapsed on the first segment on January 16 of this year, and the next segment will lapse on December 31. The stock at the time of the lapse of the first one was $30 a share. They received 1,000 shares each so instead of paying tax on the $6,000, they were paying tax on $30,000 because nobody had told them about the 83(b) election. So, the timing is very important. You have the 30 days, and if you don't do it from the date of the grant, and that's from the date of the grant of the restricted stock, you're out. You can imagine if you've gotten a grant of restricted stock in, say, Apple Computer, or Microsoft, which can really go up a lot in the six months or 12 months before they vest, it can make that 83(b) election a big deal.

There is another problem area to think about when you have nonqualified deferred compensation with a tax exempt. Let's assume you've decided that you don't care. You're going to pay it all out in a lump or whatever. You have a major issue of reporting compensation to the executives on the 990. If you suddenly have a spike one year where your executive goes from making $200,000 or $300,000 a year to suddenly making $700,000 or $800,000 or $900,000, that could be an audit trigger. The IRS is out on somewhat of a witch hunt to find certain large hospitals and is particularly trying to revoke their exempt status. You don't want to give them one more bullet in their gun that they can use to shoot at you. You don't want to have given excessive compensation to some of your executives. This is another reason to make sure you structure the deferred compensation correctly. And I've been doing a lot of work with a couple of our tax exempts. If you get a whole potpourri of ideas you can come up with a reasonable plan.

The first thing to think about is severance pay. Severance pay is a welfare plan under ERISA. Although it's not absolutely clear, presumably it is not subject to Section 457. Severance pay allows you to pay out up to two year's pay over two years after termination of employment. So, that's a good start right there. If you start with a severance plan, you've solved most of the problems you have. It's like a salary continuation plan, but you can at least fill up those first two years after retirement with some amount. It can be very helpful if you're looking at someone who's retiring early at, say, age 60, and you want to give them something from age 60-62, without using a qualified plan window or supplement. It's a way of doing that.

The second area that I think has been really underutilized and is not really that bad of an idea is Section 403(c) accounts. In a 403(c) account you're putting in taxable amounts into either an annuity or into mutual funds, just like a 403(b). The difference between 403(b) and 403(c) is what goes into 403(b) is nontaxable. What goes into the 403(c) is taxable, but the earnings on that account are tax deferred. So, if you start somebody out at a relatively young age, they can build up a lot larger amount, and you can add up to a fairly significant sum. In most cases, it's secure from creditors. So, the executive of a tax exempt may have to pay some more tax up front. We've structured a lot of them as such: we don't want to put $20,000 into your nonqualified deferred compensation. We can't really do that. If we put it into some sort of internal funding, it's still subject to our creditors, and with malpractice the way it is, who knows what might happen? We'll take the $20,000, peel off $6,000 of it, and give it to the individual so he or she can pay the tax. We'll take the other $14,000 and put it in a 403(c) account in the person's name, and it'll grow tax deferred until retirement. This gives the individual a lot more flexibility in receiving their retirement income because the only restrictions are the age 70 1/2 withdrawal requirement. So, if the individual gets to retirement age and says, geez, I can live for the six or five or eight years between now and age 70 1/2 on my other earnings, they can get a much larger otherwise deferred compensation arrangement by leaving the 403(c) accounts the way they are.

Split dollar insurance can be a solution. These are not necessarily great ways to solve the problem but you'll avoid the big impact you get when you have a nonqualified deferred compensation hit at once and absolutely kill somebody on the date of their retirement. If you do split-dollar insurance, you can partially vest it over time and stagger out the tax benefits at least in the years prior to retirement. Then you can have it hit at retirement, or have it phase in the whole time of employment with gross-ups. This is really confusing, but we have one client (the same client that had the joint-and-survivor annuity that blew up in their face) that decided the next time they wanted to do one of these, they'd do this up front. They do all these calculations with knowledge of it and say, okay, we can't do a nonqualified deferred compensation. We'll do a split-dollar arrangement with you. We'll vest you in the years as you're earning it. We'll gross you up for the tax, and then we'll back it out because you're going to be getting some tax-free income in later years, and it turned out it wasn't a bad alternative for them. The individual is completely secure in their retirement because the split-dollar insurance is in their name. The bad side of it is if the executive decides to leave, they're going to take it with them. It is their policy, and all they have to do is pay back the accumulated premium; but it's another way to try and smooth out the income flow. You don't want an executive showing $300,000, $300,000, $300,000, $1.2 million. That is an absolute flag for an IRS audit. If they see this just say that it was deferred compensation that they'd earned, and because of 457 they got hit. You don't want them looking at you if you can avoid it.

MR. GARTRELL: You have to remember that 403(b) annuities can only be used in 501(c)(3) organizations.

FROM THE FLOOR: 501(c)(6).

MR. GARTRELL: Not 501(c)(6). For example, if you have a municipal union in which employees work for various municipal organizations, that's likely going to be a 501(c)(6), and it's not going to be eligible for a 401(k) as a tax exempt, and it's not going to be eligible for 403(b) since it's not a 501(c)(3). Basically, you're left with 457 unless you go the qualified plan route.

FROM THE FLOOR: Versus the trade association. They can't do any of it.

MR. GARTRELL: What's the trade association situation?

FROM THE FLOOR: They're a (c) something. What they're muttering about is trade associations are neither. So, they're not eligible for anything.

MR. GARTRELL: He's suggesting that there's even more lurking. Also, does anybody have a tax exempt with a grandfathered 401(k)? And you might spot one, too. Now, this occurred to me when listening to Jim talk, so I don't have the cite, but there is an IRS letter ruling out there that says if you have a participant in a 457 plan, and he puts $1 in, the effect is that participant's 457 deferral, plus the 401(k) deferral, can't exceed the 457 limit. The IRC 457 limit is $7,500 which is about $2,000 less than the 401(k) deferral. If Congress doesn't change the laws the 401(k) deferral limit will continue to increase but the $7,500 is frozen. So, if you're testing such a plan, you've got hopefully a 457 plan that is available only to a select group of highly compensated and management people. So, hopefully you'd have the deferral issue come up only with respect to a few people, but, of course, they're the people that most likely will want to go up to the 401(k) ceiling. If any of you want to know the cite, let me know, and I'll track down that letter ruling for you.

I've never seen anyone do a secular trust.

FROM THE FLOOR: The Loch Ness Plan. Everybody talks about it. Nobody sees it.

MR. GARTRELL: That's right. I've certainly been at seminars where people talk about the explosive growth of secular trusts. They just haven't been exploding in my back yard. A secular trust, unlike a rabbi trust, calls for immediate taxation to participants. I mean that's bad enough, and that discourages most employers from setting up a secular trust. The IRS says that if you have a secular trust, you have a trust that violates 410(b). It's never designed to be a qualified plan. It violates every other provision behind 401; it also, among thousands of other things, violates 410(b). It, therefore, is a plan that is pushed into the 402(b) problem for nonexempt trusts.

Section 402(b) says if you have a nonqualified plan, the participants can get taxed according to the rules of Section 83, but it says if one of the reasons that you are not an exempt trust is because of a violation of 410(b), then all the highly compensated people are taxed on all the income they earn in the year that it's earned. So, if you have a secular trust, and it's accruing income, and these people are highly compensated, which most of them are going to be, they're going to recognize income equal to the growth of the fund. Now, that's a horrible result. If you have it invested in mutual funds or stocks, normally they don't recognize any income but, in effect, tax on the value. Perhaps insurance could help you in that circumstance. I think the more I reflect on it, the less I believe that's true. I think it probably is the case that the entire value, whether taxable or not, outside of a secular trust would be taxable inside a secular trust. So, that suggests you might want to put in an investment. Here's the trick: you invest in a secular trust, you buy an investment that's going to constantly go down in value, and then I guess you'd solve the problem. There are letter rulings on that, and I'll certainly be happy to provide you with those, although I think you can find them in Question and Answer 165 of the *Tax Facts*. I think it's Question 165 or it's certainly very close to it.

FROM THE FLOOR: In the 1992 or 1993 *Tax Facts*. They renumbered them last year.

MR. GARTRELL: I think it's 1993. I think it's the most recent, biggest version out there. And also in that same set of sections are a couple of rulings that suggest that the 72(t) 10% penalty applies for secular trusts.

FROM THE FLOOR: It's really insane.

MR. GARTRELL: It's really absurd. Now, those suggestions in the tax-exempt area lead to what I think Jim posed as a great solution I've not yet looked at it, but I'm going to trust him that it works which is 403(c). In a tax-exempt area you can get around 457 creatively, and I think one way you can do it is by using a sort of rabbi trust. Now, if 403(c) is an alternative, that's even better because you don't have to worry about the claims of creditors, and you may have found an effective way to do an end run around 457 but you have to pay the tax, and you may want to deal with the gross-up to the employee, but in many situations that's a far preferable result than to have no deferred compensation available.

MR. NAIDA: One other point on the secular trust. One solution we've heard is that the secular trust be set up as a grantor trust of the employee. Then you have the Section 402(b) issue that it's a grantor trust by the employees themselves as a grantor-retained interest trust. The employer gives the employee the money, and the employee puts it into this trust that has a 10- or 15-year life or whatever, and if the employee doesn't put it in, you just don't give them the money anymore. The incentive for the employee to actually follow through with the trust is that if you don't put the money into the trust like you said you would, we won't give you next year's contribution. That has been put forth as one way around it. It just seems like kind of a silly way to try and get around it. There might be another way to skin the cat.

MR. GARTRELL: There are three other issues to just kind of round out the list. I've not defined rabbi trusts, but I'm sure most of you know what they are; rabbi trusts are ways of providing some security to the executives, and it's good security. Again, when you look at the fact that most companies do go insolvent, the fact is the large majority of them are small companies that probably aren't going to have nonqualified plans anyhow. In the big companies, or sound companies, the circumstance under which you don't get paid is if there is a dispute with your former colleagues or in a change in control situation, and those are instances in which a rabbi trust is just great. I mean there's no ability for the company to tinker with it. You have an independent trustee, and a rabbi trust makes perfect sense. The employee is not taxed. The assets are subject to the claims of the company's creditors, but only in the event of bankruptcy or insolvency.

So, if that happens, it's not worth anything, but if you have a fair amount of confidence that won't happen, then a rabbi trust makes a lot of sense. They can be more attractive in certain tax-exempt situations, but, be that as it may, the IRS does have a model rabbi trust now. I think you can feel free, if you're careful, to tinker with it in certain respects to suit your circumstances, but you certainly wouldn't want to do a rabbi trust without picking up the model IRS document to see how that fits you. Incidentally, I will say that it solves one dilemma that had been kind of spun out there by an IRS official. The IRS and the Department of Labor are great for creating law by innuendo and rumor, and the innuendo was that if you had a rabbi trust that required funding in the document, then you have a funded plan for Department of Labor (DOL) purposes, for ERISA purposes, and you no longer have an unfunded plan for a select group of highly compensated employees or management; therefore, you've blown the ERISA requirements. Well, a lot of companies would like to require some funding. The IRS hasn't said much in its model document about required funding as a general principle, but apparently in a change in control situation it will permit, under its model, a requirement that the company fund immediately in the event of a change in control. So, I think that's a real helpful development, and there is a blessing now of what's called a springing rabbi trust.

The final thing that I wanted to mention is that there are ways to avoid the ERISA requirement and make a plan available for broad-based groups of employees, but you have to make it something other than a pension plan. Maybe you would provide for five-year payout. It requires some effort, but you can do it. If you have something like a phantom stock plan or something that is either a stock plan or mirror stock, there are securities issues that you have to pay attention to. The Federal Securities Laws generally are not too bad. In California the State Securities Laws create a real problem for phantom stock plans, and you may have to have the plan, even a phantom stock plan, approved by the Department of Corporations or whatever you would have to do in your particular state to comply with the state's Blue Sky Laws.

MR. NAIDA: One last comment. This is going back to the tax exempts. I had an interesting situation, and if you have clients in this type of situation, you might want to think about this. Sometimes the Section 457 issue is you want to trigger the taxation, and you want to fund the plan. I had a smaller, urban hospital having financial difficulty. Their chief financial officer had about $400,000 of old, grandfathered deferred compensation, and he was wondering how he could get his hands on that money. We said, "Well, you'll have a taxable event." He said, "I don't care if I have a taxable event. I want to have an event." For his situation it made a lot of sense to go out and actually fund the plan and trigger the tax to him because then he knew he'd have the money. I mean 70% of $400,000 was a lot better than $0 nontaxable. So, there are situations sometimes where you want to blow some of the requirements to get the funding because it's to the individual's advantage.