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EXECUTIVE BENEFITS: PART I

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The purpose of this session is to provide information on executive compensation plans in the U.S., with special emphasis on nonqualified deferred compensation programs.

MR. SILVIO INGUI: This is the first of a three-part pension seminar program. During this and the following two sessions, we will discuss various types of executive compensation programs, with special emphasis on nonqualified deferred compensation plans in the U.S. For those of you who have the stamina to participate in all three sessions, we hope to have you go away with a working knowledge of executive benefits. Part 1 of this seminar program will provide a description and purpose of the various types of executive compensation plans. In Part 2 we will cover the federal taxation of these benefits and ERISA issues. Finally, in Part 3 we will conclude our discussion on various ways to secure these benefits and some of the actuarial and accounting implications. We also hope to have some time at the end of each session to answer any questions you may have.

With me are two gentlemen who are both attorneys with extensive experience in the area of executive compensation. These gentlemen are Andrew Oringer from the New York office of Rogers & Wells and Arthur Woodard from the New York office of Kaye, Scholer, Fierman, Hays & Handler. Andy is counsel at Rogers and Wells, where he is the senior member of the firm's employee benefits and executive compensation group. Andy has spoken and written on a broad range of employee benefit issues. He earned his law degree with distinction from Hofstra, where he was Associate Editor of *The Law Review*. He received his MBA from the Adelphi University, and his undergraduate degree from Duke. Mr. Woodard has been a partner at Kaye, Scholer, Fierman, Hays & Handler since 1983, and he heads up that firm's employee benefits practice. He concentrates primarily in the area of mergers and acquisitions, executive compensation, and fiduciary issues. He is a graduate of CUNY, with bachelor's and master's degrees and received his law degree from the New York Law School.

I will begin this session with some background information on the growing importance of nonqualified deferred-compensation plans and the description of those plans typically used to supplement retirement income.

I categorize the reasons for the growing importance of nonqualified deferred-compensation plans into four areas: legislative changes, growing shift to defined-contribution plans, attraction and retention of key employees, and tax-sheltered accumulation.

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In the first area, legislative changes, 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 regarding vesting, coverage, participation, Social Security integration, definition of compensation, and general nondiscrimination are all aimed at providing lower benefits to higher paid employees. Many companies discovered that the changes required to bring their plans in compliance and maintain the pre-TRA benefit levels for their executives were going to be too costly. Thus, an approach to deal with this problem is to change the qualified plans to meet pre-TRA benefit levels for lower and middle management employees, which tends to result in lower qualified benefits for the senior management. To fill the void, a nonqualified deferred-compensation plan could be implemented for senior management.

The second blow delivered by TRA was greater restrictions on contribution and benefit limits under Section 415 of the Code. The defined-contribution dollar limit of $30,000 was frozen and will continue to be frozen until the defined-benefit limit reaches $120,000. The defined-contribution limit had attained a level of over $45,000 in 1984 just prior to it being reduced to $30,000. Thus, it has been some time since that defined-contribution dollar limit has been increased. For defined-benefit plans, the $90,000 maximum dollar benefit that was implemented by TRA was made applicable at the social security retirement age with actuarial reductions for retirement ages prior to the social security retirement age, and elimination of the $75,000 floor.

In the area of the 40l(k) plans, changes were made to further limit deferrals by senior management employees. The maximum deferral was reduced to $7,000 for 1989. This limit is indexed for inflation for years subsequent to 1989. In addition, a more restrictive average deferral percentage test was implemented, the 401(m) test was introduced, and the definition of "highly compensated employee" was changed. These changes further restricted the ability for the higher paid to defer compensation. Finally, a compensation limit of $200,000 was introduced in 1989 that was even further reduced to $150,000 in 1994.

When all the dust settled, it was very clear that changes in legislation had taken its toll on qualified benefits for senior management employees. By way of an editorial comment, I believe that the legislative changes backfired in some respects. They did accomplish their goal of reducing benefits for senior management. However, it is my opinion that lower paid and middle management will also be hurt, because many companies have discontinued and will discontinue their defined-benefit plans in lieu of less generous defined-contribution plans.

This brings me to the second reason why there is a growing need for nonqualified deferred-compensation plans, and that is the growing shift to defined-contribution plans.

Many companies have terminated defined-benefit plans and implemented defined-contribution plans. Also, companies with no retirement plans tend to lean toward defined-contribution plans, when considering a plan. Defined-contribution plans tend to produce inadequate benefits for older employees, which in many instances include the senior management people. Most defined-contribution plans are profit-sharing plans with no fixed commitment to contributions. Many defined-contribution plans are just 401(k) plans where the only employer benefit is a matching contribution. The employee who doesn't contribute receives no benefit, and even the highly compensated people who do contribute to the maximum may have their maximum reduced because of the inadequate participation among the lower-paid employees.

The jury is still out on defined-contribution plans, and only time will tell if they will provide adequate retirement income. Companies may wake up some day and find that their senior management employees cannot afford to retire. Furthermore, the age discrimination rules currently prohibit mandatory retirement for senior management people, unless they receive an employer-provided pension of at least $44,000 per year. This level of benefits may not be readily attainable through a defined-contribution plan.

The third reason for the growing importance of nonqualified plans is the attraction and retention of key personnel. In many instances a company's qualified plan may not be adequate to provide the benefits for key employees. Key employees may be older and even a qualified defined-benefit plan may not produce sufficient retirement income. A key employee may want to be kept whole, especially if he is an older employee and is leaving a company that had a good qualified pension plan under which he may be forfeiting some valuable early retirement subsidy as a result of the move. In some cases, a key employee may require a minimum benefit, such as 50% of pay, in order to make a move. Since benefit and compensation limits may restrict the company's ability to provide the required level of benefits under a qualified arrangement, a nonqualified program may be the best means to provide the benefits.

Another useful application for nonqualified plans is when the qualified plan is not sufficiently flexible to provide the benefits that key employees may desire. Nondiscrimination rules generally prevent special consideration being given to the key employees. However, you can tailor a nonqualified plan to the specific needs of the key employee(s). Special features, such as early retirement subsidies and fully subsidized surviving spouse benefits, can be provided through a nonqualified plan, which may not be practical through a qualified plan. The nonqualified plan can also be used to provide Social Security integration. As a result of TRA, some companies decided to adopt a simpler, nonintegrated qualified plan and provide the integrated portion through a nonqualified plan. Another example might be to use base compensation only in the qualified plan, and all compensation in the nonqualified plan for the executives.

The final reason for what I see as the growing importance and use of nonqualified plans is for tax-sheltered capital accumulation. As I discussed earlier, a senior employee's ability to defer compensation under a qualified plan was significantly reduced and restricted by legislation. Some key employees may wish to defer large portions of their bonuses or other compensations, or you may have situations where directors are looking to defer their directors' fees. Currently the only effective vehicle for doing this is through a nonqualified deferred compensation plan.

Having discussed the reasons for the growing importance of nonqualified plans, let's now look at some of the more common types used to supplement retirement. These are ERISA excess benefit plans, top hat or supplemental executive retirement plans (SERPs), salary deferral compensation plans, and Section 457 plans.

An ERISA excess benefit plan is defined under Section 3(36) of ERISA as a plan maintained by an employer solely for the purpose of providing benefits to certain employees in excess of limitations on contributions and benefits imposed by Section 415 of the Code. This type of plan does not have to cover a select group. However, it would be quite rare if an ERISA excess plan needed to cover lower paid or middle management employees, since typically benefits and contributions for lower paid and middle management are not affected by Section 415 limits.

An ERISA excess plan is exempt from the reporting and disclosure, coverage, vesting, funding, and fiduciary requirements of ERISA. In addition, they all are not subject to the nondiscrimination rules.

The second type, and probably the most common type of nonqualified plan, is what we call the 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 restricted beyond those that are restricted by Section 415. For example, the compensation limitation is not a Section 415 restriction, but a Section 401(a)(17) restriction. Thus, if the plan provides the benefits lost as a result of the compensation limits, you will have a top hat plan.

Unlike an ERISA excess plan, a top hat plan must only cover a "select group" to avoid subjecting the plan to ERISA coverage. Top hat plans also have to be constructed very carefully to avoid constructive receipt issues that can lead to early taxation of the benefits.

Finally, although a properly designed top hat plan is not subject to ERISA, it is however, subject to a one-time filing with the Department of Labor, and to the ERISA claim procedures.

Another type of nonqualified plan is salary deferral compensation plan. This is probably the simplest type of nonqualified plan. It basically allows a select group of highly compensated or management employees to defer receipt of all or a portion of their compensation to a later date.

MR. ARTHUR F. WOODARD: Silvio, I just wanted to add one thing before you continue. From a lawyer's point of view, where we typically see actuaries getting involved in the SERP area is when the executive that you are trying to attract is looking to make up the benefit he's lost, in one fashion or another, and/or to get some bang for the buck. What I've seen the actuaries come in and do is determine how to structure that. Do you give the person an acceleration of years with his new employer on the nonqualified arrangement? In other words, does the person get two years for every one or three years for every one that he or she actually works? Do you just give him or her all past service with the prior employer for purposes of that, or do you do something else? Also, how do you arrive at the present value of a lump sum? What interest rates are you going to use? How are you going to deal with that? Are you going to make it very rich for the person even if he or she only stays a year or two, or are you going to make the person stay a number of years? What form are you going to pay it in? If it's going to be a lump sum at all, what is the cost of that? We've had a lot of interchange on the actuarial side in that area more than any other that we're talking about now.

MR. INGUI: The last type of nonqualified plan that I wish to discuss is called a Section 457 plan. TRA basically made your traditional top hat plans unavailable to tax-exempt organizations. However, it did extend Section 457 of the Code to tax-exempt organizations. Prior to that, Section 457 basically applied to just state and local government or entities of state and local government.

Section 457 plans fall into two categories: eligible plans and ineligible plans. Eligible plans must meet the six specific requirements under Code Section 457. First, the plan must be established and maintained by an eligible employer, which is a state or political subdivision of a state or organizations exempt from tax under subtitle A of the Code. Second, only individuals who perform services for these employers may be participants. Third, the maximum deferral for any taxable year is $7,500, or one third of the includable compensation if less. That amount is reduced by any amounts contributed under tax-deferred annuity plans (i.e., 403(b) plans), and under grandfathered cash and deferred arrangements. The law eliminated the use of 401(k) plans by tax-exempt organizations, but grandfathered those that were already in place. Thus, if a tax-exempt organization has a 401(k) plan, and its employees are contributing to that plan, then those contributions reduce the limit under the Section 457 plan. The Section 457 limit is also reduced for any simplified employee pension (SEP) plan contributions under 402(h)(1)(B) of the Code and for contributions to Section 501(c)(18) plans. An exception to the $7,500 limit applies during the three taxable years prior to normal retirement. In these years, the limit is $15,000, or if less, the sum of the regular limit and the maximum deferrals from prior years that were not used.

The fourth requirement is that compensation may be deferred for a month if a deferral agreement has been entered into before the beginning of such month. Fifth, the distributions may not be made to participants or beneficiaries earlier than (1) the calendar year in which the participant attains age 70.5; (2) when the participant separates from the employer's service; or (3) when the participant is faced with an unforeseeable emergency. Finally, the plan cannot be funded. That means the assets of the plan remain the assets of the employer.

If the six requirements are met, then the participants' deferrals are not taxable until they are paid or made available to participants. Thus, in this respect an eligible 457 plan does resemble to some respect a qualified plan. If a 457 plan does not meet all six of these requirements, it is considered an ineligible 457 plan. An ineligible 457 plan thus resembles the more traditional nonqualified plan of a taxable company. The main difference though is that under an ineligible plan, the participant is taxed when the amount ceases to be subject to a risk of forfeiture. For ineligible plans, this tends to be when the participant becomes vested, whereas, in your typical nonqualified plan, that doesn't occur until theoretically the participant receives the benefits.

When the law was changed, there was some grandfathering for those tax-exempt organizations that had the traditional nonqualified plans. Basically the law said that, if there was an agreement in writing on or before August 16, 1986 and it provided for the deferral of either a fixed amount or an amount determined pursuant to a fixed formula, then that plan was grandfathered and could continue under its terms until and unless the benefit formula or the fixed amount was modified.

Andy Oringer will discuss some of the other types of executive compensation plans that are not the traditional retirement supplement plans. These are severance plans, stock plans, and golden parachute plans.

MR. ANDREW L. ORINGER: I'd like to just mention a thing or two about 457 plans, only because what I'm most directly going to speak about next is severance plans, and some problems that arise with 457 plans serve as a good lead-in to certain of the issues relating to severance plans.

As Silvio mentioned, tax-exempt employers are stuck with the 457 limit. If, in fact, a plan is established by a tax-exempt employer and the deferrals under the plan exceed the relatively low limits provided under Section 457, then there is current inclusion of income at least at the time that the person vests. As we will talk about later, when you're dealing with nonqualified deferred compensation, while it is all well and good to talk in theory about taxation prior to someone's actual receipt of the money, the fact of the matter is that plans are almost invariably structured so that you do not have taxation prior to the time that the money is received. You can have a very complicated set of rules that say that it's no big deal except that in this case, there may be taxation before receipt. What that really means in practice is that the plan is probably structured to avoid that rule. Thus in the case, for example, of the tax-exempt employer that establishes an ineligible 457 plan, as Silvio mentioned, the result will be that upon vesting the person is taxed whether or not he or she has received the money. However, in 99 out of 100 cases you won't have a plan that will have a situation where there is no possibility of receipt, or in fact, no actual receipt at the time of vesting if that vesting leads to taxation. Again, what you have there is a result under which you will not get taxed until receipt even though the hoops you have to jump through may be complicated.

For a tax-exempt employer with a Section 457 plan, it may be extremely limited to the kinds of deferred compensation that it can provide to its executives in a sensible fashion. I've heard two justifications for this limitation for tax-exempts. One is that you don't have the normal tension in the case of tax-exempt employers that you would in a for-profit situation, where the employer ordinarily, in a taxable context, would desire to get an early tax deduction for the payment of the compensation. As we will discuss later, in the case of nonqualified deferred compensation, the deduction will wait until the payment. If you work with qualified plans a lot, there results a timing mismatch where the deduction arises prior to payment. Nonqualified deferred-compensation deductions wait until payment, so you have, on the one hand, in the for-profit case, the employer trying to get an earlier deduction, while the employee is saying, "No, no, no, hold the money back, I prefer later inclusion." Thus, there's a kind of a tension there where the employer might desire to have current payment and the employee might desire to have deferred payment. So Congress is happy with nonqualified deferred-compensation where the money is just all put out later because, although the employee defers taxes, the employer loses a current deduction. In the case of a tax-exempt, the employer could care less. It doesn't pay taxes, so deductions are generally irrelevant. There is no tension there, and if the employee comes to the employer and says, "Please defer my payments at least from a purely tax deduction point," the employer might say, "Fine." Obviously there is a whole lot of other factors that might go into whether or not the employer would agree to that, but in terms of the pure tension on the tax deduction side, it's not there.

The second justification I've heard is that tax-exempt employers just frankly have enough in the way of tax benefits, and we want to simply limit any other tax benefits that tax-exempt employers could have, including the ability to provide tax-deferred compensation to employees.

What is a tax-exempt employer to do? This is what takes us to the next topic, which is severance. There is an exception in Section 457 for payment under severance plans. Before I discuss severance plans, I want to emphasize that, even though I have used Section 457 as a springboard to discuss severance, the concept of a severance plan as a way to provide nonqualified deferred compensation, as I believe Arthur is going to have something to say about it before we are done with the topic, has much broader implications than to just the Section 457/tax-exempt area.

There is a provision in ERISA where a severance plan will not be deemed to be an ERISA pension plan. The advantages of that is that you will not be required to comply with many of the ERISA requirements, most notably funding (i.e., setting aside assets separate from the claims and creditors of the employer). If a severance plan were required to be funded, you would not only have a problem with the fact that the employer has no desire to fund it as a business matter, but also you could have a very tricky and adverse tax consequences to the employee. In addition, such things as vesting and eligibility requirements provided under ERISA would not apply to a severance plan if it is deemed not to be a pension plan. It would technically be deemed to be a welfare plan.

Section 457 contains, as I said, an exception for severance plans. Many, therefore, have been taking the position that, if you set up a plan that is a severance plan for purposes of ERISA, and therefore not a pension plan but rather a welfare plan, you can then do that without regard to the Section 457 limitations because Section 457 does not apply to severance plans. The IRS has stated in a number of speeches that just because you are a severance plan for ERISA does not necessarily mean you're a severance plan for 457 purposes, so therefore if you structure a severance plan that meets the ERISA rules for being a "welfare plan" rather than a pension plan, it does not necessarily mean that the IRS will agree with you that you have successfully defeated 457. I would like now to discuss severance plans more generally and leave 457 behind, because the significance of doing a severance plan that is qualified for ERISA purposes goes well beyond 457. It is very important that you not be subject to ERISA if you do a severance plan so that you exempt yourselves from the funding, vesting, and eligibility rules of ERISA.

MR. WOODARD: The only thing I would add to that is that 457 and 403 used to essentially be back orders. Nobody paid a lot of attention to them. The universities had them, the hospitals had them. They were just there. Everybody is paying attention today. If you represent a hospital in particular, or if you represent a university, you're probably also going to have to pay attention to it in the next year or two. The IRS has audit programs going in most of the big cities aimed at hospitals, and where they start is the 403(b) and then they go typically to 457. Section 457 is basically useless if you have a 403(b) plan because of the offset of the $7,500 limit for 403(b). The tax-exempts had a huge appetite to get around 457 beginning in 1986 when the rules changed, and many consultants sold a lot of plans that were "bona fide" severance plans or other types of plans that are not subject to the Section 457 limits. The IRS doesn't like this, and I'm involved in a couple of audits regarding this. The IRS people foam at the mouth over those programs and pound the table and say, "That's not bona fide." They are very serious. They are talking about pulling tax exemptions for tax exempts over these issues. Whether that's a negotiating ploy or not, I'm not able to say at this point. If you represent any major tax-exempt, and you haven't heard something about it already, you might gain some points by mentioning to them that if they have one of these programs, they should think about taking a look at the situation in advance. Obviously, the IRS is somewhat limited in its ability to audit, but it is out there, and it is very active. In a recent speech, the IRS indicated it was extending the audit to universities. So far it's been hospitals, but the exact quote was, "Universities are big businesses, too, so we're going to take a look at them." It's a money raiser from the perspective of the IRS, at a minimum. If you screwed up these rules, you owe taxes. You owe taxes with interest, with penalties. It becomes a very big number, very fast.

MR. ORINGER: Something that Arthur just said is worthy of going back to. People forget sometimes that tax-exempt organizations are not just the private foundation down the street or the corner charity, but real, real, real big business. When Congress limits a tax-exempt organization's ability to provide deferred compensation, it puts the tax-exempt organization at a tremendous disadvantage in the workplace in terms of competing for top executives. The highest level executives of tax-exempt organizations can be extremely high-powered people with extremely rich compensation packages, notwithstanding that the organization is a "not-for-profit." There is a tremendous appetite, to use Arthur's word, for some of these organizations to figure out a way to compete with the for-profits for this top executive talent. Again, to go further on something that Arthur just mentioned in terms of the IRS pounding the table and doing a lot of speeches trying to scare people away from doing certain things, in this severance plan area, it is very frustrating. You have Section 457, which says that a severance plan is fine. You have Congress having done that at a time when ERISA regulations, which we're about to talk about, say here is an example of a severance plan. You have the IRS saying, we don't know what the rules mean and we're not going to tell you, at least officially, whether or not the ERISA severance plan rules should be used as guidance for determining whether or not you have a severance plan exempt from 457. This is something we're going to talk about later. This runs through a lot of what the IRS does in this area.

With no rules in place, the IRS is saying, "Here's what we think. We think this doesn't work." It's almost this culture of unofficial rule making because the speeches, as you may know, get extremely broad play. In a situation where somebody again goes to a lawyer to see whether he or she can do a severance plan that's exempt for 457, now the lawyer is put in the position of saying, "There are no rules, but there is this lore that has developed where the IRS, we know, from its speeches, believes that the severance for 457 doesn't work." Then the question becomes, what does the client say; what does the lawyer say? Do you say, "Gee, I'm really nervous about the IRS's position, I guess I won't do this"? Or do you say as some have said, "I'm not going to conduct my business in fear of a sequence of IRS speeches. I'm going to look at the authority I have and proceed on a reasonable basis"? It remains to be seen as to whether or not the IRS, with the official authority not out there, is successful at taking out programs that might work based on what limited authority we have. It also remains to be seen what kind of sympathies the ultimate decision maker, the tax court judge or district court judge, would have for the IRS or for the tax-exempt or anybody else in this kind of a case. When we get into some of the election rules in nonqualified deferred compensation, a disproportionate amount of the rules are developing through this network of speeches because of the lack of hard authority out there, and it becomes very difficult to practice in the area, as a consequence of it.

To go back now to the heart of the severance plan, forgetting about 457s, forgetting about all of this, because as I said, it is extremely important when you're doing a severance plan to not be subject to ERISA if you're looking at it as a method of providing deferred compensation. The ERISA rules have a safe harbor. It's important to recognize that the regulations on ERISA, which say that here's an example of a severance plan that is a welfare plan and therefore exempt from the more onerous of ERISA's rules, are a safe harbor. If you don't do what I'm about to list, it doesn't mean you're not a severance plan. In fact, in at least one case the Department of Labor has taken an agreement that does not technically meet the regulatory safe harbor for severance plans and has said it qualifies anyway. That is sort of a rare case, but it can happen. Most companies do try to conform to the safe harbor because of the ramifications of actively being an ERISA pension plan are not good if you've done it without structuring it in accordance with the ERISA rules. The first requirement of the safe harbor is that payments are not directly or indirectly contingent upon an employee's retiring. The word *retiring* there being a term of art, and it's as distinguished from any termination of employment.

What does that mean? That means that if I'm doing a program that's attempting to provide deferred compensation and I want to stretch payments out over a long period of time and I want to say, everybody who is 55 years old can go out and, as a supplement to the pension plan, we will give you this severance to tack on to your pension benefit, it will be unfunded. It is not subject to ERISA. You will get it for ten years, 15 years, maybe it will be for life. Who knows what it will be? That will be, at least to the Department of Labor, a real problem, because if the people eligible for the plan are either explicitly at or, depending on the age of the people who you have captured by operation, if they're nearing retirement age, the Department of Labor will take the position that the plan is contingent upon the employee's retirement, and will then say that it is not a safe harbor severance plan. The Department of Labor will then say that the plan is out of the safe harbor, it is not a severance plan at all, therefore, it is an ERISA pension plan, therefore where's your funding? Where's your eligibility? Where's your vesting? Where's any number of other things? When I say eligibility, I'm not talking about discrimination-type eligibility. I'm talking about things like you can't make somebody have more than a year of service before being eligible.

These are things that people do not intend to comply with when doing severance plans, whether they be ordinary severance plans, or these kind of deferred compensation severance plans. It's a real treacherous endeavor to do a severance plan in the case of some kind of an early retirement or retirement program. You have to be very careful that you're not either explicitly or by operation having the payments be directly or indirectly contingent upon an employee's retiring.

The ability to use severance for this purpose is limited, at least under the safe harbor. The total payments being made under the plan cannot be in excess of twice compensation. You take the person's final compensation, and you multiply it by two. Depending on who you're talking about, that can be a fairly large amount, and that is the amount of money you can pay out under the severance plan. A very important point here is for this purpose the "kitchen sink" is included in the definition of compensation: pension benefits, welfare benefits, fringe benefits, anything in the nature of compensation. So if you have a fairly highly paid executive who has a lot of perks and real good medical benefits and a pension benefit, and you add that to his taxable compensation and then multiply that times two, you may get somewhere with a severance plan. You may find the ability to provide a fairly decent amount of deferred compensation under the severance plan. Even though the two times compensation limitation sounds somewhat restrictive, it isn't necessarily the worst thing in the world.

Finally, the payments have to be made over a fairly circumscribed period. You can't play them out forever. In the case of a limited program of terminations—and again be careful dealing with early retirement windows because you might run afoul of the contingent upon retirement rule—you have to pay out either over two years, or you can extend out in two years past the normal retirement age. So that, in the case of a reduction in force, for example, gives you a fairly decent period of time potentially over which to pay out. If it's not a limited program, then you have to essentially pay out over two years.

The last point about severance is that, if you're dealing with one or two people and you're working out an individual arrangement with them, you may want to make the argument that the thing is not a plan at all and therefore not subject to ERISA at all. That is a bit of a treacherous argument and ordinarily the attorney will propose structuring it assuming that the individual arrangement is in fact a plan. But, depending on the appropriate circumstance, it may be worthwhile to explore taking the position that the arrangement is not a plan subject to ERISA at all. That will not mean, just as in the case of a welfare plan severance plan, that you're done. That's the ERISA funding side. That's the ERISA vesting eligibility other rules side. You still have to watch the tax consequences. The rules we'll be discussing later, relating to the taxation of nonqualified deferred compensation, will apply to any deferred compensation, whether or not in the nature of a severance plan, so you have to make sure that the money is again not taxed until actually received. I think with that, it makes sense now to go to a much more mainstream area in which deferred compensation is provided, a not forgotten, not missed area, which is the area of stock and other equity-type compensation, and Arthur will start off on that topic.

MR. WOODARD: Let me start out with something that I guess is fairly obvious. Again, Andy used the word *tension* in that area. We're talking about a tension-filled area in a lot of different ways. What the lawyers are typically doing in this, let's be very clear about it, is structuring ways to get the most money to executives on the most favored tax basis. These are big dollars typically. We'll talk about golden parachutes. The first golden parachute I ever worked on, the executive got $58 million at the end of the day. We can be talking very big numbers. The IRS sees those numbers, it doesn't like those numbers, and it doesn't like some of the things that people try to do. We structured one of the first indemnity insurance products that we'll talk about later. The IRS did not like it one little bit. The IRS spent six years jawboning about it. The IRS people, like Andy said, spoke at every American Bar Association (ABA) meeting, and hated it. They waited about seven and a half years to finally come out with a ruling on a different product where they gratuitously slapped the product we had created seven years before.

It's a tremendous amount of tension. I'll be a little more critical than Andy was; I call it legislation by speech. You have to pay attention to what they're saying, but what they're saying isn't necessarily the state of the law. The lawyers very often, at least, would be pushed to push the envelope as far as they can to say, "What really is the risk continuum here?" You fund it totally today, you're dead. It's unfunded, as Andy will talk about, you're probably totally safe. What's in between? We'll talk more about the things that are more questionable later. Right now I have the ability to talk about stuff that's pretty clean.

MR. ORINGER: There's an irony. So many memos that I write on nonqualified deferred compensation start off by saying, here is the IRS's position with the next sentence being, "However, many employers do not strictly conform to the IRS position."

MR. WOODARD: Or, here is the IRS position and here's the law, which also doesn't conform very often.

MR. ORINGER: Right, and it's an odd result because, often when you're talking to the client, there's not a real awareness that there are a large number of people who believe that what the IRS is saying is just wrong. If a person read in the paper that the IRS has come out and said here's what you can or can't do, then that person would put down the paper assuming here's what you can or can't do.

MR. WOODARD: The real problem is what you can or can't do really depends on whether you're really ready to go to court about it. There's no area that the IRS has done worse in court than nonqualified deferred compensation. It has lost, beginning in 1944 with the Veit case, just about everything it has litigated for the last 50 years. Whether that will continue, I don't know. However, nobody wants to litigate it, so very few people push it to the extreme limit. The question is how far you are willing to push it.

Stock plans and stock in general are also things that have become very hot. It's hard to pick up a newspaper today in any week, *The Journal*, *The Times*, whatever your local paper is, where you don't see some kind of an article or some kind of a statement by the chairperson of California Public Employees' Retirement System or the chairperson of New York State Pension Fund or somebody else basically saying, "Aha, there's not enough of an identity between corporate executives and the corporations they're running. They're making big bucks and the corporations are going down the tube, and we're going to have proxy fights, or we're not going to vote for management, or we're not going to support the program. We're going to do something because we believe that there has to be checks and balances." One of the checks and balances that I'll talk about is Section 162(m), which sets an absolute limit on the ability to deduct, on certain kinds of compensation, unless it is performance based. The reason Section 162(m) has the performance base is because people have made a decision, again, mostly in the newspapers, that if you get compensation that's based on some measure of performance, it's fine, whereas if you get it based on what people believe is not a measure of performance, it's definitionally bad and the Treasury should not subsidize it. The answer is probably somewhere in the middle of those two positions. The politicians don't like middle, so they made an absolute rule.

The easiest kind of stock plan for people to understand is plain old garden variety stock options. They're just what they sound like. It's an option to buy stock in the future. There are two kinds, one is lovely from a lawyer's point of view because he or she doesn't have any restrictions basically, that's nonqualified stock options. It's just what it sounds like. It's nonqualified. It does not have to jump through any real hoops. It's an option given to an executive, typically at fair market value on the date of grant, but not required to be fair market value on the date of grant. It is exercisable at some time in the future, generally somewhere between three years and ten years, and exercisable to a price that the stock will be whatever the date it is exercised. It has no real rules. It can be issued at a discount. I'll come back to the tax treatment of that in a second.

You look at that versus what's called an incentive stock option (ISO), which is, in effect, a qualified stock option. There was an old qualified stock option in the Code, so the IRS came out with ISOs to give it another name. The incentive that it was supposed to be, as we'll see on the tax side, is a different tax treatment than you get with nonqualifieds. ISOs don't have a lot of the problems the other things have, but they do have a fair number of statutory rules that you do have to meet. They must be granted a fair market value on the date of grant. You have to hold them for one year from the date of exercise and two years from the date of grant in order to get the favorable tax treatment. They can't exceed ten years as a plan. There are eight or ten rules that you have to go through.

The tax treatment of the two arrangements again is quite different. The nonqualified option is taxable as ordinary income on exercise on the difference between the then fair market value of the stock and the exercise price (i.e., it is includable as ordinary income to the employee and the employer receives a tax deduction).

On the ISO, the rule is no tax on grant, no tax on exercise, but tax on disposition equal, at a capital gains tax rate, between the value then and the value when granting. There is no tax deduction for the employer ever. The incentive in Congress' mind was capital gains rates for the employee. If you think back to about 1980 when ISOs came in, there was a very substantial difference between capital gains rates and ordinary income rates. Thus, the game in 1981 and 1982 was to put in ISOs. Everybody wanted ISOs because everybody wanted capital gains, 20% versus 50%. Then the Reagan Congress changed the rules and made the rates level. Now the issue was, executives are getting capital gains, but the employers are not getting a deduction, versus nonqualified plans where the executives were getting an inclusion at ordinary income, but the companies were getting a deduction, which was better. When you run the numbers, the nonqualifieds became better then because the value of the deduction obviously was worth something. What happened then? We structured programs where the employer would give up some of the value of its deduction to the employee to make up to the employee any difference between ordinary income and capital gains, if there was any. We shifted and we went to the nonqualified options being the favorite, and everybody put in nonqualified options plans. I'm exaggerating a little because most of the time you put in both, but you used one.

Today we're back to where the rates are somewhat different, and everybody is again saying which one is better. I think I'm seeing more ISOs come in today than non-qualifieds, but it is not heavy on either end in my practice. Maybe we're sort of in the middle today. It will change again. Maybe they'll drive capital gains to 15% or 12% or who knows where, and we'll go back to ISOs being the favorite.

MR. ORINGER: My experience has been that, while ISOs are definitely being more considered and are coming back a little bit because the rate gap is not nearly what it was at the time, nonqualifieds are still the rule. Combined with the fact that you're not in a mid-to-late 1980s mindset, where companies thought it was fine to give away anything to the benefit of the company so long as it was to the benefit of the executive. I'm seeing a lot of decision makers saying, if I have to give up the deduction, I don't want to do this for my executives. I don't believe that was the mindset of the 1980s.

MR. WOODARD: Neither option as of today, unless it is granted at a discount, has any real accounting impact at all. If a nonqualified is granted at a discount, it does seem logical to say that at least that portion of it should be a charge on the corporation's books, because you're clearly giving something in most people's minds today even though, of course, the stock could drop and wipe away that.

The FASB has said—there's actually more going on than that. What's happening here is, we're giving you an option, which we recognize for tax purposes has no readily ascertainable fair market value, but everybody knows it is worth something. You have all kinds of modeling programs out there that model an option. It's worth something. We ought to put it on the balance sheet today to show that the corporation has given up some of its assets to the executives. I think the FASB first floated that about 1985 or 1986. However, this year in particular, the FASB got very serious about requiring a charge to earnings, and had a series of open meetings and discussions. However, recently they withdrew the proposal for this year, because they ran into a firestorm of testimony against it again with even the Clinton Administration and a lot of Congress waving a small business flag that this will kill high-tech companies that give out tremendous amounts of compensation in options. I think a lot of that discussion was as bogus as the discussion on the side of responsibility of corporate America, but nevertheless, it was withdrawn this year. I suspect it will come back. I suspect that it will be something that companies will have to live with, and again, logic would say that there is some merit to it. I do think if somebody offered us 50,000 shares of IBM, most of us would think we've received something of value at the point that we received the piece of paper that said we had 50,000 shares to exercise, even though we haven't received a discount. I think we would expect over the next five years that the value would go up.

Stock appreciation rights (SARs) are the next type of plan to discuss. That's really the same thing as saying to you, I am simply giving you a phantom right to the increase in the value of my stock, starting today to some point in the future. Why do you use these rather than options or rather than a lot of other different techniques? Because an SAR is pretty easy. It's a piece of paper. You start out with the price today. You look at the price in the future, and you don't have to deal with a lot of bells or whistles. Very often when push comes to shove and the person has the right to the amount, theoretically that gain can be paid in stock. You would think that, since this is a "stock plan," it would be paid in stock. In point of fact, most of the time it's paid in cash. It's just another form of bonus in effect. It is a golden handcuff. All of these things are essentially a form of golden handcuff. There again, the term is just what it sounds like, if you haven't heard it. You're handcuffed to the company for three years, four years, five years. The handcuffs are golden, because if you stay for the time period that is required under the arrangement and the stock performs the way it is expected, you will get a lot of money. The trade-off again, and the explanation for it under the business judgment rule and other rules, is that giving up this compensation is beneficial to the employee because the only way he or she gets it is by staying. It's not like giving a $1 million bonus and just seeing the person then give his or her resignation a day later. Something positive has to happen for the employee to get the gain.

SARs are often granted in tandem with options typically with nonqualified options because basically you use one and give up the other depending on whether you want stock or cash typically. The SARs are typically given in cash. Thus, if the person is given 1,000 options and 1,000 SARs, when the time comes that he or she has the right to exercise either and can take a look and decide, the person wants to exercise his or her options because he or she gets the stock and believes the stock is worth something. Alternatively, he or she can say I want the cash and exercise the SARs.

I want to talk a little bit about so-called cashless exercise programs. Typically, for example, where if an executive has an option, exercisable at $10 a share, and the stock has gone up to $20, he has to go out-of-pocket for the $10 to actually exercise his option. The company then gives him the stock, and he can go out and sell the stock, and get his $10 back plus the appreciation. However, he's out-of-pocket for some period of time, and most executives don't want to go out-of-pocket for anything. Under the cashless exercise program, the company enters into an agreement with a broker. The broker, using the five-day sale period, basically sells enough of the stock on day one, even though you don't really have it. The broker sells it on day one, gets the proceeds, which are used for the exercise, and then has the stock from the exercise to actually deliver. It's just a shuffling of paper. This is just a way to allow the executive to have part of the gain or enough of the gain to pay the taxes. It has become very popular. Virtually every client I have above a medium-sized company that has an option plan has some form of cashless exercise program with a brokerage firm.

MR. ORINGER: Something we'll be discussing at a later session is 16(b)3, SEC rules on short-swing trading of stock (i.e., essentially purchases and sales of stock within six months of each other), and the possible need to disgorge profits, if you're an executive who has done that. That issue sort of floats around and works its way through a lot of the things that Arthur has mentioned on the stock plans and some of the things that I'm going to be mentioning. I don't think we should pepper this part of the discussion with 16(b)-type issues. It applies only to public companies, and I think it's better left to the end, but I just wanted to mention it.

Restricted stock is a type of property that is transferred to an executive for services. It happens to be a very common type of property. It's stock subject to a vesting requirement, and as you work, you vest into the restricted stock over time by performing services and meeting certain hurdles. There are a lot of variations on this, but the most common would be, for example, here is 100,000 shares of stock. If you're still here in five years, they're yours. Maybe there will be some rights of first refusal, but basically as you vest in the stock, it becomes yours, unrestricted.

The taxation of this kind of a transfer is under Section 83 of the Internal Revenue Code. Section 83 provides that you are taxed on the transfer of restricted property at the first time that the property ceases to be restricted or where the property becomes transferable free of the restrictions. That last prong is really probably more technical than practical. I think in the real world, in 99 out of 100 restricted stock plans, what you're really talking about is, when the forfeiture restriction comes off, then you're going to be subject to taxation when you have the rights to do with the stock what you wish. You have to be careful here where you're talking about closely held stock, to address a rule that I mentioned earlier, which is that generally these plans are structured so that you do not get taxed until you receive the compensation. In the case of closely held stock, you're technically going in accordance with that concept because you're taxed when you have the unrestricted right to the stock. But if, in fact, you can't do anything with that stock because it is closely held and there's no real market, you just have to be careful that you haven't put the executive in an untenable position of taxation before really being able to enjoy the compensation.

There are a couple of issues relating to what it means to have a forfeiture condition, the most common being a years of service requirement. Other types of forfeiture conditions that are less clearly effective to defer taxation would be things such as requiring a person to comply with a noncompete or requiring a person to continue to perform consulting services after termination of employment. The IRS would look extremely hard at provisions like that in any kind of an agreement for fear that it is a sham.

On the other hand, of course, if in fact, that requirement to perform consulting services is bona fide and the former employer really does request that the employee continue to perform consulting services and they're substantial, then there's every possibility that the arrangement will be effective to forestall the taxation until the close of the period. You also have to make sure that, while you're busy forestalling taxation, you're in fact being consistent with the business goals of both the employer and the employee. The employee might be extremely surprised if it isn't carefully communicated that, when he or she terminates employment, he or she is still subject to a real genuine risk of forfeiture. Everybody has to be of one mind when the arrangement is finalized on things that people are doing purportedly to satisfy tax requirements that might have real results.

When the person vests, the taxation under Section 83 will be ordinary income. The reason being that this is deemed to be a compensatory transfer and therefore should just be treated as wages. Arthur mentioned earlier that in ISOs, you do not get a deduction, and that's really very consistent because with ISOs there is the special tax treatment that you get capital gains. Capital gains are sort of out of the compensatory arena, so consistent with that, the employer can't get a deduction. Also there's a more general trade-off on Congress's part to say, if we're going to give the employee capital gains, we're simply not going to give the employer a deduction. There is some consistency there. Here, this is ordinary income when the restrictions come off, and as ordinary income, the employer gets a deduction. A word of caution here, the IRS takes the position, and I believe there's actually a court case pending as we speak challenging the IRS's view on this, that if the employer does not properly withhold on the compensation that gets paid, then the deduction is lost. This withholding issue can be a treacherous one, especially in the closely held company context where the stock may not be liquid. I'm not going to get into great detail about what you have to do with tax withholding, but make sure whenever you're doing one of these plans, that it is very much on the table that tax withholding requirements have to be satisfied. These tax withholding requirements can be significant, and you may have to do some very careful structuring to make sure that the employee is not put in the position of having to come up with a substantial amount of cash to satisfy the employer's tax withholding requirements, with stock that he cannot liquidate to satisfy that cash. The last thing you want to do is put an executive in the position where he has to really hurt himself on cash flow for the benefit of getting something that he really can't do anything with at the time because it's not readily tradable. In the case of publicly traded stock, the issue may not be as significant, although we may have 16(b) issues.

The exception to this tax treatment is under Section 83(b), where the employee is given the right when he receives property—and this is not available under options – to make the 83(b) election, and to recognize income at the time of transfer. Take the hypothetical case where the person is given stock that is going to vest over five years. The employee can say, I want the tax now or I want to take that income right now. You can take it into income even forgetting about the vesting restriction. It will be the full value of the property transferred. Why would you do that? You would do it because that closes off the compensatory aspect of the transaction, and therefore that's the end of the wage treatment. Appreciation in the stock after that time will be entitled to again the capital gains, and consistent with the way ISOs are treated and consistent with this whole compensation/gain structure, the difference in appreciation after the compensation element closes off and to the actual sale of the stock is not a deduction to the employer. Again, that's not considered compensation. The employee is getting a benefit of capital gains. Therefore, the employer doesn't get a deduction. However, you do get a deduction for the initial amount that is recognized as income, again consistent with the fact that amount is considered compensation and wages and therefore subject to taxation and withholding. The most common area in which this 83(b) election is used, although it is used in a host of areas, with such things as founders stock or starter company stock, is where the initial accelerated income hit occurs when the stock may be worth next to nothing. Thus, for a couple of pennies of tax up-front, you convert the entire subsequent amount to capital gains, and that can definitely be worth it.

Lets move off of restricted stock and go over to performance share units. Performance share plans, often called phantom stock are similar to stock appreciation rights but by no means identical. I guess the main difference between phantom stock and an SAR is, in the case of an SAR, you're essentially getting the margin. You're getting the appreciation in the value of the stock over time so, for example, if I give you an SAR for IBM when IBM is trading at 50, and then two years later it's 60, you don't get 60, you get 10.

In the case of a performance share or phantom share plan, you will get the entire value of the unit, whether or not the unit is framed in terms of a share of stock or some kind of a synthetic unit based on a combination of different factors within the company, or whatever this unit is, you will get the entire value. The salient distinction there, from the point of view of comparing the tax treatment of SARs to the tax treatment of phantom shares and performance units, which is something that I think it's appropriate to get into some more detail later when we talk about constructive receipt, is that with SARs, you can pretty much allow the person to draw his SAR down at any time without current taxation until he actually does the drawdown. In the phantom unit situation, the elections have to be carefully structured so that the taxation doesn't occur until actual receipt. I'll hearken back to that when we talk about constructive receipt as to why the SAR gets better, more liberal, more relaxed treatment from the point of view of structuring of elections, than do phantom units. However, I just want to plant a seed in your mind that with SARs you can generally structure very easily, with almost no significant rules and election procedures, whereas with phantom units you get back into the issue of whether or not you want to knuckle under to the IRS's position and what you can permit people to do in terms of elections.

At this point, I will go back to Arthur for some of the rules relating to the new $1 million limitation on compensation.

MR. WOODARD: Section 162(m) is new. It's the newest thing we're going to talk about. It just came in January 1, 1994. What does it do, and why does it do it? What it does is it denies a deduction to any publicly held corporation for compensation paid to a covered employee in a taxable year to the extent the compensation exceeds $1 million. That's what it does. Why does it do it? It does it pretty much as a political solution to a lot of the outcries we talked about. You'll see how political it is when you realize it's only in excess of $1 million, which most people think is a pretty big number, and the definition of covered employee is defined as the individual who is the CEO on the last day of the year and any other individual whose compensation is required to be reported to shareholders under the Securities Exchange Act of 1934 because the individual is among the four highest other compensated officers of the company. It's five people only that it applies to: the CEO and the four highest paid officers. It only denies a deduction above $1 million. I think that's a pretty political animal. It doesn't say that it's across the board. It was intended, I think, to be a statement that Congress is out there trying to stop certain things.

The limit does not apply to a lot of the things we're talking about. If the amount is paid to an executive under a performance based program, it does not count against the $1 million limit. In order to be a performance based program, the payment has to be payable on account of the attainment of one or more performance goals. The performance goals have to be established by a compensation committee of outside directors. That's the other political statement. Most major companies have them anyway. The compensation committee must have two or more people, and no inside directors on that committee, at least for this purpose.

The material terms of the compensation, the performance goals, have to be approved by shareholders before payment is made, and after the time is run but before performance is made, the compensation committee has to certify that the performance goals have been satisfied. What has all of this done to a large extent? It's made consultants very happy because they've been able to do all kinds of charts and planning in general under this and the new shareholder disclosure rules for proxy statements. It's also made people who serve on compensation committees extremely unhappy, because now the SEC and Congress have given them a lot of responsibilities they never had in the past or didn't think they had in the past, and have made them potentially liable for a lot of things in the future. I'm finding that compensation committees are becoming extremely difficult to deal with in the real world. They want an answer to everything, and if Andy hasn't already made it clear, there are a lot of things that we can't answer in black and white. This may be good, this may not be good. This may be this, this may be that.

MR. ORINGER: Arthur, you mentioned that most companies already have outside committees in place, but there is that issue, I guess, that the outside director requirement for 162(m) is different than the outside director requirement that we've been living with under 16(b), and so there is a whole lot of controversy right now over whether or not the people on the existing committees are going to continue to be approved after the transition rules expire.

MR. WOODARD: There is a dollar limit as to how much an outside director can receive or his or her business can receive from the company and qualifies an outside director. That does not exist for securities law rules. That does exist for this, and there's been a lot of talk about changing that dollar limit.

MR. INGUI: Let's take some questions now. We'll try to quickly cover golden parachutes in the next session.

MR. J. BRADFORD FISHER: I was wondering if someone cared to address the application of the $7,500 deferral limit under a 457 plan when the 457 plan is set up as a defined-benefit plan.

MR. ORINGER: I think the best estimate as to what goes on there is that, and maybe this is going to be an unsatisfactory answer because it just throws it back in your court, you do a present value of the accrual for any particular year in excess of the amount previously accrued (i.e., the marginal accrual from year to year). That becomes the amount accrued in that year, and if that amount is in excess of the $7,500, then you have run afoul of the $7,500 limitation to the extent of the excess. There are people who think you can draft a plan to say that the excess is not really paid under this plan but paid under a non-457 plan and currently taxable. However, I don't lose the 457 shelter, as to the amounts that are within the $7,500 limitation. My conversations with some people at the IRS and probably some people in this area is that they are not really adverse to that. They don't want to see people shooting themselves in the foot as to the whole amount, just because they go over by a penny. I think you would do a present value analysis. But as to what you would use to do the present value analysis, I wouldn't be surprised if a lawyer would defer to you.

MR. INGUI: There's a simple way around it. One way you do it is you set up two plans. Unless you know basically actuarially that you're not going to violate the $7,500 rule, based on the value of these accruals, what you do is you set up an eligible defined-contribution 457 plan for the $7,500. Then you set up an ineligible 457 plan as the wraparound, that gives the full defined benefit, less a carve out of the $7,500. This is similar to nonqualified defined benefit that wraps around a qualified defined-contribution plan. That's probably the simplest way around the rule. You set up two plans, then you structure the ineligible plan very carefully so that the person doesn't vest until he or she retires and at that point you pay it all out in a lump sum and he or she pays the taxes.

MR. ORINGER: That's the trick. As a business matter, as an employment relations matter, is it going to be approved that he doesn't vest until he retires?

MR. INGUI: Either that or he has to understand he's going to pay taxes on it when he vests.

MR. ORINGER: I think that's right. Thanks.

MS. LESLIE L. THOMPSON: A lot of our SERPs are designed to replace income and then are offset by qualified plan money and a piece of social security. Can you comment on any of these plans, when they trigger against the social security earnings limit?

MR. INGUI: You mean about the taxation on it?

MS. THOMPSON: That social security becomes taxed away because of receipt.

MR. INGUI: I was going to cover that in the third session under actuarial issues. We'll cover that in the third session. This is going to be strange because you're going to have questions, which we may get to in the latter session, so I'm going to defer those questions if I think we're going to cover them.

MR. ORINGER: Just one quick comment on the question is that the IRS has indicated that the fact that a benefit disappears over time because it's wrapped around doesn't necessarily mean the taxation waits. We'll talk about how it works in detail later, but the IRS has indicated that just because you may accrue a gap and the gap may shrink because the qualified benefit may rise closing the gap, that maybe that does not forestall the bad result that you're worried about.

MR. INGUI: These are some big issues, and we're going to cover them in Section 3.

MR. GENE BRYANT FIFE: On some private letter rulings from the IRS I've seen plans that are deferred compensation that are negotiated by unions. I wondered, what is the basis for a union being able to do that if it's only subject to a large group of employees.

MR. INGUI: When you say negotiated by union, for who?

MR. FIFE: I think one of them was in 1990 there was a private letter ruling talking about when you recognize FICA taxation and the proration of the year since 1983 over the total number of years.

MR. WOODARD: I think we just played stump the band. I am not familiar with the rulings. I am certainly not familiar with any carve out—there's no carve out for unions in this area like there is in the multiemployer plan section or anything. It should be the same rules. If you're saying it covers all union members, then I really don't know what it is. It wouldn't be something that we're talking about up here. If it's only covering union management, it would be subject to the same kinds of rules we're talking about. A union, as an employer is entitled to do what any other private employer is doing, but beyond that I don't know. If you want to send me one of them, I'll be happy to look at it and try to respond, but I don't know what it is.