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EXECUTIVE BENEFITS: PART II

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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 second in our three-part pension seminar program. For those of you who were not at the first session, we covered some of the background with respect to why nonqualified plans and other kinds of executive compensation plans are important. We started discussing some of the various types of programs that are out there. I have with me Andy Oringer from Rogers & Wells and Arthur Woodard, who is an attorney with the firm of Kaye, Scholer, Fierman, Hays & Handler. Arthur is going to finish what we didn't cover in Part I. He's going to cover another type of plan called a "golden parachute" and speak a little bit more on the limitations on deductibility of executive compensation. Andy will talk about some of the taxation for constructive receipt and the ERISA issues of these plans.

MR. ARTHUR F. WOODARD: I'm going to go over 162(m) a little more, only because it is hot, and I think you're going to see more about it. I gave a general rule in the first session, so I won't do that again. We talked about the fact that performance-based plans are not subject to the $1 million limit. The way the regulations define performance based, you can use any business criteria as a performance goal, so long as it's in writing before the employee performs the services and while the achievement of the goal is substantially uncertain. As you will find out, it sounds a little bit like nonqualified deferred compensation in the tax rules (i.e., things have to be done beforehand and there has to be some level of uncertainty). Nevertheless, the goal has to be fixed, and the amount of compensation, essentially, has to be nondiscretionary. The regulations are somewhat contradictory in that they provide that an observer must be able to reasonably calculate the amount of compensation the individual might receive by reason of the formula. The problem is that the regulations also say that you don't have to specify to shareholders exactly what the formula is going to be. You can say that we're going to base compensation on some formula of performance or increases in net profits, but you don't have to say, for example, an increase in net profits of 10%. You don't have to have that level of disclosure. It's not always clear how the observer is going to determine, within even a range, what the amount will be.

The IRS and Congress spent a lot of time thinking about what performance based plans are. We talked earlier about stock option plans and stock appreciation right (SAR) plans. The regulations recognize that those are clearly performance-based

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arrangements. They then set forth certain criteria that you have to follow in order to have the performance goal requirement met. SARs have to be made by a compensation committee. There has to be a per employee limit on the number of shares for which options or SARs may be granted, and they have to be granted at fair market value. The fair market value requirement was interesting. As I said earlier, you can grant unqualified stock options at a discount, and people do it. You would think that, even if the IRS wanted to say that the discount element is not performance based, because it's already built in, the IRS would then have said you can't take the discount element out of the formula for terms of the limit, but you can for everything else. The IRS refused to bifurcate the option. The IRS said if you grant an unqualified stock option at a discount, it is not all deemed to be performance based for purposes of 162(m). In other words, the IRS essentially said, don't grant a discount option under these rules. The IRS clearly thought about it, because the regulations talk about it. The regulations also talk about it with respect to restricted stock, where the same rule applies. The IRS basically decided that all awards must be based on a single transaction or the occurrence of a single set of events, and bifurcation of a particular kind of program didn't fit within that definition. So the IRS refused to bifurcate the option.

There's a grandfather rule and a transition rule that I won't talk a lot about. The grandfather rule applies to any program that was in effect or in existence on February 17, 1993, and it basically says that any such program is outside of these rules. The grandfathering is lost if there was an increase in compensation under the contract. It's also lost if you have a contract that is terminable at will or renewable at a certain date. The grandfather protection is lost either when it's first terminable or when the renewal date comes up. That has an importance in employment agreements where, for example, an employment agreement may be a five-year agreement and it may provide for performance based programs to be grandfathered. They won't be grandfathered when that employment agreement comes up for renewal.

MR. ANDREW L. ORINGER: Another item on the transition rule, just to mention a potentially important thing, is what people are calling a public private or private public exception for plans and arrangements implemented by a company before it goes public. This could be extremely important for a company in an initial public offering (IPO) situation. Apparently the IRS is conceding, in conversations on the phone, that if a company, while it's private, adopts a plan and continues that plan while it's public, then that plan or arrangement is grandfathered even as to grants and conduct and activity taking place after you're public. Thus, I do an option plan five days before I go public, and then I make millions of dollars worth of grants after I go public, those grants may be out of this basket. I'm not sure if this is going to hold up, but it is important if it does. That could put newly public companies at a great competitive advantage for executives as compared to existing public companies that unfortunately weren't given the opportunity to do things while they were private because they were public at the time these rules came in. The ability to adopt a plan while you're private may really give you a shot in the arm in terms of just getting out of all these rules. However, be careful if you're doing this if the IPO is a spin-off of a company from a company that is public. It is a possibility there that the company that's being spun off won't be considered to be private while it's owned by the public company. But in a vanilla case of an IPO where a company is not owned by a public company and it's just a good private company going public, you may have a lot of good planning opportunities.

MR. WOODARD: In point of fact, the IRS has said that, because we did one. Some of the rationale is right that the regulations don't really pick up the exception. In addition, the IRS feels that there will be adequate disclosure of the program to the public and that you may not want to implement too rich a plan or blow past 162(m) when you're going after the public with proxy disclosure anyway. But we did put in a program in an IPO situation.

What are "golden parachutes"? They are what they sound like. They are something to cushion the fall in a change-of-control situation. Congress again decided that they didn't look too good; they were terrible. However, instead of dealing with the issue with a set of corporate rules, Congress dealt with the issue through the tax code. I think that's a mistake that Congress typically makes, because Congress thinks it's easier, but nevertheless it was done. What did Congress do? It said basically you *can still have a soft landing Mr. Corporate Executive, but it's not going to be quite as* soft as it was, or at least there will be a cost attached to it. You can still do it, but we're going to charge both you and the company something for it. What it does is it applies both a nondeductible excise tax to the employee and a loss of a deduction to the employer for what Congress has defined as an "excess parachute payment."

An excess parachute payment is any payment that exceeds, by a penny or dollar, three times the executive's base amount. The base amount is the average of his compensation in the five years preceding the change of control. For example, the employee's average is $300,000 for the five years, and he's going to get $800,000 on a change of control. Three times $300,000 is $900,000. Since he's going to get $800,000, no harm, no foul, no problem. He can get it, it's deductible to the extent it's deductible as reasonable compensation and everything else under the general tax rules. Section 280(g) does not apply. Now assume he's going to get $1 *million, which exceeds his $900,000 limit. We now have a 280(g) excess parachute* payment; however, it is not an excess parachute payment of $100,000, which logic might tell you it should be. It is everything in excess of the $300,000 base average amount. So your excess parachute in the example I just gave is $700,000, a difference between $1 million and the $300,000. The employer loses a deduction for all of that amount and the employee has a 20% nondeductible excise tax tacked on to his payment. The math is interesting. The rules look at the three times as a safe harbor. If you exceed the safe harbor by even a penny, it's lost, and you go back to the general concepts of what you're compensation had been in prior years.

It's an all or nothing proposition. If you're $1 over, it's bad; if you're $1 under, it's good. Therefore, as you might think, what tends to happen is that we negotiate agreements where the executives get what I call the best of all worlds. There are a number of ways to do that. One is simple and it's not the best of all worlds, but it's to say, in no event, if there's a change of control, the executive will get more than 2.99 times your base amount. In other words, we will always be at least $1 under the safe harbor amount no matter what. We may promise you $10 million, but if that $10 million would create a problem, you're only going to get $1 million, if that's the safe harbor. That keeps the deduction for the company and keeps away the excise tax for the employee.

As you might suspect, the employee will look at that and say, wait a minute, that's terrific, but nevertheless I'm not getting everything I was promised. Maybe if I was promised my $10 million, I'd rather have the $10 million and pay my 20% excise tax on it, because I'd still be ahead of the game. If you mathematically run the numbers, you'll see quite clearly that there's a point in time, where even with the excise tax, the executive is better off getting more dollars and paying the excise tax, than he would be being capped at 2.99. It generally breaks at about 3.75 times. Therefore, if the employee is going to get five, six, seven times, he clearly is better off paying the excise tax. You can draft it that way. You can basically say, we'll take a look at the arrangements and the situation, and the executive will have a choice on what he wants to do. He can either not pay the excise tax, or if he thinks he's better off, he can pay the excise tax, and we the company will pay him the whole amount. That is surprisingly not, according to the corporate lawyers, a bad thing under corporate law as a poor exercise of business judgment. As a tax lawyer, I always wondered if a company could agree to basically just let the deduction go and pay any amount that corporate lawyers say quite clearly is a proper exercise of business judgment and not a problem.

The other thing to think about is how you calculate the parachute amount. It's easy in certain cases where you just look at salary and bonus. However, in other situations it's a present value calculation to determine what is subject to the excess parachute rules as of the date of the change of control. Obviously in certain cases, this is not so easy to do. What's the present value of an option, what's the present value of a lot of other pieces of compensation? What the rules say is that, if you have compensation that is substantially certain to be paid in any event, it will not count against you for this rule. In other words, if you are entitled to deferred compensation except for passage of time, it doesn't count for purposes of 280(g), unless the payment is accelerated. If the payment is accelerated, the rules look at the accelerated value of that amount. This is where we get more into the actuarial world, because somebody has to sit down and calculate a present value. The way it's basically done is through a set of present value discount rules that the IRS has imposed. In the case of options, basically you look at what the value of the option is on the date of the change of control, treat that as the value it would have been in the future, discount back for present value under just general discount rules, and then apply a 1% per month lapse of time discount on top of that. Whatever that final amount is, that counts against the 280(g) calculation. For example, assume you have options worth $600,000 in two years and the present value of this is determined to be $545,000. You then apply a 1% per month or 24% additional discount to the present value, for the fact it's payable over two years, to derive the value of the acceleration payment of the option. Thus, the thing to remember is that this is a present value calculation, therefore, a moveable calculation, and as such, you have some ability to play with it. We have had situations where, with actuarial help, we have creatively played with the numbers in such a way that there was not a three-times payment. There is some room for play within these rules if you can find somebody creative who is willing to sit down with a piece of paper and a pencil to put a present value on it.

MR. ORINGER: I recently represented about eight or ten executives who had parachutes coming to them, and the company immediately said, we want to get an adversarial setting in here, we want them to have their own counsel. This is a great area for actuarial work that lawyers think that they can do, and they're just flat-out wrong. These calculations are hard. To calculate the amount, we had ten pages of Lotus spreadsheet printouts that nobody except the actuaries understood. We had the benefit itself being close to $3.5 million, and then after the gross-ups were done with these actuarial tax calculations, the payments went from $3.5 million to $13 million. It is a tremendous expertise to learn the proposed regulations that provide you with the matrix of things you can do, and to be able to spit this out in spreadsheets. You are then in the position of being able to tell the company and the lawyers, "You guys can't do this, let me show you why," and throw one spreadsheet at them, and have them say, "You're right, we can't."

Now we're going to go back to tax consequences of some of these plans and the rules that we're trying to dance around to make the plans have the desired effect. The basic rule, at least in the case of nonqualified deferred compensation and generally any executive compensation (with a couple of exceptions for options and restricted stock), is that the deferred compensation is not taxed until it's paid. Now, how you get there is a different story. The rule that you will be trying to deal with most often is the rule of constructive receipt. This rule says that the compensation is not taxed until it's paid or made available. The fact of the matter is that while the desired result is that you wait until payment, the rule is that, if you make it available earlier, you are taxed earlier. Thus, to me, the practical application of the rule is that you don't make it available before it's paid, at least as a technical tax matter.

Once again, constructive receipt says that you are taxed not only when income is actually received, but also when it is made available. For this purpose, the mere fact that I make a promise to pay money to you in the future is not deemed to cause you to be in receipt of that money until you receive the actual dollars. The mere promise to pay, if it's not funded, is not the receipt of anything. It's not the receipt of the money you're going to receive a year from now, it's not even the receipt of a current promise that accounts for tax purposes. The unfunded promise to pay is a tax nothing.

The fundamental rule of constructive receipt is that if, in connection with this promise to pay money, I enable you to draw down on that promise, free of substantial restrictions on your ability to draw it down, it has been constructively received. Thus, if I agree with you that you're going to receive $300,000 three years from now, but if you want it next year, just ask me for it, then you'll be deemed to be in constructive receipt of the money at the first time in which you could have drawn it down without substantial restriction. If all you're giving up is the right to get it later, then you haven't given anything up. You then have constructive receipt. The idea here is that it's a fundamental premise of tax law, at least in the IRS's view, and I'm sure the IRS is right about this, that the period in which you are taxed is not something that should be at your discretion. You should not have the right to control when you take taxable income into account. Taxable income should occur by virtue of things that happen. An obvious exception to this is the 401(k) rules, where you can say, "I know you were about to pay me that money. I don't want it. Put it in the 401(k) plan, and pay it to me later." For that very reason, the IRS really doesn't like 401(k) plans, because they conflict with what the IRS views as one of the more fundamental precepts of the tax law. Consequently, outside of that area where you're dealing in nonqualified deferred compensation, the IRS hits you pretty hard on this. We'll talk about what it means to have control of receipts subject to substantial limitations and when you're in constructive receipt.

Another doctrine under which it is possible to accelerate the taxation of deferred compensation is what's known as the economic benefit doctrine. In a purely unfunded context, I'm not sure that it's really an overly relevant concept, but it is relevant to nonqualified deferred compensation because of the incredible efforts that people make to secure the nonqualified deferred compensation promise. As soon as you try to secure it or fund it in any way, you bring in the economic benefit doctrine, which says that, if I set aside for you a fund of money, then you can be currently taxable on it now because you have a current economic benefit in that fund. Remember that I said earlier that a mere unfunded promise to pay is a tax nothing, it's not considered a current receipt of anything. As soon as I give you an economic benefit in a fund of money, that whole protective rule starts to fall apart, and you may indeed have current taxation because it's no longer a mere promise.

In the case of a rabbi trust, the employee is not deemed to have an interest in the trust, because the creditors of the employer can get to the assets of the trust. Therefore, you may ask, how does the use of a rabbi trust avoid immediate taxation under the economic benefit rule? The reason is that rabbi trusts are structured precisely, in light of the economic benefit rules, to avoid the result that there's accelerated taxation, by making it be deemed that the employee does not have a current interest in that fund.

MR. INGUI: As actuaries, you have to be careful. The term "funded" as used in the context of a nonqualified plan does not merely mean setting funds aside. "Funded" means that you have funds set aside with no potential loss to the employee. It's basically a protected fund. Keep this in mind as Andy and Arthur talk about the concept of funded. It's not just having some cash reserves. That in itself does not create a "funded" plan in the context of nonqualified plans.

MR. WOODARD: The IRS is looking at all these concepts, which get extremely blurred in articles, in court decisions, and even with the IRS. They are looking both to the timing and the amount of income. Constructive receipt is basically a timing concept. In constructive receipt, typically you're not arguing about what the amount is, but when do I get it. The general tax rule under Section 61 is that whatever you get is taxable today. Compensation from any source is taxable today. Constructive receipt is generally picked up under Section 451 and, to a large extent, is a timing concept. Economic benefit involves both timing and amount. In the third session we will discuss securing the promise, which is what Silvio was talking about. Here the line can get blurred as to which of these concepts applies and how it is applied.

MR. ORINGER: Section 83 of the Code, which we touched on earlier in the first session, has a lot of concepts in it that are similar to an economic-benefit-type concept. It governs the situation in which noncash property is transferred as a compensatory matter. Again, rabbi trusts simply would not be deemed to be property. Section 83 essentially says, when the property vests, you'll be taxed on the value of the property, as a general matter, unless you've elected accelerated taxation under Section 83.

What is the IRS's ruling position regarding constructive receipt? The IRS has set forth a Revenue Procedure, 71-19. If you have a plan that meets the conditions of Revenue Procedure 71-19, then the IRS would give you a ruling that the beneficiary under the plan is not in constructive receipt of the compensation that is to be paid under the plan. This is very helpful as a theoretical matter.

Recently, in Revenue Procedure 92-65, the IRS embellished 71-19, which set forth the rules for getting a ruling. First, the election to defer the compensation has to be made before the taxable year in which you start earning the compensation, except for new plans or newly eligible persons. For example, this means that prior to 1995, I have to make my election as to what compensation I don't want paid to me for my work in 1995, but would rather have it deferred and paid to me later. I want to interject for a moment that the IRS's ruling position is not necessarily the IRS's view of the law and it is certainly not necessarily the tax court's view of the law. What's happening here is that, by promulgating this ruling position, the IRS is pushing practitioners towards conforming with it. However, a lot of people don't feel like knuckling under. They pick and choose. They pull some of the things from the IRS's ruling position, and they do some things not in accordance with the ruling position. Therefore, when we don't follow the IRS ruling position, one of the things we deal with is to try to figure out what might or might not happen if we actually had to go to court.

Second, the plan has to clearly define how the employee will receive his or her money. Third, the plan must provide that the employee has no right to the money other than as a general creditor of the company. Fourth, the plan has to state that it is intended to be unfunded for tax and ERISA purposes. Fifth, none of the employee's creditors can get to the money. Again, if the employee's creditors can get to the money, then the money has a present benefit to the employee, which the IRS would argue should accelerate taxation. The IRS will let the employee get it for hardship, but only under a very narrowly defined basis.

I want to back up to the election to defer compensation. As I indicated, it has to be made before the period in which the earning starts, except for new plans or newly eligible people. The IRS essentially takes the position that the election to defer, and this is probably where almost all the pressure is, before the earnings period commences includes not only the election to defer, but also the election of how you defer. In other words, it must say how you will ultimately get the money. If you have money that you're about to earn in 1995 and you're about to make a 1994 election as to how you want your money paid later, the IRS would require that you state in 1994, for example, that you defer your 1995 money and that you want it when you retire in a lump sum, or that you want it when you retire in ten annual installments, or that you want it ten years from now, and so on. However, the problem is that often when you're deciding to make your deferral, you have no idea how or when you're going to want the money. So the IRS's ruling position here is extremely burdensome. This is an area in which people do not tend to necessarily knuckle under to the IRS's position.

The effect of not complying with the IRS's position, if the IRS would win in court on this point, is that you would essentially be taxed on the money the first time you could receive it. Thus, for example, assume I make my election in 1994 not to receive my 1995 compensation, and the company permits me to make an election to receive that money in a lump sum when I retire. However, instead I choose to take it in installments when I retire. In this situation, the IRS would claim that even though I chose installments, I would be fully taxed on the value of the lump sum at the time I retire.

Many people believe that, if the election is made into the earnings period, it is still fine so long as the election is made before the money would first become available. Where the opinions vary is how long before the money is made available must the election be made. Some believe that you can make it right up until you retire, while others feel that it's safer to require the election in the year before the first year you could get the money. This is the controversy that will presumably continue to be resolved in litigation.

It's worth discussing SARs and phantom stock for a moment here, in that they illustrate some of the pitfalls of the rules that we deal with. Remember that SARs are rights to receive the marginal amount of appreciation in stock from time to time, and phantom stock is the right to receive the value that a share has. The difference is that if I'm granted an SAR when the stock is at $50 and it goes to $60, I have the right to $10. On the other hand, if I'm granted a phantom unit at the time that the stock is $50 and it goes to $60, I have the right to $60.

The IRS applies the constructive receipt rules to the SAR as follows: If I exercise the SAR, I am giving up the right to stay invested in the underlying share of stock without having to make an investment in the stock. Look at the way the SAR works. I can ride with this $50 share of stock while it goes to $60 and $40 and $70 and $30 and fully benefit from any upwards appreciation over the initial $50 price, if that was the strike price that the SAR was granted at, without paying a dime for the unit. If I exercise the unit when the underlying stock is trading at $60 and take my $10 and then decide I want to get back into the stock, I have to take $50 out of my pocket, combine it with the $10 of appreciation that I just got, and repurchase the share.

The IRS concedes that the need to take the $50 out of your pocket is a substantial restriction on getting at the $10 of appreciation. The need to take that same $50 out of your pocket to recreate the investment also places a substantial limitation on getting the appreciation. Thus the IRS says that because you would have to give up the right to ride with the stock without a capital investment, the IRS will deem that you're not in constructive receipt of the $10 even though you could at any time get that $10. Therefore, SAR plans can be structured with unbelievable election rights. The election right can say the employee can exercise the unit whenever he or she wants, and he will not be deemed to be in constructive receipt of the margin at any given time until he actually exercises. One cautionary note: if the SAR is granted at a discount, different rules may apply. Contrast that with the phantom unit plan, where you have the right to get the entire value of the unit; the IRS says this is a different issue. If you have the right to get a unit worth $60 at any time, you can draw down the $60 and then go back and buy the stock a day later. What's the substantial restriction on drawing down the $60? None. Therefore, constructive receipt occurs from the first time you can draw it down. Thus, the election rules we encounter in your typical deferred compensation plans tend to remain the same in your phantom stock plans.

The reason I contrast SAR and phantom stock is because I think it's a very good indication of how the IRS views these constructive receipt rules.

MR. INGUI: With respect to the issue of constructive receipt, much of what is documented is in court cases, and that's where we actuaries don't necessarily have the necessary exposure. Therefore, it is important to seek qualified legal counsel. Another point to make clear is that companies have to make a business decision here. It's important that you tell your clients about the IRS ruling position and the other positions that exist. Your clients have to make a business decision. This is clearly not a black or white issue, but one where a considerable gray area exists. They have to realize that if they're challenged, are they willing to take the IRS on in court, because that's basically where they are going to end up. Obviously, that's an expense by itself that would have to be dealt with.

MR. ORINGER: There are potentially two perspectives here that I think are both wrong and that you tend to see. You sometimes see a consultant coming in and saying, "No problem." I think that's wrong in terms of taking an aggressive position. Then you sometimes see a lawyer coming in and saying, "I'd be very worried about diverging from the IRS ruling position on this." That's equally silly. I think that Silvio is exactly right. You have a superconservative position, you have a superaggressive position, and you have a million things in between. Thus, a business decision has to be made.

MR. WOODARD: I think Silvio said what I said before, that it is a position of whether you're willing to litigate it. The IRS lost virtually all of these since 1944. It has lost issues on second deferrals. It has lost issues where it has litigated on lump sum versus annuity in terms of payouts. Nevertheless, litigation is not a lot of fun if you hire a law firm. If you go into a courtroom today even on something that looks fairly straightforward, the client's not going to be really happy when he or she is looking at a $250,000 or $500,000 legal fee, and that's what it would take to litigate this kind of an issue. So being right may be terrific, but you may also lose a client in the long run.

What we're saying here is, if you get involved, there are two things to do. One, it's probably a good idea to call a lawyer. Two, you need to take the time to make sure the client clearly understands what he or she is doing, because clients very often have a viewpoint that is very limited, (i.e., how much can I get and how do I get it, and when do I get it). They don't necessarily hear, unless you say it seven times, that unless you do it right, you may not get it.

MR. CHARLES E. DEAN, JR.: These plans are really out there. Real people are covered, so benefits are really paid and some taxes are paid to the IRS right now. Is it the case that these plans are all being treated by the recipients as if they are, in the most favorable status, in this IRS view or the ruling position, as not collecting any taxes from anyone right now?

MR. ORINGER: What is the ultimate question?

MR. DEAN: The ultimate question is, are the taxes being collected right now and to date following the IRS position?

MR. ORINGER: People who are diverging from the IRS position are most definitely treating their position, for tax purposes, as being correct. If people are diverging from the IRS position, understanding the risks, there is no way that they're reporting to the IRS as though they're wrong and filing for a refund. They are asserting that there's no taxation currently.

MR. DEAN: And that's both the employers and the executives.

MR. ORINGER: Absolutely. There's a small issue, which I'll just raise. There's a recent court case that indicates that there might be the ability to get a current deduction for the interest on deferred compensation. A lot of practitioners think that decision is wrong, and it's being reheard. Thus, with respect to the issue of current deductions for interest, know it's out there and know that it's heavily criticized. For all I know it will survive. The risk here is that there may be some noise about current inclusion of interest on the employee side if in fact the employer winds up winning the case. So it's a real double-edged sword.

MR. WOODARD: What we're really talking about here is timing. The IRS wants it today. Somebody does pay the tax; it's just a question of when. Recognize that the executive is gambling on two levels, one of which we'll talk about later. If bankruptcy or something similar happens, the executive may never get this money; the executive is also gambling with what the tax rate will be in the future. If the Clinton administration makes it an 82% tax rate, you've made a very bad bet. There's real tension there, and the IRS could come out far ahead. However, the IRS doesn't want to do that. The IRS wants to tax today as much as it can. Actually I think very often the IRS just does not want executives to defer compensation.

MR. ORINGER: Sometimes what a client will say to you is, wait a minute, if the IRS comes in and challenges us, and accelerates the income to the executive, don't we get a current deduction in that event? The answer to that will be yes. So as a practical matter, in the right case, it may be that the IRS has no substantial incentive to actually come after it. However, I think that Arthur is right that the IRS doesn't like the ability to manipulate the system and so would, therefore, probably challenge it even if it were a "no win" situation.

Under the social security rules, social security taxation generally tracked the income taxation, so you don't have to make a lot of special arrangements. In the deferred compensation area, that's not the case. In fact, there's a provision in the social security tax laws that says that nonqualified deferred compensation is taxed when vested, whether or not it's received. This is sort of a violation of the cardinal rule, no taxation until actual receipt. How can that be pro-taxpayer? It's pro-taxpayer because there used to be a social security wage base cap and a Medicare wage base cap. With the elimination of the Medicare wage base cap, this is a real issue. If somebody is going to defer $50,000, $100,000, or $200,000 of compensation, 1.45% of that can get significant. Take also the case of somebody who has a five- or ten-year vesting schedule, who has been accruing substantial amounts of deferred compensation over time and then vests. That's five or ten years worth you'll be taxed in one year. That can be a substantial amount, and I think people are taking this very seriously.

FROM THE FLOOR: *My question was what types of these compensations apply to* the earnings limits that reduce social security benefits?

MR. ORINGER: More than likely, the deferred compensation will not hurt you on the earnings limit, and in fact, the IRS form is structured to give information to the Social Security Administration that some of this money is money that shouldn't reduce benefits, because it's attributable to prior periods. The earnings test is supposed to reduce your benefit for being actively employed and receiving compensation for that. If the earnings are attributable to a prior period, you're probably off the hook. There's some technical rules that say that, even if you can't make the earnings attributable to a prior period, as a technical matter, you get that same acceleration that we talked about, (i.e., that the money is includable when it vests rather than when the money is paid, for purposes of the earnings test). Consequently, if, for example, in 1994 you vest, but you get paid in 1997, the money was already included for purposes of the earnings test in 1994, when you couldn't have cared less because you're not collecting social security. By the time it gets to 1997, the money is not included anymore, and therefore, you're fine.

Let's discuss filling out a W-2 on nonqualified deferred compensation. If it's for an employee, don't use a 1099. Filling out the W-2 is very tricky, and if you do it wrong, you could hurt the person because you could accidentally be failing to inform the Social Security Administration that some of this income should not be counted for purposes of the earnings test.

I do want to make one point on the ERISA *issue.* A *lot of people try to structure* things to be exempt from ERISA. Being exempt is not always what you want. You certainly want to be exempt from ERISA's substantive provisions. You don't want to be trapped in ERISA's funding provisions, because you can't fund these plans for all practical purposes. Since you can't fund, you can't be trapped by ERISA's funding requirements, and therefore you have to be careful to not be a pension plan. We talked about it being a severance plan treated as a welfare plan. You have to be a top-hat plan, which, as Silvio mentioned, is exempt from ERISA's substantive requirements, or possibly an excess plan that, if it's unfunded, may be exempt from ERISA altogether. Yes, *you have to be exempt in 99.9 out of 100 cases from the substan*tive ERISA rules, but you will be subject to a couple of ERISA rules that we'll just go over. One is reporting in disclosure. You have to be very careful as to whether you're subject to full-blown Form 5500 reporting requirements or possibly a one-page letter to the department of labor (DOL). Even little agreements, little arrangements, little plans, certainly top-hat plans, will be subject to the one-page requirement. It is extremely important. If you miss the one-page requirement, then you're subject to the full, annual Form 5500 reporting requirements. That is not good, and the IRS and DOL are serious about those fines.

MR. INGUI: With respect to this whole issue of ERISA, probably the most commonly asked question is, what is a "select group?" Did you want to respond to that?

MR. ORINGER: It's a seat-of-the-pants situation. The DOL has clearly set forth its position that it is about to come out with a position. I suspect that this is going to be developed through litigation, if anywhere. If you're doing a plan for people over the $150,000-Section 401(a)(17) limitation, most people believe that you should be fine. If you have a super-high-powered work force, like certain investment banking firms or consulting firms, maybe it doesn't work anymore. However, the DOL, I think, by not coming out with authority, has really put itself behind the eightball to challenge that. The bigger problem is when you try to make up for people who are merely highly compensated employees (HCE) under Section 414(q) of the Internal Revenue Code. I think a lot of people are worried that covering everybody who is an HCE may not be a "select group." Therefore, you may get trapped with a band of upper-middle management whom you can't help, because ERISA's going to say that you have to fund them if they're not a select group, and then the Code's going to say that, if you fund them, you have disastrous tax consequences. Thus, there may be a band of employees between the Section 414(q) HCE limit and the $150,000 limit under Section 401(a)(17) for whom you can't do a lot.

MR. WOODARD: It's a two-level determination. It's both what's "highly compensated" and it's also what's "select." Those can both be moveable targets. For example, if you have 82 employees and two of them make more than $50,000, you may have a select group of highly compensated, even though the two only make $80,000. The DOL has been making this legislation by speech and has been essentially saying for some number of years that its rule is going to be restrictive, at least on this highly compensated issue. The DOL seems to be trying to convince people that it is going to come out with a definition. Will it? Won't it? I don't know. It has been an enormously long time and the DOL has not come out with anything.

MR. ORINGER: I've told clients that, if you're doing this in good faith in the absence of regulations, and if you can look yourself in the mirror and say, "I really believe that I'm covering a select group" without laughing, then I think you should go do it. I don't believe the DOL will prevail if it goes running around scaring people to the point where you can't do anything. In my own view, I think that's what the DOL is hoping. I think the DOL is hoping that the advisers are going to force the clients to be in good faith and that will self-police to an extent.

I think that's a dangerous technique. People often don't realize that, even though you're out of the substantive ERISA provisions, you may well be in the nonsubstantive ERISA provisions, the provisions controlling claims, the provisions controlling interpretation of the plan, litigation, and things like that. There are some extremely favorable aspects of being covered by ERISA in this way if you're the employer. You could have a uniform body of law and some certainty as to what's going to happen under the plan. You tend to know the rules, and your lawyer doesn't always have to look up state law. There's a whole host of things that you may not want to argue, for example, that a particular arrangement or agreement is not a plan at all, it's just a series of individual arrangements not subject to ERISA. If you do, you may succeed in that argument, and if you succeed, you may lose ERISA preemption, and you may lose this uniformity.

Examples of the uniformity of a rule that you would use is that ERISA tends to preempt punitive damages and ERISA tends to defer greatly to documents that provide for an employer's internal right to interpret the plan so that the employer has more control over the documents he or she has established. That doesn't mean that you should always have provisions that defer to the employer or a committee for plan interpretation. You may have a situation where your executives want to be protected, and they don't want the agreement prone to being manipulated by the employer when things get bad. In any event these are the things that should be examined carefully. In summary, I'm saying you don't automatically want to be totally out of ERISA. There may be reasons that on this one little piece of ERISA you want to be in, and if you are structured correctly, you can be in that piece without being in the more substantive, invasive rules that ERISA provides.

MR. WOODARD: Andy, I also think that most people don't know that ERISA has probably the broadest preemption language of any statute. You have to search long and hard for a statute that has broader language. Anything that relates to an employee benefit plan is preempted. There are a lot of cases, including Supreme Court cases, that interpret that very broadly. If you get into a situation where it looks like your client is about to be sued, think ERISA preemption, think of getting the client's lawyer involved. It's a tremendous tool, at least from the employer's point of view.