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EXECUTIVE BENEFITS: PART III

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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 Executive Benefits Part III. It's the third of a three-part pension seminar program. This pension seminar program discusses the various types of executive compensation plans with special emphasis on nonqualified deferred compensation plans. With us we have two attorneys, Andrew Oringer from the New York office of Rogers & Wells, and Arthur Woodard from the New York office of Kay, Scholer, Fierman, Hays & Handler.

In the first session we covered some history on why these plans are becoming so important and discussed some of the types of plans. In session two, we talked about the tax and ERISA implications. In this session we're going to discuss two areas. The first is the different ways to try to secure these benefits without creating taxation. The second area will be about some of the accounting and actuarial issues with respect to these plans. Before we start, we didn't get a chance to address questions at the last session, so I'm going to open it up to the audience.

FROM THE FLOOR: With respect to Social Security taxation on a nonqualified defined-benefit plan, that provides benefits above the 401(a)17 limit, is the plan designer free to determine when vesting takes place? Can the plan designer determine whether vesting takes place at the same time the qualified plan would vest, say five years, or do the nonqualified benefits not vest until retirement or do they not vest until they're paid one at a time?

MR. ANDREW L. ORINGER: I think the answer is yes. On the nonqualified side, you can do whatever you want.

FROM THE FLOOR: If the answer is the last that you vest employees only as they are paid, they are not guaranteed vesting until they're paid.

MR. ORINGER: But what would be the condition under which the employer could forfeit in that circumstance? In other words if I say to you that you're not vested until you're paid, and I know I'm going to pay you, then you are vested. Are you saying that, if a person dies before receipt, that the money would disappear? Would that be the only contingency?

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FROM THE FLOOR: No. The company decides not to vest because of financial reasons the company just won't make any more payment from the nonqualified plan.

MR. ORINGER: If you stay decided, then you're probably in good shape, then you probably haven't vested, because you haven't given the employee anything. On the other hand, if there's a binding obligation but it's subject to the company's ability to pay, as everything the company does is subject to the company's ability to pay, that will not be enough to forestall the vesting.

FROM THE FLOOR: How you vest, the point in time that you vest, is that when the Medicare tax is payable?

MR. ORINGER: Yes.

FROM THE FLOOR: In other words if we did determine, somehow, that these employees weren't vested until each payment due is paid, then the employees would be paying those taxes for the rest of his life.

MR. ORINGER: Yes, assuming, for the sake of argument, that the plan was a nonqualified deferred compensation plan within these rules. Actually in your particular example, which has the extreme case of no vesting until payment, which you don't generally tend to see, that's probably the case in any event, because that would be the normal rule even in the absence of the special rule that brings it back to vesting. The interesting issue that arises is that I don't know what the IRS is going to do with a situation where the person loses the benefit if the person dies before payment. Is that a forfeiture condition in itself? Frankly, maybe it is. However, I think what you're going to find, as a practical matter, is that your executives are going to want no part of a plan that says that if they die their family doesn't get it.

FROM THE FLOOR: So in the most practical situations of either a five-year cliff, just barely qualified or at retirement, then there is a tax payable on a present value calculation at that point I would assume.

MR. ORINGER: I think that's right, and there are a couple of IRS rulings, not formal rulings but private rulings that purport to say what you're supposed to do in terms of how you figure that out.

MR. GENE BRYANT FIFE: In the earlier discussion you talked about whether the executive should make his election as to how he's going to receive his benefits before he even makes any deferrals. I've heard of some cases where the executive is allowed to wait until retirement and then elect either a lump sum or an annuity, but if he takes the lump sum he has to take a "hair cut," per se.

MR. ORINGER: Yes. That is one way to address that question. This isn't consistent with the IRS ruling position, but there is good IRS authority that the "hair cut" is the substantial limitation that we talked about with respect to constructive receipt (i.e., that you only are deemed to be in constructive receipt if you have the right to receive the money with no substantial limitations). For example, if I say to you that you can only have the money now if you lose 6% of the money, then I think the IRS would probably concede that that's a substantial limitation that should not result in constructive receipt.

MR. ARTHUR F. WOODARD: You also sometimes have a committee that you can ask for a lump sum or an annuity, and the committee will have the right to make the decision. That should work. This goes back to what we were talking about before. Under case law, there's no doubt in my mind that as of today, the courts that have heard this issue would say that you could make an election, three months before you're going to retire, to take a lump sum or an annuity, as long as you do it before you actually reach that date. Basically, I would not have a great problem going along with that for a client (i.e., allowing an election three months before), as long as the client is willing to understand that it may be challenged.

MR. ORINGER: Personally, I like to do one of two things. I either like it to be a situation where the election is made before the sum of money is known. For example, if it's a performance-based plan, the election is made before all the performance is met. That helps the argument. I also tend to like the election to be in the calendar year before the money is payable. However, frankly I have no support for this, and in theory, my approach could be less than three months, if the employee is retiring on December 30, and the money isn't payable until the next January 1, my approach lets him make the election on December 31, one day before it's payable.

MR. WOODARD: You're right. Most of us would feel much more comfortable if it's in the year before the year that the money can actually be received. That's pretty much what I think virtually any lawyer wants, only because it makes us more comfortable. I think Andy's example of December 31–January 1 works, in point of fact.

MS. ELIZABETH D. BURGETT: Back to the ineligible 457 plans. Could you comment a little bit about these rolling vesting dates and talk about how aggressive you think they are, and how you might structure one?

MR. ORINGER: In the last five or six months the IRS has on two or three separate occasions said that it doesn't think rolling vesting works. I don't agree. If before you are vested you agree to continue not to be vested, I don't know where it is that you vested. In the constructive receipt side, I think the IRS has a slightly better argument, and it's also, at least, more time-tested in terms of the IRS asserting it. At least the IRS has developed revenue procedures and some kind of authority, where it thinks that constructive receipt requires an election before the amounts earned. On the rolling vesting, I'm very troubled by the argument that says that it's no good to think that if you're about to vest, you can't make yourself continue not to be vested. If this were true, then the rule would be that you're taxed when you're almost vested, because at the time you're almost vested is the time that you should be deemed to be vested. However, that's not the rule. If you were, on a day by day basis, to extend the vesting period, then I think you have a problem. My preferred approach to this would be to have one election somewhere in between where you could have the period cut short or you could agree to play out the maximum period. I've heard people say they think you should be able to do it year by year. I would rather have it be one time, in light of the noise that the IRS is making, but it thinks that even one time doesn't work.

MR. INGUI: Let's start the next session here. Arthur is going to talk about how you can secure these benefits.

MR. WOODARD: Let's go back a step before we go forward. Let's all understand what we're talking about. We're talking about an executive making a decision. If an executive has the right to some level of compensation today, then he is making a decision, presumably at least in the pure deferral situation, to defer it. He's taking the risk of tax rates. He's taking the risk of the IRS taking a contrary position and saying you're taxable today even though now he's given up the right to it in the future. However, the issue the executive often raises, when making a decision to defer compensation, is how he is to know if he is going to get his money. How will he know the money is going to be there? If you go back to around 1979 and 1980, you didn't really have any way to know. It was basically an unfunded promise to pay. It existed on the company's books, and it wasn't much more than that. There really was no effective way to secure these benefits. Why do you want to secure the benefit? The reason is obvious and if you go back to the early 1980s it became even more obvious: change of control. Toward the late 1980s the concern turned more towards bankruptcy.

There were a lot of New York City lawyers who sat around and thought, we have to come up with a way to protect these benefits. Clearly somebody out there was a lot smarter than all of us and decided to set up a trust for a rabbi. They created the trust and asked the IRS for a ruling on whether the trust works. For tax purposes, the rabbi trust is a grantor trust, which is an asset of the employer. The IRS ruled that you can create a trust, you can fund that trust and that trust can basically be dedicated to payment of the deferred compensation promised to the rabbi. That was the first time anybody really got a fund of money that was unfunded for tax purposes, but could be dedicated to deferred compensation.

Why is it unfunded? Because it is still subject to the claims of the company's creditors. It's a grantor trust that belongs to the company and, therefore, still reachable in a bankruptcy situation. It wasn't perfect protection, but it was a pot of money sitting out there, and it caused people to go nuts. Everybody wanted a rabbi trust. So we spent time running around drafting rabbi trusts, but not really knowing what the rabbi trust had to say.

In the 1980s, the IRS issued about 15 or 20 private letter rulings on rabbi trusts that pretty much got to be formalistic. Then in 1992, in Revenue Procedure 92-64, the IRS basically set out a specific set of rules for rabbi trusts and a model rabbi trust document. If you use the model, you have no tax issues as to current taxation on the funding of the trust. The good news was that you have certainty, you don't have to go in for a private letter ruling. The bad news is that the rabbi trust is drafted in typical IRS jargon. It's not a very good document. It's sometimes difficult to deal with in the real world. But it's out there, people do use it, and it gives you some degree of certainty. If you don't want to use it, you're not required to use it, but then you cannot have the protection of an IRS letter ruling. You're on your own if you vary from it. Why would you vary from it? It has distribution rules and a number of things that some clients don't like.

MR. ORINGER: There's no requirement that you go for a ruling in any of the rules.

MR. WOODARD: You never have to go for a ruling, but obviously, to go back to some of the things both Andy and Silvio have talked about, there are certain people who want as much certainty as they can possibly have in this context. They basically feel that a ruling gives them some real protection. I'm assuming that everybody knows that a private letter ruling only protects the person who gets that ruling. It is not like a revenue procedure or something like that. It is not general publication. You apply for a private letter ruling as an employer, you get it as an employer, and technically only you can rely on it. However, for purposes of providing opinions, it's an authority that we can use, although not a primary authority. It has real merit to the people who get it.

What is a rabbi trust? What have we done so far? We've gotten protection. You can have a trust out there that basically will provide a benefit in the case of a change of control. However, in a bankruptcy situation, it is reachable by the company's creditors. It's not full protection.

The next step, before we get to the real bankruptcy issue, is called a secular trust. It is essentially the same form of trust as a rabbi trust, but it has the situation that its assets were beyond the reach of the company's creditors. In other words it is no longer a corporate asset, and is therefore funded for tax purposes. As a funded trust, the employees are taxed on the amount that they vest in when they vest. That can be over a period of years, or more typically, at one point in time (i.e., retirement) where they would actually reach it.

Since the executives are going to have tax, the secular trust normally would be drafted in such a way that it would distribute sufficient income to pay the tax in any year. What tax lawyers hoped the result would be was that the income would not be taxable to the trust, but to the employer. Then the employer would treat it as a contribution to the employee, and the employer would get an offsetting deduction for that. The IRS disagreed with that tax characterization and basically said that a secular trust is essentially a trust under Section 402(b), a nonexempt trust. Therefore, the trust income is taxable currently to the trust and eventually to the employees. It's a potential for double taxation. Most people thought that killed the secular trust because, as a tax matter, paying taxes at two levels is something you always want to avoid.

Lately I've seen consultants perform calculations comparing a rabbi trust to the secular trust, and the secular trust still came out better from a net basis. As such, people are beginning to play around with them again.

MR. INGUI: I agree. Actuaries can play a role in this, and I recently went through one of these exercises. A CEO of a company was concerned because over 50% of his retirement income was going to be payable from a nonqualified plan. That made him a little uneasy. Therefore, we started talking about rabbi trusts. That did not sufficiently comfort him, so we then looked at secular trusts. He also did not like the concept of not vesting until he retired. He wanted to be vested, and under the secular trust, that was going to trigger all kinds of taxation. We started looking to restructure his nonqualified plan. For example, let's assume he is to receive $100,000 of nonqualified retirement income per year, which would have been a taxable benefit to him at the time he received it. We started restructuring under a secular arrangement whereby we targeted for an after-tax benefit of about 55% or $55,000 per year. Thus, we structured the secular trust to provide him with $55,000 annuity and the value of the difference (i.e., the present value of the other $45,000) would be paid to him as income so that he could pay the tax.

MR. WOODARD: I think we're going to see more seculars come back where they have been dead for the last two years or so.

MR. INGUI: I have heard that there is a way to avoid one trap of having the secular trust income taxable to both the corporation and the employee.

MR. WOODARD: There are a number of potential ways to do it, by also using Section 402(b), and I think some people are doing that as well.

MR. ORINGER: Arthur said that these ways are not really mainstream right now. I don't think they were ever truly mainstream. They're extremely complex and can involve a lot of actuarial and consulting fees, which can also lead to resentment. I've had clients come back to me and say, "My consultant suggested this and we decided it was a very good idea. We did it and now we have substantial fees every year." It actually could wind up working to create some bad blood. It is a very complex thing, and I think the client should really need this vehicle before it is the one that the client proceeds with.

The other issue is that this may well be, and in fact probably will be, an ERISA plan. Because it's funded, it will not be exempt as a top hat plan that has to be unfunded. There's a circularity there. Making this an ERISA plan is tricky. You help the executive because you probably protect the money from not only the employer's creditors, but also from the executive's creditors. But on the other hand you have to worry about things like annuity rules giving the executive's spouse, depending on the way the plan is structured, possibly a 50% interest in the funds that are accumulated. I think that before a company gets involved with it, the company should really know exactly what it is buying.

MR. WOODARD: Let's discuss corporate-owned life insurance (COLI). The insurance people are out there marketing COLI and marketing reverse split dollar and marketing a lot of things. What is COLI? It is what it sounds like; it's corporate-owned life insurance. It's again an unfunded way to fund a plan. It is insurance taken out on the life of the executive that is owned by the company. Since the company is the owner and the beneficiary of the policy, it pays the premiums on the policy and has all the incidents of ownership in the policy. So it's a corporate asset. Why do you use it? One of the reasons that's given, that doesn't have a lot of credibility, is that you can borrow against the policy and use that to pay the deferred compensation that is required through the years, rather than use corporate assets. However, since you've paid the premium on the policy, you've essentially already paid those assets.

The real reason is supposed to be it's a great economic vehicle. The life insurance industry will tell you that, if you use COLI, you're basically getting all this for free, because the insurance is so good, the internal rate of return is so good. However, if you look at the calculations carefully, it's not the greatest thing, unless you take all the insurance company's assumptions as gospel, (i.e., that the company's going to have an internal rate of return of 9%, 10%, 11% on its dividends, etc.). Then the fine print tells you, however, we only guarantee 2%. It can, however, work out. I mean insurance is clearly better than it was 15 years ago, where you didn't have universal or variable life insurance. Just be aware if you get into COLI, as actuaries in particular, people are going to look to you and say, "Is this really as good as it seems?" If you hear that somebody is using insurance for deferred compensation, then maybe, as an actuary, it's not a bad time to say, "I should take a look at this to see if the economics really work the way they're supposed to work." If you do this, then I think you can perform a real service to your client.

MR. ORINGER: We had a public company client considering COLI and what we told that client to do was to get an actuary in there to analyze the product. The mistake that the lawyers make, is thinking that we have the slightest clue as to how to analyze the economics of a COLI.

MR. INGUI: What I attempt to get clients to do is to look at variations in the numbers. What if life expectancy is one, two, or three years longer, on average, than what the projection shows? What if the dividend scale is only 4% or 3%? If you start running "what if" scenarios, they get a sense of the volatility that some of these assumptions can have on the results, and thereby, be in a better position to make a decision. What I see as the biggest value in using COLI is the pretax buildup on the assets. It's the only product that I know of that you can get a tax deferral on the investment portion. If you have a young enough group, that could be a meaningful factor. It's not as meaningful when the executives are all in their late 50s and early 60s.

MR. WOODARD: I think that's right. As long as you do it right it may work out. The tax-free buildup is worth a lot.

MR. DREIGHTON H. ROSIER: Along that line I'd share a couple personal experiences. We are what you might call a boutique insurance brokerage. In the private placement products, the variable life insurance separate account products, if you're dealing with a corporation large enough to put in $10 or $15 million a year in annual premium, you can pretty well structure that to work very much like the executive's own qualified retirement program is going to work, so far as the way the assets are managed. You should be able to get very real numbers out of that kind of deal. If you're leaking 50 basis points to manage a pension trust, you should be able to have the same type of management. However, you can't pick the manager because there are investor control issues. That means simply that, to have it be an insurance product and qualified as an insurance product, you cannot go out and say, I'm going to have a partial insurance company manage it. However, you can certainly pick investment managers from the carrier's list of approved managers.

MR. WOODARD: I thought I've seen them with the carrier picked. It's not a modified endowment.

MR. ROSIER: No, this is purely separate accounts. It can be in real estate, foreign equities, just about anything that would qualify as a pension asset would qualify as a separate account asset. The one difference is the degree to which the policy owner controls the investment process. What I wanted to get to is that typically on a pension trust that large you're going to be leaking around 50 basis points in expense to manage it. For the insurance product itself, you should be able to get your expenses down to 70–90 basis points, fully loaded with brokers fees and all that, because these are financial products and we're not making a bundle on them. There is a tremendous amount of activity in this area. I would also mention split-dollar COLI, but that's probably beyond the scope of this meeting.

MR. WOODARD: I think you're right. What I said before, the world has changed a lot. There are private placement products, there are other products out there, and I think it's more a disclosure issue. What does trouble me about this is that often the client does buy the product without asking the questions, and if what the client bought is a product that has very little load and very little anything, then it probably does work out just fine. The problem is if the client gets burned by somebody.

MR. ORINGER: There is a frustration when you go to the client and you ask if the client has looked at the finances of the product. The client says "Yes, the broker walked us through all that." You may need to point out, without disparaging or meaning to disparage anybody, that your client may be getting the positive aspects about the product from the person who is selling it. It can just be a situation where there might be other information that the person who is buying it might also need to have. This is why there is a need for an independent consultant to give a balanced and more complete recitation of what may happen.

MR. WOODARD: I'm going to move to an area that I find the most fascinating, which is, how secure is secure. In other words, we know that a promise to pay that's not secured in any way is fine. We also know that a funded promise is not fine, and we talked a little bit about the rabbi trust and everything in between. Now let's talk about third-party guarantees. There was a real issue that, if a company promises to pay an executive $50,000 in the future, is that secure? Is the company so secure that it was almost a funded promise? Nobody really thought that this was terribly likely, but we as lawyers would talk about this. Another question was, what if a subsidiary of a company promises me $50,000 a year? Now let's say the parent company guarantees it. Is that now so secure? Have I two corporate entities securing the same promise? Have I now so much security that in effect I have an economic benefit today? I don't have constructive receipt, but I have economic benefit. Economic benefit is basically something that's there, and you're not going to lose it.

The answer was that we didn't know for a long time. The IRS did finally come out with a private letter ruling some years ago that basically said that a guarantee by a parent to pay deferred compensation does not result in current taxation, and the IRS limited that ruling fairly tightly by saying that essentially it was the same control group. The ruling doesn't spell it out as well as you'd like, but the IRS seems to be saying, in essence, it's the same promise. The fact that it might have been a barely solvent subsidiary that you're working for versus a very solvent parent didn't seem to matter a lot. The IRS basically gave it in the context of the control group that you did not have a problem. The IRS did not go outside of the control group issue, (i.e., a third-party guarantee).

MR. ORINGER: Very recently, in the rabbi trust area, the IRS has gone the other way. It said if a rabbi trust is established by an affiliate, and the creditors of the affiliate can get to the assets but not the creditors of the actual employer, then that may not work, as distinguished from the completely unfunded mere guarantee. Who knows where any of it stands, but the IRS has made special noise about the rabbi trust, so be careful if you're doing a rabbi trust for affiliated entities.

MR. WOODARD: Indemnity insurance is the most important thing that's out there today for securing benefits. What is indemnity insurance? It's insurance typically written on the casualty side of an insurance company that provides for insurance in the event the employer does not pay the benefit. It's a policy that says basically exactly that. If for a specified set of reasons the company does not pay the benefit, the insurance company will pay it.

The issue is what happens from a tax perspective. Is a premium paid? In the old days it was paid by the employer, and the question was, does the payment of that premium by the employer either result in taxable income equal to the premium, or does it create a secured obligation so that the entire deferred compensation that's being insured against is currently taxable in income. The IRS first looked at this issue in the context of a surety bond. The IRS basically said that, in that context, if the employee purchased a surety bond to secure payment of his employer's promise to pay him deferred compensation, there was no constructive receipt or economic benefit, and therefore, no current taxable income. Had the employer paid the fee, the IRS's answer probably would have been different. It would have been taxable income to the employee equal to the deferred compensation. That ruling was issued in 1984 or 1985. About a year later, the IRS began to speak about that ruling, because the IRS apparently did not realize how a surety bond works. It thought you go out and buy a surety bond and that's the end of the game. The IRS then found out, that the employer agreed, in that situation, to reimburse the surety company for any cost it had as a result of the employer's failure to pay. The IRS then began to say, "Forget that ruling, we probably would not have given you the same ruling if we had been aware that the employer was responsible." We feel that is unclear. The IRS never said why that promise to repay the third party creates constructive receipt, but it kept saying it. The question still was what can you do if the employee pays the premium.

A new product was started around 1988 that I actually was involved in negotiating the first one that was sold. It was an insurance protection issued by Lloyd's of London to employees. It had a couple of features that the IRS eventually made very clear it did not like. The new product had situations where the employer expressly agreed to a counterindemnity arrangement, where if it ever did not pay the benefit and the insurance company had to pay the benefit, the employer would reimburse the insurance company for that amount. Sometimes there was an enhanced subrogation right where the employer actually agreed that it would pay the insurance company within five days or ten days after the payment was not made. Even though as a subrogation right, the insurance company wouldn't have the right to that payment that quickly. The IRS jawboned against that product for a couple of years, again on the basis it was constructive receipt or economic benefit and on the basis of the entire amount insured would be currently taxable.

Most tax lawyers believe that, even if the payment of that premium, somehow or other, is taxable, it's only the premium itself that's taxable. It's hard to conceive how, if I buy insurance as an employee, I am getting some right to something today that's beyond what I had before. All I have is the insurance company's right, and that can go away in bankruptcy like anything else.

In summer 1994 American International Group (AIG) went in for a ruling on an indemnity product that it issued and it received a private letter ruling. The ruling is interesting on a number of bases that we've talked about. What happens in the AIG product is it gives you protection basically in change of control and bankruptcy situations. The employee pays the premium, and the IRS forced AIG to basically take the position that the employer could not be involved in the negotiations of the policy at all. The employee has to do all the negotiating and buy it, etc. The IRS position was any employer involvement taints the product. In point of fact the IRS has said orally that it recognizes there's got to be some employer involvement because the employer, at least, has to produce certain documents that the employee probably won't have.

In that way, the IRS basically blessed the insurance policy. The policies can be five years of protection so that if anything happens in a five-year band, the insurance company will pay off. There are a couple of problems: (1) They're expensive. They're typically about 7% or 8% of the amount insured. (2) The employee is supposed to pay it. Can the employer bonus-out the money to let him pay it? Theoretically the answer is yes. The IRS would probably say no. If the employer did, it would only be a bonus taxable to the employee, he or she would still be better off with that and paying tax on the bonus rather than having to buy the whole thing out of pocket. What's troubling about the ruling is the ruling is good news and bad news. It's good news in that there's a product out there that you can tell your clients basically you can in fact secure the benefits probably better than anything else out there. The problem is that it's expensive. The IRS basically forced the insurer to go for the ruling exactly the way the IRS wanted it so that its private letter ruling would be very specific (i.e., there would be no employer involvement and the premium would be paid by the employee). Most important, the IRS gratuitously issued a ruling under Section 132. Section 132 is the fringe benefit section of the Code that allows you to exclude fringe benefits from income.

If you read Section 132 as it's written, you come to the conclusion that the employee would be able to exclude from income the amount of the premium if he had to. The IRS ruling office had no authority over Section 132 at all in this ruling. The IRS inserted a negative 132 ruling in the private letter ruling despite that. In order to go in for a ruling now, you have to basically give up any possibility of using Section 132.

The other problem is basically that your client's securities have to be investment grade or better to qualify for this product. What does that mean? That means you basically have to be a company that's not in financial distress. If your company is not in financial distress, you may not want to pay 8% for this insurance. It has been sold. I don't know where it's going to go, but it's probably the most active executive compensation issue we've had except for Section 162(m). This product is out there; it's being marketed aggressively. I think other companies are now marketing it.

There will probably be variations of it. Do you have to stick with what the IRS said? The answer is no. What's the risk if you don't? The risk is that you'll be in a situation where, for the executives that you deal with, the IRS will assert the position that they're fully taxable. Can the IRS win that? I don't think that the IRS can win any argument that says the purchase of this insurance creates an economic benefit or constructive receipt to the employee. I think the most it can win is that the premium, even if the employer pays the premium, is taxable income today to the employee.

MR. ORINGER: Arthur, you had mentioned that the IRS ruled on the 132 that the premium was not excluded. Do I understand from that you think there's a good argument that it should be?

MR. WOODARD: I wrote an opinion to that effect, yes. The answer is that 132 probably was not intended to pick this up, but that a literal reading of 132 does pick it up and that I believe typically that you're entitled to read regulations as they are written. Caution on that to the nonlawyers in the room. It doesn't seem to be the rules any more. You used to be able to say that, if the IRS issued a regulation, it was whatever it said. The IRS seems to be cutting back from that position in a nonrelated area in partnership tax. The IRS recently came out with regulations that basically say, even if you follow the law, if the IRS deems it to be an abusive transaction, or anything that avoids tax, the IRS can recharacterize the transaction. We have to look at rules like that as if they will come into our area as well. Right now the ruling is quite clear that you can't use 132 if you want a ruling on your situation. If you go for the AIG policy or whoever is issuing it, the only way you're going to get a ruling is to give up 132.

MR. ORINGER: Who goes for the ruling, the insurance company or the employer?

MR. WOODARD: In this context it was the employee. In fact, the IRS had to withdraw the ruling at first because the first employee that the IRS went in with, the employer was in the room with him and the IRS would not issue the ruling. You'll find that if you get into this, it's going to be very hard to jump through all the hoops to put this in place without some level of employer involvement, although AIG is doing it and apparently selling a fair amount of it.

MR. INGUI: I'm going to end up with covering some of the actuarial and accounting issues. When you go away from this session, for those of you who don't do work in this area, I hope you'll see that there are a lot of areas that involve actuaries. I mentioned some things earlier, such as analyzing secular trusts and COLI products. An interesting one I had not heard of before is using actuaries to determine what is the compensation for purposes of the three times rule on phantom stock.

There's also some more routine actuarial work that has to be done with respect to some of these plans. With respect to, let's say, the traditional top hat or excess plans, there is no requirement that they be reserved or assets be put aside. They're not subject to Section 412 unless they become a legally funded plan. Then ERISA applies including Section 412. If you do have a client that wants to use a rabbi trust and wants to start putting funds aside, then the question becomes, how much? You don't have to follow Section 412.

Some companies like to know that at any point in time the rabbi trust has assets at least equal to the present value of accrued benefits. That could be one objective and the driving funding method. Others will just simply use the *SFAS 87* expense calculation as the amount to contribute to the rabbi trust.

On the accounting side, a defined-benefit top hat plan or defined-benefit excess plan, is subject to *SFAS 87* and *SFAS 88*. They do have to be expensed. The expense will accumulate as an accrued expense liability on the company's books. As employees receive payments, they are treated as cash contributions against the accrued expense.

If you have curtailment or a settlement, then *SFAS 88* applies. Therefore, it is important to note to your client that, although these are not funded plans, they will impact on the income statement.

The other actuarial area is the whole issue of how you calculate the amount that's going to be subject to Federal Insurance Contribution Act (FICA) tax, especially when you've got a defined-benefit type nonqualified plan. A defined-contribution plan is pretty simple, but in a defined-benefit top hat plan the calculation is not as clear. One problem is where the largest value is not at retirement, as is often the case where the nonqualified defined benefit is reduced by the value of a qualified defined-contribution plan.

One issue is what actuarial assumptions are you going to use, what mortality, what interest rate. A nonqualified plan doesn't have to specify an actuarial basis in the plan. This is going to be a big issue, and the numbers may not be insignificant.

MS. DEBBIE L. BENNER: I had a comment on the secular trust. In my recent previous life with Mercer we were setting up secular trusts with a company, and I understood that, if you offered cash at the time the money was put in, you avoided a double taxation.

MR. ORINGER: The problem with offering cash is that it's absolutely not what any company wants to do generally. There's paternalism involved to the extent that you're setting up a pension plan. The whole point is that, if the company had no interest in being paternalistic at all, just give the employee the cash and let him or her do whatever he or she wants. The fact of the matter is, that it's usually counter to the basic precept of the pension plan to allow a cash distribution of this annuity amount and so companies don't want to offer the cash. Actually in your particular case, or the issue you're raising, the cash option has to be at the time that the contribution would otherwise go into the secular trust. I haven't followed it closely enough to know whether or not what you're suggesting beats the issue and maybe it does, but for most companies it's going to be a nonstarter as a business issue. If you offer cash, then the IRS concedes that it's an employee contribution and then the rules get turned on their head.

MS. BENNER: I think the company might not have cared because it grossed up the tax and made it a nongross up if the employees took the benefit in cash.

MR. ORINGER: In that case the IRS would then say "Yes, it's OK." Those are the early secular trust rulings. It is an employee contribution, but I'm not sure if that has the effect of avoiding the double taxation that Arthur was referring to.

MR. WOODARD: I wasn't aware of that particular wrinkle from Mercer.

MR. ORINGER: The way I think to beat the double taxation is to do it with insurance products so that there is no second time to tax because the first time doesn't get taxed because it's insurance, but then you have to pay the loads and all that stuff.

MR. GERARD C. MINGIONE: There's another alternative that I've seen, and I can't swear to how shaky the logic is behind it, where you simply kick out the investment return each year to the executive and force the executive to send it back into the trust in order to remain a participant, and that was intended to keep from double taxation.

MR. WOODARD: I've seen that.

MR. ORINGER: The mechanics there is that you can't deem the earnings to come back to the employer, and then back in, which would have solved the problem. The reason you can't is because it's an ERISA plan, and the money can't revert back to the employer.

MR. MINGIONE: So are you saying it works with a caveat or are you saying it doesn't work?

MR. ORINGER: I guess you would raise the question of whether or not if you kicked the money back in with the requirement that it be repaid as to whether or not that would be respected as having any substance. If the person's only right to get the money is if he puts it back in, then have you made a distribution recontribution at all?

MR. MINGIONE: He'll have the option to keep the money, but then he will no longer be participating in the secular trust.

MR. ORINGER: That's interesting. Maybe.

MR. INGUI: I think there is a way where you can just pay out the income of the trust.

MR. ORINGER: Again for the same reason at the Mercer level, that's just as a business matter, not what it wants to be doing. The company wants the money accumulating for retirement.

MR. INGUI: It's an approach. We did an analysis where we had to look at it that way to avoid the double taxation. Having the individual getting the interest paid out is just another aspect of the calculation you may have to investigate.

MR. ORINGER: It's frustrating because I think that on this one, the IRS was upset at the possibility that a lot of pension accruals could go into the nonqualified route through the secular trust, and the IRS adopted this double taxation theory, which may have some technical support, as a way of keeping more of the pension money in the qualified plan rules where all the antidiscrimination rules apply. I think this was an example of using technical arguments to accomplish a policy goal, because I think that as a policy matter, it's hard to imagine that Congress really thought that somebody should be double taxed on these earnings.

MR. ROSIER: You mentioned that you had seen quite a bit of activity with the indemnity insurance. We've seen a great deal of activity of employers looking at it, but when they get through the analysis, they find when they don't need it, it doesn't cost an awful lot, it's 5–7%. However, when they do need indemnity insurance, it gets very expensive, plus you've got to renew it every five years and have a premium rewrite. So our experience has been that, yes, there's a great deal of activity, but so far no real buyers. I'd like to know what your experience has been.

MR. WOODARD: We have had a couple of clients that have done it, but I think there's been a lot more looking than there has been buying. My feeling is that maybe ten or twelve policies have been sold so far, and maybe 500 people looked at the product. Is that good or bad? I think that's a lot of activity for this kind of an area, because at least one of those was in excess of a $200 million of policy. If you add up the ten or twelve, it may well be $1 billion or more. That catches my attention. A bunch of clients have pulled away from it. I don't know that they've pulled away from it forever, though. I think there's a time frame again where, if they sell 50 or 100 of these, there will be more enthusiasm by some of the clients to get involved. Your point is well taken. There is a relatively significant cost, but the second phase is to cost a little less if you're investment grade. If you're not investment grade, you either can't buy it or the cost becomes spectacular.

MR. INGUI: The other danger is, if you're investment grade when you buy it and you deteriorate, you may not get renewed. Depending on the time horizon, unless the executive is going to be retiring within five years, there is some reduction in the comfort levels.

MR. WOODARD: Although I haven't seen it from other insurers, the policy that we originally wrote was ten years and my understanding is some of the people out there are going beyond the five-year horizon, but I haven't seen it yet, although I've heard that some people are willing to go beyond that. I assume it means people must be going to ten years rather than the five, but again I don't know who it is at this point.

MR. BRIAN N. O'KONSKI: I have a question going back to the earlier sessions. Section 457 plans are available to both public employers and to tax-exempt entities, but tax-exempt entities are not exempt from ERISA requirements. For example, they are to be funded plans unless they are top hat plans. Who can you offer a Section 457 plan to for a tax-exempt employer?

MR. INGUI: A Section 457 plan for a tax exempt, an eligible 457 plan, cannot be funded. Therefore, to make it work, basically a plan must cover only the higher paid employees. It's a way of giving some of the higher paid people in the tax-exempt organization, if they don't already have a 403(b) annuity, something that's comparable to a 401(k) plan. That's basically what it is. If you are tax exempt and you cover everybody, you do have a problem because it isn't funded in the legal sense, and then you have ERISA issues that kick in.

MR. ORINGER: Right. That was actually a point of real conflict when this first came out. People assumed that, when 457 was extended to tax exempts, that there must be some implicit exemption from ERISA from the funding requirements. That's been squarely rejected at least by the Department of Labor (DOL) and the IRS, if not by a court, and I think the DOL and the IRS are right on this. You are left with the odd situation that you have to offer the 457, if you're tax exempt, to only your high paid, unless you're a church plan. The other troubling thing in the situation you're pointing out is what do you do with a 501(c) other than 501(c)(3). Let's say you have a 501(c)(6) trade association that's tax exempt but not because it's a charity and you're pointing out the 401(k) problem. That tax-exempt organization will not be able to do a 401(k) because tax exempts can't do 401(k)s any more. You won't be able to do a 457 plan for the rank and file because of the funding issue you've just identified. On the elective deferral side for non-501(c)(3) tax exempts, it may well be the case that you can't do anything. These are more examples of the rules just not fitting exactly right.

MR. INGUI: I personally see more activity. Those who run large tax-exempt organizations make large sums of money, and they don't like to know that their qualified pension is limited by the $150,000 compensation limit any better than an executive in a taxable company. We've been finding more activity in the ineligible plans. We're trying to do something as closely as possible to a typical top hat plan for the executives of the tax-exempt organization. Unfortunately it isn't quite as good, but it's better than nothing.

MR. WOODARD: The only caveat there, is that from the legal point of view, I think you're well advised to tread softly in the whole 457 area. I said it at the first session, the IRS is very serious about the public pronouncements it's making with respect to tax exempts. It is expending an enormous amount of money on the audit with respect to those entities. It typically asks how does your 403(b) plan work, what have you got under 457, and what do you get around 457?