**RECORD, Volume 22, No. 2***

Colorado Springs Meeting
June 26–28, 1996

# Session 28PD
# Executives Need Pensions Too!

**Track:** Pension
**Key words:** Non-qualified Pension Plans, Supplemental Executive Retirement Plans (SERPs)

**Moderator:** WILLIAM B. FORNIA
**Panelist:** STEPHEN C. KINSKY
**Recorder:** WILLIAM B. FORNIA

*Summary: Because of reduced limits on qualified plan benefits and recognizable compensation, interest in executive benefits has increased. However, because of the Federal Insurance Contribution Act (FICA) tax, and funding issues, the complexities of designing and administering supplemental executive retirement plans (SERPs) have also increased.*

**Mr. William B. Fornia:** I'm from Buck Consultants, and Steve Kinsky is from the Equitable. Steve is an associate agency manager, where he is responsible for sales development and advanced underwriting at Equitable Denver; and I'm from Denver, as well. I'm a pension actuary with Buck Consultants. Steve has 20 years experience in the business. I have 17 years experience with pension actuarial matters. I'm your classic, large plan, pension actuary, but I do probably spend about 20% or so of my time on nonqualified plans. This is a subject near and dear to my heart.

I'm going to spend some time on an overview of SERPs. Steve is going to talk about supplemental executive retirement plans funding, and an analysis of some of the approaches that Equitable takes.

Finally, we'll wrap up, by discussing FICA taxation of SERP rules. We probably could have had two 90-minute sessions on those proposed regulations, because as some of you might know, they are very elaborate, with lots of issues and many interesting details. I'm going to go over what the regulations are.

Let's discuss a little legislative background on nonqualified plans. The reason that nonqualified plans exist is that it was never legal to have a plan that was dramatically discriminatory in favor of the client who is paying your bill—the highly paid people in the plan. That has always been the case. Even early on in the ERISA, Section 415 caused limits on the qualified plans, so naturally, employers considered having nonqualified plans. Finally, with the $150,000 pay cap, a new limit came into play. I'd go out on a limb and say that for most qualified plans, the $150,000 pay cap is probably a bigger restriction on executives' benefits than the 415 limits. So that's now taken over as, in many cases, the primary limitation of the pension benefits. Given those factors, many employers decided they want more for their executives, so they put in nonqualified plans. That's not really news.

There are two broad categories of nonqualified plans. The simplest one is just an ERISA excess plan. That is a plan that only pays benefits in excess of the 415 limits. The other classification of nonqualified plans is what we typically think of as SERPs, which are top hat plans. There is a distinction, because ERISA excess plans are more automatic; you don't cover a select group of managers or highly compensated employees in your ERISA excess plan. Anyone who exceeds the 415 limits can be in the ERISA excess plan. It doesn't even have the reporting requirements that the top hat plans do.

The top hat plan has to be an unfunded plan, and this is actually in ERISA. It has to cover only a select group of management or highly compensated employees. Unfortunately, there's not much guidance on what it means to be a select group of management or highly compensated employees. It does not mean the traditional highly compensated employee definition that's elsewhere in the code. It's more restrictive than that, generally. If you have a client who has a lot of people that are highly compensated, you may not be able to put all those people in your top hat plan. That became a serious problem for a lot of these nonqualified plans, especially when the pay cap came in and it made it harder for you to pass your average deferral percentage (ADP) and average contribution percentage (ACP) tests.

Many of these employees are between the highly compensated limit and what the employer can comfortably consider a top hat group. Tweeners is what we call them, because they're in between; they're getting hurt by the limits, but they're still not executives. Those people are out of luck in many cases. The last feature of a top hat plan, and the nice feature, is that the disclosure requirements are very streamlined. You don't have to file Form 5500s and such, as long as you have written to the Department of Labor (DOL) stating that you have such a plan within 120 days after you adopt the plan. Again, that is all in ERISA. If you're going to have one of these plans, you probably ought to do one of these letters because it will save you many headaches later on.

I'm going to talk real briefly about some typical design types of plans, and the lingo is my own. There is really no standard or conventional language. The type I'm most familiar with is a SERP. What is a SERP? This one is a wrap-around defined-benefit plan, where you use a defined-benefit plan formula that generally takes into account all compensation. It maybe has a richer formula than your qualified plan, but before you pay the benefits, you must subtract out or offset the pension which you get from the qualified plan. I've seen plans where you offset a benefit which would be attributable to what the employer has put into the savings plan or the defined-contribution plan. Sometimes I've even seen plans where they also subtract out Social Security. In a classic case, you might want a 60% retirement benefit, 60% of final pay, not limited by 415 or the $150,000 pay cap, or anything like that; that's your target, and you just subtract all the pieces that the employer gives you. That would be a relatively typical SERP design which I call a *wrap around*.

Another common design is what I call an *add on* SERP where you just have a very explicitly defined SERP that is added on to whatever your other benefits would be. In some cases, it's added on to zero. Some companies don't have qualified defined-benefit plans for all employees, but they do have nonqualified defined-benefit plans for their executives.

A third type of plan is what I call a *mid-career plan* and that can come in two forms. Some of the largest companies will have a standard mid-career hire policy, where they grant additional service credit. If you're hired at age 40, you still want a full retirement benefit, or close to a full retirement benefit if you work until 65, so it will have a faster accrual. That can either be on an ad hoc basis, where you do a special contract for each executive which you hire, or you can have a standard plan which you use for all your mid-career executives. It's not uncommon for even medium-sized companies, which to me means maybe 1,000–10,000 employees or more. It's not uncommon for them to cut special deals when they want to hire an executive at age 40, because the executive may have a good defined-benefit plan from the prior employer. They need to do something to sweeten the pot, so maybe they'll have a carve-out of what the other employer provides, or something along those lines.

Finally, the fourth type is a defined-contribution plan. I'm going to call it an account plan because that's what the proposed FICA regulations call them. A classic example of that is some type of a 401(k) make up plan. If you're over $150,000, you get to continue to defer into the deferred compensation plan, and perhaps even get a match. Those are typical plan designs. We're not going to talk too much about the account plan because the topic is, "Executives Need Pensions Too!" not just Executives Need Retirement Plans Too.

**From the Floor:** On the wrap around, how much do you worry about tying everything together, if you're subtracting something off? They all have to happen at the same time. It's the savings account plan or the plan from the other company, if the employee is hired mid-career.

**Mr. Fornia:** There are many cases where it's a deferred-vested benefit from the other employer. There are two ways to do it. Let me clarify what I think the question is. Let's say you have an executive that you're hiring, and he or she is getting a deferred vested benefit from Company X and you're joining a new company. You want to be able to retire at 60, but the deferred-vested pension doesn't pay at 60; it pays at 65. There are two ways you can do it. One is, when they do ultimately retire, you come up with your own actuarial reduction, or you could just have a benefit that steps up, or that pays a lower annuity from age 60 and then a higher annuity at 65. What's probably more common is, many of these plans pay lump sums, so you would just do all the calculations and say, "Here's your lump sum." The idea is if you invest the lump sum, it can pay you 60% of pay for the next five years until you turn 65, and then it will only pay 50% of pay because your old employer is going to pay the difference.

Lump sums are very common in these plans because they are unfunded. If I'm an executive of a company, and I'm about ready to retire, I don't want to just be an unsecured creditor of my former employer. The lump sums, I don't have any statistics, but I would say, 60–66% of these plans pay out in lump sums. What do you think, Don?

**Mr. Donald J. Segal:** It's the form to take, be it lump sum or annuity; it's a nonoptional benefit. It's stated in the plan that the employee has no option.

**Mr. Fornia:** Typically, if the employer is willing to provide lump sums, there is a constructive receipt problem with letting the executive wait until the year they retire. Qualified plans are exempt from constructive receipt. In other words, when you're about to retire, you can make a choice if it's a qualified plan.

Let me give an example of constructive receipt. If you buy a Colorado lottery ticket, you must state when you buy whether you want to take the winnings as an annuity or as a lump sum. You must say that before you give the attendant the dollar. The reason for that is, if you don't say this upfront, and you take the annuity, the IRS will say, "We're taxing you on the lump sum because all you're doing is deferring receipt." It's just like if you get a paycheck on December 31, you can't put it in your drawer and wait until next year to cash it and then try to not pay income tax on it that year. That's constructive receipt. Qualified plans are exempt from constructive receipt. If your qualified plan has a lump-sum feature, even though you have the ability to choose the lump sum or choose the annuity, you'll get taxed on it as you receive the annuity, even though you could have received the lump sum.

Nonqualified plans are not exempt from that rule; therefore, you have to make the election some time before you get the payment out. There is no clear guidance on that. I know that you can't do it right before you retire, but the conservative way is that employers, at the time they adopt the plan, will make you take an election. Most of my clients do that. When the executive goes into the SERP, even though they won't retire for another 15 years, we ask, "When you retire, do you want a lump sum or do you want an annuity?" That's the safest way to do it. There are some law firms which have been giving legal opinions that say, executives will be allowed to change those elections periodically. The most aggressive one I've seen is how every two years you can change it, but the change is only effective if you wait six more months after that. That still gives you some flexibility. This is just another deferred compensation plan. If you're about to take a lump sum and you defer it (you say I want it in annuities), that's just like a deferred compensation plan. I think there's a good argument that says that in the calendar year before you're going to retire, you should be able to say, I want to defer the compensation I'm getting next year. That would just make another deferred compensation plan.

**From the Floor:** Is it up to the actuary to calculate lump sums?

**Mr. Fornia:** Actually, I specify it but you don't have to; it's not subject to the same rules that qualified plans are.

**From the Floor:** Where's the confidence of one side or the other?

**Mr. Fornia:** I think you need to specify it. If I was an executive, I'd sure want it specified. Especially since you need a low interest rate. Consider the concept of a lump sum. In a qualified plan you take the lump sum, and the theory is, you roll it into an IRA. You invest it, and you get tax deferred build up and then you take it out and you pay yourself exactly the same annuity that you would've gotten if you'd taken the annuity. Then you die when the actuary says you die. You all know that we don't use real contingencies. We know you're going to die at a certain age, and that's the way I try to explain it to my clients, at least.

In a nonqualified plan, say you take a lump sum and you pay your tax, (let's say tax rates don't go up or down). When you invest what's left over and earn income on that investment, you have to pay taxes on the income on that investment. In theory you should use a lower interest rate for calculating a nonqualified lump sum than for calculating a qualified lump sum because you don't get the tax-free investment return; you get taxable investment return. So you may be using a municipal bond yield. I often use 65% of a 30-year Treasury bond or something like that. It is usually very desirable to specify the interest rate so the executives have the confidence that you'll get a decent deal. Don't forget that these are opposite of the qualified plans where you're often trying to really limit the benefits you're giving to these participants. In the executive plan your client is the person you're giving the money to, so they like to be a little generous and it's very reasonable for them to want to specify an interest rate.

Let's discuss some common design features. Obviously a higher pension accrual formula is not uncommon. I just touched on lump sums briefly. I think I mentioned the participant is an unsecured creditor of the corporation; that's part of the reason that they don't have to pay tax on it. Occasionally, a SERP will have a more generous early retirement provision than a qualified plan.

In terms of vesting, I just said that you're often more generous to your executives than you are to other participants. I sometimes see nonqualified plans where the vesting is more restrictive. They want to have some kind of golden handcuffs on the executives, so they may not give any vested benefit. Now, this is more common in the type of SERP with a higher pension accrual than in the SERP that's just a make up for the qualified plan limits. I think if you have a SERP that is just a make up for the pay cap, it's hard to argue that you shouldn't have the same vesting provisions as your qualified plan. I'd have trouble telling my client, who's a participant, that he can't be vested.

**Mr. Segal:** Vested by you or you directly receive it?

**Mr. Fornia:** You don't receive it. It's still deferred compensation. Let me back up. In the classic deferred compensation, you say, "Hey boss, you know the bonus that you're going to pay me next year—don't pay it to me next year, pay it to me at age 60." So even though you're vested in that, meaning that the employer has a contractual right to give you that, you don't have constructive receipt of that because you've already, irrevocably deferred it. That's how you avoid constructive receipt. Even if you're vested in a defined-benefit plan, you still don't have constructive receipt because you have to terminate employment to get it. I'm not really clear on all the ins and outs of constructive receipt, but I believe you have to do something like die, quit, or retire to get it, and then you are not taxed on it. Before I go on, let me mention one huge exception to all this, and that's not-for-profits. If you have not-for-profit clients that have deferred compensation plans for their executives, they are subject to federal income tax, so it doesn't work. This kind of stuff doesn't work very well for these people, and they never have vested benefits, or if they do they have to pay taxes.

**From the Floor:** Can you define all these plans to get around the constructive receipt issue?

**Mr. Fornia:** One way to avoid this is you are subject to the risks of default if you're employer goes bankrupt. That's one of the reasons why people like lump sums, as I said before, so that's part of the reason you don't pay taxes on it.

Another provision that's not unusual is change-of-control provisions, where there's a more generous benefit upon change of control, or perhaps an immediate payout. Don't forget, these things are typically not funded, although Steve will discuss some of the ways that some of these are funded. Finally, there are what we call bad boy clauses. These are more common when these plans pay annuities. What it basically means is after you terminate, if you go to work for a competitor, the employer has the ability to stop payment and ask for money back. Now, this is not enforceable in many states, but that certainly doesn't stop employers from giving it a try. It makes sense, and it's usually in their best interest. Obviously, you can't do that in a qualified plan.

I briefly mentioned DOL disclosure. That is required in order to be exempt from filing Form 5500s. You need to write a letter, shortly after you adopt the plan, to the DOL. The SEC disclosure is what I call the proxy statement. In the proxy statement, you need to list all compensation that your top five executives get. Finally, there's participant disclosure. I don't really think there is any required participant disclosure, but obviously, since these are your most important participants, you will want to do something.

**Mr. Segal:** What about the SEC index a couple of years ago, in terms of certain requirements for filing and the SEC blew up this issue with no action letters. I think this started with a Merrill Lynch case. It had a nonqualified pension plan where there were several hundred executives in it. They said the benefit was dependent on the financial solvency of the employer.

**Mr. Fornia:** I don't know the answer to your question, but what you're alluding to is, since the executives are unsecured creditors of the corporation, it's almost like the corporation has issued a bond to these executives, and therefore, they need to do some kind of SEC filings. You need to send out prospectuses, perhaps, to these executives. I don't know the answer to that, but I know that the SEC was looking into that very heavily and it's a good question.

I mentioned the tax impact for lump-sum payment issues. A peculiarity that happens if you try to offset your savings plan benefits is that you need to consider how that's converting a lump sum into an annuity, or vice versa. Obviously your assumptions are very important there. Constructive receipt is a very big issue. There's some thought about control over the assets, too. It influences when you are taxed. In other words, if you had a 401(k) make-up plan, I'll call it, where you just provide additional deferrals, and the executives have full control over where they invest the money, there is some school of thought that says that you have some form of control over it and you might have tax liabilities. You have to be careful when you design those plans. I haven't designed many of them so I'm not careful with that.

**From the Floor:** I know the government changed rules for the way it reimburses government contractors last year. They used to allow plans that had a relatively solid foundation to improve upon federal responsibility even though they weren't funded. Now they have to be funded at something like one minus (*I*) in order to get reimbursed. Do you run into any of these issues?

**Mr. Fornia:** Are you talking about the cost accounting standards (CAS) rules?

**From the Floor:** Yes.

**Mr. Fornia:** I don't know. I don't know what the CAS rules are for those things, but it's a big problem because technically these can't be funded. Now, perhaps CAS lets rabbi trusts count as funding? I don't know.

**From the Floor:** I think that's why they have that rule of the tax rates. It says, in effect, set up a fund, put money into it, pay taxes on it, and the government will reimburse you.

**Mr. Fornia:** Perhaps a secular trust would work, it's a taxable trust. Let me just define what I call a rabbi trust. A rabbi trust is a trust that's still an asset of the corporation. It's still subject to the risk to creditors, and therefore, it's considered an unfunded trust for DOL and ERISA purposes. It makes sure that your company is at least putting aside the money so that when you retire, you get something. They are asking about rabbi trusts in the CAS Rules, and the reason they use one minus the tax rate is because in a qualified trust, it's tax deductible. You need to make an adjustment for that when you're looking at a nontax-deductible payment.

**From the Floor:** In terms of cash flow?

**Mr. Fornia:** In terms of cash-flow reimbursement from the government. Now Steve is going to talk about funding and then we will talk about the FICA rates.

**Mr. Stephen C. Kinsky:** I started with Equitable in 1985 after seven years at Security Life in Denver. I began work in Colorado Springs at a subsidiary that had to do niche product development, primarily leveraged corporate-owned life insurance (COLI). In 1986, like anybody else, I began to see the writing on the wall about where COLI was headed, and sure enough that came to fruition in August. Within a year after that Equitable made an offer to me. They really wanted to disband Equitable of Colorado and didn't see a need for a company that just had leveraged COLI. They wanted to move me into the home office to do financial actuarial work. I wasn't excited about moving to New York, as a lot of Colorado residents would probably tell you. So what I had was an arrangement. I had a good rapport with the agency manager in the Denver office. He made me an offer I couldn't refuse.

I have responsibilities over a small unit that does advanced underwriting, a little sales management, and some actual bona fide beginning agent work. I actually became an agent in 1988. The reason why that's good as background is that I quickly realized that should have been a natural market for me to move into the non-qualified deferred compensation arena. I realized this was really for the big players.

I kind of laughed to myself when Mr. Fornia said 1,000 employees is a medium-sized company. Within our agency, as with probably any agency in the Denver area or throughout the U.S., a medium-sized company is more like 20 or 30 employees. These companies have different problems than companies that have 1,000 employees. Mainly the problems that they have with respect to nonqualified deferred compensation plans are that you have to look a little bit more at the securitization of the asset. Mr. Fornia asked me if I was going to talk about rabbi trusts—the reason that I'm not going to talk about rabbi trusts is that, number one, Mr. Fornia did a good job of explaining them; but number two, rabbi trusts will not be coming up as any sort of protection mechanism in a small organization where continuity of management and maybe the very existence of the corporation may be somewhat in question for some of the key executives that are really looking to the business to take care of the difficulties that they have on the limits of qualified plans.

I will talk a great deal about the securitization issue. When I say that I mean, how can an executive be sure he or she is getting funds that would inure to him or her as a result of his or her relationship with an employer over a number of years?

This particular presentation that I'm going to show you—and I thought I would use a presentation which we used about four years ago—we initiated it, it actually had a number of different issues involved. A company that was trying to create a deferred compensation plan for some of its car salespeople. It was a regional car dealership.

Not only were we not talking about executives, we weren't even talking about employees, so it was a different issue. We have seen a couple presentations given by, practitioners of maybe less renown companies that were really proposing traditional deferred compensation, rabbi trust issues and so on, but these didn't really even apply. They weren't even employees, much less top hat employees.

We had to put our thinking hats on and talk about some of the ways to create a plan for that. Out of that came a presentation which examined the three types of funding of nonqualified deferred compensation plans. We didn't even call it a nonqualified supplemental executive retirement plan because, as I mentioned, these were independent contractors.

The second method used, just as much or maybe more in small businesses, but can be used in fairly large public companies as well, is split dollar. As a matter of fact, the SEC now has a regulation that discloses the nature of certain split-dollar arrangements and that has been in place for two or three years. The new idea which was to use a Section 83, restricted the property plan.

Let's discuss the first concept, which is the standard nonqualified deferred compensation plan, or supplemental income plan. As Mr. Fornia pointed out, you really have no participation or vesting requirements. The only requirement that you have is limited reporting and disclosure requirements. In fact, I looked at the prototype letter that the DOL has for that type of thing. All you have to disclose, and I can't remember if it's within 60 or 90 days, is the name of the employer, the employer I.D. number, and the number of participants. We talked to a business, and this would probably be a large company by our standards, of about 200 employees which had a fairly noncompliant, I would assume, nonqualified deferred compensation plan. Not only were they including those who were not top hat employees, which would, of course, bring it under ERISA, but also they never bothered to disclose the existence of the plan early on.

I think about three or four years ago, the DOL had a grandfathering provision, or a waiver, or an amnesty provision, that would allow you to do that within a certain time period. I don't know how many companies did that. I would imagine there are still quite a few out there that have never really disclosed even that in their plan. In any event, that's all you have to do. You can, of course, tie or bend an employer or employee according to the contract terms. Within the context are some of the creative ideas that Mr. Fornia was talking about. There's a lot more creativity which you can apply to a nonqualified deferred compensation plan. However, the employee has no or limited control over the asset. I think there's some concern about a 401(k) excess or 401(k) look-alike plan, as we call them, and how much right you can give the employee to designate where the assets go. I think most people would agree that you can probably control the asset to that extent, but you certainly can't take distributions from an asset that's developing in your name to match the liability which is set up for the deferred compensation plan.

The asset should be subject to the employer's creditors. As one gentleman pointed out a second ago, that's really what protects an asset when it's informally funded like this, from being taxed under Section 451 of the Code. As long as it's subject to employer's creditors, as the rabbi trust would be, and as any asset that's just in the general account of the employer would be, it's not subject to taxation. The employee or executive is not in constructive receipt, and therefore, it's not taxable. That's only for selected employees.

I haven't followed things closely recently, but I know that the DOL has never issued regulations on top hat employees. About the best definition that I have seen, in my humble opinion, as to what defines a top hat employee, is it's probably a group of management that could be deemed to have control over the actual design of the plan. I've seen numbers as high as $150,000 of salary a few years ago and much higher than I think many people were assuming needed to designate a top hat employee. I think the best definition that I've seen so far has been this one which says if it is deemed that you can control the design of the plan, you're probably in the top hat group, and therefore, the plan would be exempt from ERISA.

**From the Floor:** Can you design the 401(k) excess plan so that the investments in that plan will grow nearer the qualified form?

**Mr. Kinsky:** Yes, but to be candid with you, it's something that I don't think is very definitive.

**Mr. Fornia:** I'd like to comment on that. I think your best approach on that is to make sure that the plan document doesn't require that be the case. The actual authority for the investing, I think, needs to be someone other than the executives. You probably want to run it by your ERISA attorney.

**From the Floor:** We've done the same thing but we leave the executives in control simply on a pseudo account. There is not really any cash associated and the executives are actually moving around. They just say I want my units moved into that or you can give me that in credit based on where the units were won or lost, had they actually been invested that way. The executives aren't really managing money.

**Mr. Kinsky:** The actual assets may not be in those accounts?

**From the Floor:** That's correct.

**Mr. Kinsky:** That seems like a reasonable approach. It is definitely worth running by your ERISA counsel because they may have some very strong opinions on that.

**Mr. Segal:** Would you have any real assets?

**Mr. Fornia:** No. The assets are the assets of the corporation.

**Mr. Kinsky:** Not necessarily, but presumably you are going to be able to create an asset. Maybe it's a variable life insurance product which has the same accounts.

Within the deferred compensation agreement, you have an arrangement between a corporation and an employee or executive, which, in most cases or in all cases, you are planning due to the top hat rules to pay retirement benefits at 65. Maybe it's an early retirement benefit, or maybe not, but in many cases, especially if it's funded by a life insurance plan, would probably have a death-prior-to-retirement provision in it. We'll call it a death benefit only plan, which would allow for payment of survivor benefits if the individual died before they actually hit retirement age.

I had a great deal of difficulty looking at this from the product side when I moved into the selling side of this whole procedure. I had a little difficulty at first seeing just how it was that a nonqualified plan could compete with a pension plan. Not necessarily compete, but how you could portray it as being as good as a pension plan if it were funded with life insurance or some tax-favored investment. The example below doesn't assume an interest rate, but I think it's a good way to describe how they work and how the funding isn't any more onerous than it would be for a qualified plan.

Take an individual at a corporation in the 35% tax bracket. The total amount of retirement dollars required are $1 million. We're just talking about a lump sum for the sake of simplicity here. If you need $1 million, you must acknowledge the fact that, in a qualified plan, the deposits are deductible, but the payouts are not, because they are coming from a pension trust which isn't a taxable entity. On the other hand, if you look at the annual deposits in a non-qualified plan as not being deductible, but the retirement payments certainly are, there is a parity there which allows you to have basically the same after-tax funding requirement from the corporate standpoint. That is demonstrated by the total dollars needed to fund the retirement payment. You need $1 million in a qualified plan, but you only need $650,000 in a nonqualified plan. The reason is, if you pay out $1 million you're going to get a credit against taxes, assuming you're in the 35% tax bracket, for $350,000. That $350,000 of reduced taxes plus the $650,000 that you have is enough to fund $1 million benefit. That is clear to me these days, but I know I struggled with it at first.

**From the Floor:** In the first nonqualified plan, if the goal is to accumulate $1 million, and given the millions that you've deposited in trust according to your current investment income, it would seem that you would need a lot less than $50,000.

**Mr. Kinsky:** This hasn't taken into consideration, yet, the funding mechanism. I'm going to talk about that in a little bit. Whether the deduction is to the pension trust or it's compensation to the individual, it's still the same, from the employer's standpoint, if it's paid out at one time. When you have a deferral process in place, it's more difficult.

**From the Floor:** You say that your annual deposits in the qualified plan don't need to equal $1 million?

**Mr. Kinsky:** No, you'd still need $1 million, but the after-tax cost to the $1 million would be only $650,000 because you take the deduction upfront. For those of you who remember the Rule of 72, you know we can actually just give some numbers right off the top of our head. Let's say, for example, we're in the 35% tax bracket and over a 20-year period, over half the deposits come in during the tenth year, on the average. We're going to fund over ten years. That basically cuts the funding requirement in half. Now it takes $25,000 to fund $1 million over a 20-year period and that's what the pension contribution would need to be to grow at 7.2% interest to $1 million at age 65.

What does it take in the nonqualified arena? That's a good question because what it really boils down to is what kind of investment you have. There are really only, in our analysis, two that make theoretical sense. One has maybe never occurred to you but would work quite well. The other one is, of course, life insurance, to the extent it has tax-free growth and you can get tax-free withdrawals and distribution by means of loans from it. That's what makes life insurance work; that's why it's probably the product of choice for most funded SERP plans. Not to mention that agents get paid a little more commission on life insurance than they do on other vehicles. It is the only thing that works very well.

What if you go that one step further and say, what is required on the nonqualified side? You might only need deposits of $16,250 to grow to $650,000 using the same proportions over a 20-year period. The $16,250 would grow to $650,000 and that same $650,000 would fund a $1 million benefit. Does anybody want to guess what the other perfect investment might be if you could find one that could generate the kind of equity returns you might need? The answer is: dividend income producing stock. Business that is either over 70% or 80% owned by a corporation and you have a dividend pass through. You don't have full taxation on the dividends that come out. The problem with that is that dividends don't typically reach the kind of equity returns you can get with equity investments. It might work to a limited degree, but for the most part, we're talking about life insurance as a funding vehicle. Remember, we're not primarily using COLI in a closely held market because of the lack of securitization issue. It's just a little too difficult for an executive to feel comfortable about the funding mechanism when it's being done with COLI.

What has evolved over the years has been the concept of the split dollar. I do want to caution you. Maybe some of you are not aware that there is a significant technical advice memorandum, (TAM)9604001, from January 1996 that has put a lot of doubt into the use of a particular type of split dollar called the equity split dollar. How is that to be used? I'm going to talk a little bit about that, but that's a subject of its own. I'm just going to touch on it briefly when we get a little further along.

The split dollar has no participation or vesting requirements, limited reporting, and disclosure, except it becomes a welfare benefit plan if it has over 100 employees. You can use it the same way you can within a COLI-funded nonqualified deferred compensation plan to tie or bind the employer or employee. However, the employee has no control over assets and that is maybe a little bit of an overstatement. That really should be an asset that belongs to the employer. In a split-dollar plan, you basically have a splitting of premiums, cash values, and death benefits. The cash values which belong to the employer are really what the employee should have no control over, but, the employee does have control over a significant portion of that asset over time. Again, it's only for selected employees, like top hat employees. It really shouldn't be used for rank and file. As we said earlier, you need to file a Form 5500, and do welfare benefit plan reporting for plans covering more than 100 lives.

Let's discuss equity split dollar. I want to caution you that there's a significant TAM out there that just about everybody is attacking. The Association of Advanced Life Underwriting (AALU) had a 26-page memorandum to the IRS attacking the TAM ruling, which wants to tax split dollar in a way that was never taxed before. All the guns are loaded and they're ready to be fired. I actually think that this is one that the industry will win. I don't think there's much substance to it. There are a number of existing plans out there which have what we call collateral assignment, equity split-dollar approaches to them. They are certainly at issue. Going forward it may very well be that equity split dollar will be reincarnated.

The basic concept is that the premium, in effect, is split with just a little bit of it being paid by the corporate executive, and the majority of it being paid by the company. Under Revenue Ruling 66–110, you can use alternative term rates which are available under a term policy to the general population to standard risks. I think in Equitable's case, those rates are 0.5. Nevertheless, since you can use those rates, it's a very effective way of illustrating and minimizing the employee's contribution to a split-dollar plan. More and more of the equity goes to the employee over time. The whole trick to this is the interest earnings. In an equity split-dollar arrangement, the corporation puts up the whole premium, other than the term cost, and even that could be a bonus to the employee, but typically that's the way it works. Then the employee assigns back to the business the premium payments that the business has put up. There's no real interest. Under the original split-dollar ruling escaped, and is still, for that matter, really outside the no-interest-loan provisions that the IRS goes back to from time to time and tries to recapture.

My understanding is that it was better for the IRS to look at it, and to have it done that way because they were going to get some taxation. When no interest loans fell out of favor in the early 1980s, they tried to recapture those provisions and couldn't do it. That's the way it stands now, notwithstanding the TAM ruling. I want to talk about a concept called reverse split dollar, which has some of the same favor in it.

I'm going to try to describe for you how reverse split dollar works. Reverse split dollar is simply what it says. It reverses around the whole notion of who owns, but not who owns what. What you'd see in a reverse split dollar is that the business is going to own most of the death benefit. The individual owns the policy, and the business is going to own most of the death benefit. Instead of paying out alternative term rates they're going to pay PS58 rates. Under Revenue Ruling 66–110 many people would criticize the use of one or the other, but if you read the law closely, it is structured so you are allowed to pay PS58 rates, which are taxable.

Basically, the employer is going to put up the PS58, which is considerably higher. All the cash value goes to the employee. The way it is typically structured is, after 15 years, the need for corporate and for key man death goes away. The employee takes away the policy completely and is entirely on his or her own, and then he or she gets all the death benefit. The employee puts up only the difference, so the premium outlays are low. The leverage isn't quite as good as equity split dollar, but it does work pretty well. If he or she puts up $164,000 he or she will have a cash value of $480,000. There's a three-to-one return on what the individuals put up.

**From the Floor:** Now in the 16th year the employee has paid off the policy. What is the next step?

**Mr. Kinsky:** None, because he or she has owned the policy all along.

**From the Floor:** The employer is just paying for the death benefit?

**Mr. Kinsky:** The question is, What's the tax impact of the employee? The answer is that the tax impact is on the employee. He or she has owned it all along. There is no value that the employer is moving or transferring to the employee at that point in time.

**From the Floor:** The employer is contributing and I didn't see where there was any tax implications for the employee included for that range.

**Mr. Kinsky:** Under that arrangement, the employee is putting up the premium.

**From the Floor:** It wasn't clear to me at first whether or not this is a benefit. Who owns that policy?

**Mr. Kinsky:** The employer. Under Section 264 any ownership of a policy by a corporation means that the premiums are not deductible. The only time that it becomes deductible is in the 16th year when it gets paid out. That's basically split dollar. I've seen it more and more. I haven't seen any agents in our agency use equity split dollar in the last four months, so to be candid with you, people are really nervous about it. I see more of a movement in the reverse split dollar. I see more support for the reverse split dollar. I'm a CLU and subscribe to *Keeping Current* to keep up. There's even more mention of reverse split dollar as a way to fund and take care of some problems with split dollar.

**From the Floor:** How would you use one versus the other?

**Mr. Kinsky:** Well, I probably wouldn't have even explained reverse split dollar if not for the fact that this TAM ruling exists. Some people have claimed, hindsight is 20/20, that they saw it coming down the road. There may be some truth to that. Equity split dollar works out a little better than reverse split dollar, from a straight compensation standpoint.

Basically, we developed this approach. We had heard about it about two or three years ago. We developed it because we weren't working with executives. We were working with rank-and-file employees and actually independent contractors. Liability is removed from financial. It's restricted property not subject to the employer's creditors, absent an intent to defraud, basically it's going to work for you. That's because you take on, in essence, the role of a secured creditor. The employee is taxed only if property becomes transferable, or no longer is subject to a substantial risk of forfeiture. That is the way Section 83 is worded. An employee may elect, under 83(b), to take property into income within 30 days of the transfer date.

It makes more sense to actually be taxed on it upfront than it is to be taxed on it down the road, contrary to the usual intuition on matters such as this. The property is later forfeited assuming an 83(b) election has been taken or resold to the corporation. The employer must put it back into income if a deduction has been taken. If 83(b) is elected, the amount of property may be grossed up to cover the employee's tax liability, if applicable. FICA taxes would be due on the grossed up amount, and I think that will be consistent with what Mr. Fornia's going to talk about a little bit later.

In addition, if applicable, FICA would be due as vesting takes place. If property is later forfeited there is no deduction for the employee. Don't forget, in most cases, it probably would be grossed up anyway, but there is no deduction allowed. There may be an ERISA requirement if it ends up insuring more than 100 employees. This really is not much different from what you might call an executive bonus plan. It's better than I think a secular trust, because a secular trust is subject to ERISA, because it's a funded plan. Restricted property plans are really a property issue and it comes under an entirely different section of the Code 83.

**From the Floor:** What makes it a Section 83 claim?

**Mr. Kinsky:** What makes it a Section 83 claim is the fact that you make the property either subject to substantial risk of forfeiture or only taxable when it's subject to substantial risk of forfeiture or transferable. It's restricted in that case.

**From the Floor:** What makes it subject to Section 83? Is it the structure of the plan document?

**Mr. Kinsky:** Yes. That would have a great deal to do with it. I was always instructed that you didn't make too much reference to a funding vehicle when you were talking about a nonqualified COLI funded plan because you didn't want to have that tie in. You certainly couldn't say that those assets were set aside and free from creditors. But here it doesn't matter because it's a whole different section of the Code. You should refer to the property because that's basically what it is. It's an outgrowth of restricted stock plans. Restricted stock plans have been in place for a while. The way it works is, contributions are made on the participants behalf, and income becomes taxable as or before the property vests under the 83(b) election. The employee gets retirement income from a financial institution, pays taxes as the property vests, or before.

**From the Floor:** What is the down side to this?

**Mr. Kinsky:** I don't think it's as highly tested. There are a few Equitable people that are using it, but I don't think it has been tested as much. Split dollar has a much longer legislative history. I don't know that too many people have been using Section 83 plans, or using insurance to fund a Section 83 restrictive property plan. From the standpoint of leverage, it doesn't work as well as split dollar. There's a mystique that split dollar works fairly well, and 83 is almost too straightforward.

**From the Floor:** Can you use other types of funding vehicle besides insurance?

**Mr. Kinsky:** The only problem is some people use annuities, but then there's an issue of whether you have a nonnatural entity. If you have a nonindividual owning an annuity, it's taxable under the Tax Reform Act of 1986. I forget when the law changed with respect to that. The other thing that's used, of course, is restricted stock. That's really how it started. Unfortunately, I really can't get to the numbers too much, but I think you get a sense of where I'm headed with all this. That is, to make it a little bit more palatable in the closely held market, or what I would call the small business market, you really need to do something a little bit better than just using COLI. You can use split dollar or Section 83.

**From the Floor:** Is it actually better to pay tax upfront or is it better to defer?

**Mr. Kinsky:** Well, if you pay it upfront and you use a vehicle that has good tax-favored growth and tax-favored distribution, it's like an insurance policy. You can show that over time it comes out a little better. The only other option would be to not take it now, but when you take it a little later on, it becomes taxable.

**Mr. Fornia:** We're going to go back to another technical issue with a totally different perspective: FICA taxation. When we designed nonqualified deferred compensation, the whole idea is that you're deferring the compensation; therefore, you don't pay tax on it. That just pertains to income tax. Income tax and, in most cases, FICA tax are based on what is called the general timing rule. When you receive the money, you pay your taxes on it. FICA, starting with Social Security Amendments in 1983, switched to the special timing rule. That was really very helpful because what that meant is that rather than paying your Social Security taxes when you got your benefits, as a nonqualified retiree, you would pay them as you earn the benefits.

In 1983, there was a Social Security wage base which was relatively low. Many people earned way over the Social Security wage base, so we had to tell executives, "Guess what, you owe FICA tax on $20,000, but you're already earning over the wage base so you don't have to pay anything." That was the special timing rule. You were taxed when services were performed and there was no substantial risk of forfeiture. Nobody really worried about this until 1994 when the Medicare wage base cap was lifted. Now, all of a sudden, we need to figure out the value of these benefits that are being earned in these years and what tax is due. Although the wage base was lifted, there was no guidance on how to calculate these. The IRS had never bothered to put out regulations, mainly because nobody cared and they had many other things to do.

The IRS put out a notice in 1994 saying you could use reasonable good faith efforts to try to figure out what the value of these deferred compensation amounts were, and good faith was valid through 1996. Now the proposed regulation came out in the beginning of 1996, and that's what I'll be talking about. We're talking about Social Security taxes on nonqualified deferred compensation. It's probably simplest if you think of the simplest example, which is deferring next year's bonus. You still have to pay your Social Security taxes on that bonus; even though you're deferring it out another 10 or 20 years. That's the basic concept.

Let me make sure that I mention there's a very good source of additional information on this. In March 1996, I believe, the Pension Section put out a 10-page supplement that describes these regulations fairly well. The regulations themselves aren't too bad; they are about 50 pages, mostly consisting of examples. If you need to do these calculations, especially for a SERP or a defined-benefit plan, you are going to have to really roll up your sleeves and figure this stuff out, because unfortunately, it's confusing.

The first question is, what is a nonqualified deferred compensation plan? The reason that's such an important question is because a nonqualified deferred compensation plan is subject to the special timing rule, meaning you're taxed early. Such a plan is only valid once it's adopted in writing and made effective. So if this plan was just put in place in 1994, you can't go back and say since it's based on past service and most of the past service was before 1994, we already paid our taxes. You just can't do that. You have to start with when it's effective, in writing, and adopted. The plan has to actually provide for a deferral of compensation. It doesn't count if it's a bi-weekly payroll and you're getting paid in January; that December pay is not true deferred compensation. It's an exception to this.

Examples of plans that are not deferred compensation plans are stock options and stock appreciation rights. Phantom stock, though, is really a deferred compensation plan because it is just a deferred compensation plan where stock is the investment vehicle which it's hypothetically being put into. Vacation, severance pay, and so on are not. Qualified plans, obviously, are not deferred compensation either.

So let me talk about the simple case, which is what the regulations call account plans. That's a defined-contribution type plan. The more complicated case which we'll spend most of the time on are nonaccount plans. So in an account plan, the amount subject to tax or taken into account as the proposed regulations call it, is the principle amount as soon as it is vested. For example, if you had a 401(k) look alike where the employer is making, let's say, the 3% match, once it's vested and that 3% match is taken into account and FICA is taxed that year. At that time, it would include the interest that accrues up through that year. Now a while ago some creative actuaries or lawyers, came up with a nifty idea of using a very high crediting rate. In other words, if you could fund a small amount in these plans and generate 200% interest, then you could just take the principle into account, but the 200% interest never got taxed.

The IRS was smart when they came up with these regulations. It says that the crediting rate has to be reasonable. If it's not reasonable, or based on a pre-determined investment, then in addition to taxing the principle, you have to tax the excess of the amount credited over the federal mid-term rate. That's their failsafe mechanism. There's really no guidance on what reasonable interest rates are; it's somewhat subjective. Perhaps the final regulations, which are hopefully going to be out this year, will clarify that. The amount taken into account means the amount that's treated as FICA wages, which means it's subject to the 1.45% Medicare tax, and maybe the 6.2% Old-Age Security Act tax if you're under the wage base. The idea is to try to do these in years when they're over the wage base.

Now we'll go into the more complicated cases; nonaccount plans, which are SERPs and defined-benefit plans. In this case, if you think about it from a theoretical point of view, the amount taken into account should be the present value of the benefits that you earn that year. What the regulations call earning means for which you accrue a legally binding right during that year. Again, it's the year you're vested in something or if you're already vested, it's just the accrual. You can use any reasonable actuarial assumptions. Actually, if you don't pay the tax you're supposed to, and then the general timing rule falls into play, later on you pay the tax. Don't forget the executives might not be over the Social Security wage base. You want them to pay the tax while they're over the wage base so they can avoid the 6.2%. This is unusual because, in all these cases, we're still only talking about a tiny tax rate of 1.5%. Keep in mind while you're doing this work for your clients, the numbers you come up with may be small, except for the bill that you send them, so you need to be real careful on that.

As an example, the accrued benefit deferred to age 65 is basically the amount that's taxed. As you can imagine, that's hard to figure out. What is the present value of the benefit earned during the year? It's almost like calculating a normal cost when you're doing the funding. What is it you need to tax this executive on? So the IRS has what's called the reasonably ascertainable rule. This is a new concept and what it means is, if it's not reasonably ascertainable, don't worry about it. Just do it once it's reasonably ascertainable. What reasonably ascertainable means is that the only assumptions you need to use to determine the value are interest, mortality, and the cost-of-living adjustment. In most cases, it's just interest and mortality. That means is that in many cases you just don't tax it until the year that they terminate. That's usually the case. In fact, I can't think of any SERP that would be reasonably ascertainable before termination. For example, if there's an early retirement subsidy, or if the qualified plan is an offset you certainly don't know what the qualified plan is going to be three or four years down the road. If there's an option selection as a form of payment that they haven't yet made, or have the right to change, that means that you may not be able to ascertain the value. If it's related to salary, you might not be able to ascertain the value. I'd even go one step further to say this isn't specified in the regulations. I'd even say delayed retirement. Unless the benefit is actuarially increased for retirement beyond the age of 65, which I've never seen, delayed retirement would mean that the benefit is not reasonably ascertainable.

The bottom line is that virtually every defined-benefit SERP is not reasonably ascertainable, and what that means is you can wait and tax it until they actually retire. What that also means is all the work we've been trying to do in the last two years for our clients is moot because we didn't have to do it because it wasn't reasonably ascertainable. The whole reason we asked for regulations is because we couldn't figure out how to do it and the IRS came out and said you don't have to do it. In many cases, it's beneficial not to even do the calculations until they retire; then do the calculations and pay taxes on that.

There are all kinds of nuances like you can have an early inclusion date if you want. If you know your executive is going to retire in, say March of 1997, and you know that they won't have $60,000 yet—the Social Security wage base—you might want to include it in 1996 so that you can pay taxes at the 1.45% rate instead of the 1.45% + 6.2% rate. There is a lot of room for creativity here. The final regulations, hopefully, will clarify what creativity is allowed. In most cases, I find you can go ahead and wait until they are about ready to retire or do retire.

**From the Floor:** Regarding this FICA taxation, what is excludable prior to January 1, 1994. How would that have been calculated?

**Mr. Fornia:** That's a great question. I'm struggling with that. I have some plans that have a service cap and my executives have already met their full service prior to 1994, so I would like to say that whole SERP was accrued. In this case, the plan was effective long before 1994. I don't think that's really clear in the regulations. I don't know if anyone has some ideas on that.

**From the Floor:** What about pay increases since January 1, 1994?

**Mr. Fornia:** It would be nice to take the position that, before 1994, we taxed the biggest possible benefit we could dream of. In 1994, we did something else using good faith. I have one client where I was very aggressive, meaning I was taxing a lot. In 1994, I told them they had to tax a large amount because if you do that you get to say you taxed the large amount before 1994. I don't think that's very clear in the regulations.

**From the Floor:** You can't just say, "I was really stupid. I didn't take advantage of any of these delays that were readily ascertainable." I taxed the worse possible case, assuming the executive would retire at the first opportunity.

**Mr. Fornia:** You're saying it's hard to justify the position that, in the old days, you were taxing very early and now you're not. I agree. I think that's hard, but I don't believe it's very well addressed as to what methodology is used to determine what has been paid prior to 1994.

**From the Floor:** I'm wondering about using a delay as a result of your early vesting. An advantage of defining a not necessarily aggressive posture, but minimal amount of accrual is that you avoid paying tax on the buildup.

**Mr. Fornia:** Yes. One advantage of paying it early is that it avoids paying it on the buildup.

**From the Floor:** I think that large illustration is really excellent. It shows that there may be a disadvantage to avoid the tax on the buildup because it could give them interest rate problems. If you tax at high interest rates and bring it forward, you will have to tax later at low interest rates. Most of the time, it looked to me like it wasn't advantageous.

**Mr. Fornia:** In the Pension Section supplement, Heidi Dexter from Foster Higgins put together some illustrations showing changing interest rates, where you use different interest rates every year. If the interest rates are falling and the interest rate is lower the year the executive retires, you may find yourself taxing more than if you had elected early inclusion. You have to watch the interest rates. If you're not taking anything into account, you could get hit taking something into account at a lower interest rate later and have a higher amount. Unfortunately, it is not that simple. Hopefully the final regulations will clarify a few items. I wish it weren't a

1.45% tax so we could take the time to do some really wonderfully precise calculations, but sometimes the numbers are still very small. I think you need to consider that there are a lot of issues here. It's just like normal costs. It's just like a funding method and how you are allocating things to different years. Just imagine that in certain years your employer has no cash.

Let me run through the last couple of points on my formal presentation on the FICA rates. We have just scratched the surface. Please read the regulations and read Heidi Dexter's paper because they will give you a much better appreciation of how complicated this stuff really is. One item that is important to know is that you don't have to pay the taxes throughout the year (quarterly) like you do with other FICA taxes. You can wait until the end of the year. Even if you can't do it by the end of the year, you can either use the estimated method, where you make an adjustment and true it up next year, or use a lag method where you postpone it until the first quarter of the following year.

**From the Floor:** Which of the two methods, the estimated method or the lag method, is more advantageous?

**Mr. Fornia:** I think most employers will wait. Are you talking about account plans or nonaccount plans?

**From the Floor:** Account.

**Mr. Fornia:** I would think the estimated method is better because under that you can choose what year you recognize it. In other words, you can call it last year's wages or this year's wages. Whereas in the lag method, I think you have to use the subsequent year's wages as the amount.

**From the Floor:** I thought with the lag method you calculate it and you can tax it but the tax is actually for the prior year that you paid it for.

**Mr. Fornia:** Yes, I may have gotten it backwards. I think in one of the two methods you had a choice of which year you applied it to and under which one you don't. I can't remember. I haven't done one yet. Again, this isn't effective until 1997, so we still have good faith in 1996. Obviously, we want to strategize what's the best faith to have about this.

**From the Floor:** Under the lag method, if you delayed it, would it be counted as wages the next year?

**Mr. Fornia:** Yes.

**From the Floor:** We did recognize very early with some clients, and for some of our clients in the year in which they first vested, a significant amount was paid, so the employer chose to gross up the payments. But most of them after that do not do anything.

**Mr. Fornia:** You're saying for many clients the first year that they hit a big amount the employer would gross up to cover the tax. Yes. I know clients that were advised to gross up. I think a lot of clients, particularly in 1994, did do gross ups to cover the executives SERPs. I am not comfortable with that. I think a 1.5% tax is fairly minor, and you don't need to gross that up.

As I mentioned before, we have good faith in 1996. The regulations are effective in 1997. You can also claim refunds for open tax years if you think that's in your best interest. In 1997 the open tax years will be 1993–96, so if you want to go back and claim refunds for what you've done in good faith for 1994, 1995, and even 1996, you can do that. Again, I think you need to think it through because of these other issues we talked about.

**Mr. Segal:** Can you offset against your 1997 tax or do you literally have to go through the process of asking for refunds?

**Mr. Fornia:** I don't think you can offset it. I have never seen that. I think it would be reasonable though, and hopefully the final regulations will let us do that.

**From the Floor:** There seems to be some question about taxes and how employees ask for refunds.

**Mr. Fornia:** The question is, how does the employee go about getting his money back? What I have heard, is that the employer, when he's asking for the refund, can ask for the refund on behalf of the employee. Now that, of course, brings questions about things like former employees and so on. I don't know. My gut feeling is that I don't see the advantage of asking for these refunds of under $100 in 1994, 1995, and 1996. The logical thing is to carry it forward until they retire. You definitely can credit what has already been taxed against. When you determine at ultimate retirement what the value is, values that have already been taxed are clearly subtracted off, albeit at a different interest rate. I don't think refunds make much sense, but I haven't calculated the numbers yet.