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EXECUTIVE COMPENSATION

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Recorder:

PHILIP J. BIELUCH

- o Design issues
- o Excess versus supplemental plans
- o Funding, including Rabbi Trusts and employer-owned life insurance
- Accounting treatment/expense determination
- o Tax considerations
- o Pending developments
- One company's approach

MR. CHARLES I. HARRIS: I would like to discuss some of the definitions we need to establish, because semantics play a role in how well we understand what people are doing or wish to do. Then I will discuss some of the general design aspects of supplemental and excess plans.

I would like to begin by establishing the difference between an excess plan and what is generally referred to as a supplemental executive retirement program (SERP). An excess plan, defined in ERISA Section III(36), deals with unfunded programs designed to make up benefits lost by the application of Section 415—and only those benefits lost by Section 415. It does not permit a plan to make up for benefits lost under Section 401(k). The \$200,000 cap imposed on qualified plans, as added by Section 401(a)17, is not under Section 415.

I am drawing a very fine distinction here because there is no definition of an "eligible participant" in an excess plan. Any individual affected by Section 415 limits can have the corporation make up for his or her lost benefit on a nonqualified, unfunded basis. Lower-paid employees could even participate if, for some reason, their benefit exceeded 100% of pay or the Section 415 limit.

A SERP is a plan that makes up any other kind of benefit. Some examples are the regular plan benefit based on compensation exceeding the newly imposed

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\$200,000 limit; a benefit designed to make up a benefit on pay which is excluded from the basic plan (i.e., bonuses); or any other variation from the regular plan.

When we try to find out how many companies have excess plans and how many have SERPs, we run into a problem. Many companies' programs include all scnior officers covered by their regular plan, but they include bonuses in the definition of final pay. That could also hide an excess plan because they might also be picking up the Section 415 limits. There is very little reason to separate those two programs; there is, however, a very important difference between who can be eligible for an excess plan and who can be eligible for a SERP. A SERP must be a "top hat" plan and cover only those employees who are highly compensated and/or managerial. It is an old definition that goes way back to ERISA, Section 201(2).

We're allowed to have an unfunded, nonqualified deferred compensation plan limited strictly to highly compensated/managerial employees. We don't know exactly what that means -- there are many interpretations, and the IRS has yet to issue a definition. (As of now, it is not the term high-paid that was recently defined in TRA 86.) We must make sure we understand this definition of "top hat" because if we go below that level (whatever that level turns out to be), then we encounter all the ERISA funding, participation, and vesting requirements. If we stay above that level, we are permitted to provide benefits without considering those requirements.

A trial balloon was recently sent up by the Deparatment of Labor (DOL) indicating that the people who could be covered by a "top hat" plan would be those whose earnings exceeded three times the Social Security wage base. That seems to have gone nowhere.

Let's run through some of the design issues relative to excess plans. I'll then move to more interesting areas -- some of the design issues relative to SERPs.

EXCESS PLANS

There are no eligibility restrictions. We could limit the make-up to senior executives, or extend it to all employees by stating in the regular pension plan, "If any benefit is limited by Section 415, a payment to the affected person will automatically be triggered out of a nonqualified, unfunded program."

Generally speaking, an excess plan has adopted the same provision as the basic plan it covers. The only question we might ask about what benefits an excess plan should provide is what should be the form of payout. Should it be the same as the basic plan, automatically triggering the joint and survivor benefits? Should it be different? Should we consider a lump sum payment?

The reason I raise the question of lump sum payment is that there is always that question before retirement as to whether the benefit will be paid (because of change in management or bankruptcy or whatever else). If we allow a lump sum payout at retirement we could remove an element of doubt during retirement years. One of the problems with a lump sum payment is that the regular plan could continually readjust its benefit to pay a higher amount as the Section 415 limit moves up in the future.

The Defined Contribution (DC) ERISA excess plan entails a number of design issues. Basically we are looking at the \$30,000 limit imposed by Section 415. The high-paid could easily reach the maximum and lose a company match on

otherwise matched employee contributions. Should we make that up? If we do, should we require an individual to undergo payroll deductions in a nonqualified, deferred compensation arrangement in order to receive the company match?

There are a few other issues relative to DC excess plans. Should investment opportunities be available to the individual? Is the company willing to underwrite the stock market's performance by making a guarantee? Remember that these assets are staying on the company's books and the company is basically going to guarantee some rate of return. These are some issues one has to think about, but more and more corporations are encountering them as average compensation for executives rises high enough that these limits are having a real impact.

SERPS

The design issues connected with a SERP or "top hat" plan are interesting, because they are uncontrolled. Remember that the SERP is going to provide a benefit designed solely to meet the employer's need to attract, retain, and motivate. Because it is nonqualified and unfunded, there are absolutely no rules: we can do anything we want. I will try to give you some examples of what some of our clients have done.

The first thing we do is look at the definition of pay. This can be anything. Generally, one of a SERP's prime purposes is to make up for pay not covered by the qualified plan (including deferred compensation, which can never be covered by a qualified plan). A number of SERPs include all forms of cash compensation, including amounts deferred in that year. Even using last year's pay or highest pay ever is fine.

Service is another area in which a SERP can be very useful. Service can be limited to participation in the plan, although generally it is years with the company. We can also go back and pick up all years with a prior company. It can be used in a very innovative way, if executives are hired in mid- to late career. Senior executives are hired at that point in time because of their experience. Sometimes it is advantageous to count service with related companies, or companies in related businesses before the executive comes on board. For example, if someone has only seven or eight years to go, you can credit them with twenty or thirty years of related industry experience under the SERP.

Eligibility can be very discriminatory and discretionary. It is generally left to a committee of the Board. However, we must make sure we maintain that "top hat" concept. Another item one can consider is to control the charge against earnings by having high age and/or service eligibility criteria (i.e., age 50 and 10 years of service).

Retirement ages should reflect corporate goals. Do we want people to stay longer? Do we want people to leave? Remember we have a difficult time with mandatory retirement these days. A SERP can be an excellent way of getting people to pay attention to what the corporation wants. I once designed a SERP for a company that wanted people to leave at age 65. The only thing the SERP was doing was including incentive compensation in the definition of pay. But if an executive left one day before or one day after age 65, without Board approval they received nothing. It worked for a few years, then the company put in more typical provisions. You can do anything you want just so that it satisfies what the corporation wishes.

Early retirement may not even be included in the program. If it is, it may have some very typical rules, but yet have an overriding provision where the Board, at its pleasure, would allow for unreduced benefits.

Normal Retirement Benefits -- Generally, 50% to 60% of final pay is a competitive benefit level. Remember that final pay is total pay, in most instances total cash compensation. Usually there is a shortened accrual period; earn the benefit over a period as little as 15 to 20 years. Offsets to the SERP generally include the regular Defined Benefit (DB) plan and DC plan, if any. Social Security is usually offset at 100%.

Termination Benefits -- I haven't seen too many vesting provisions in SERPs. Generally, management does not intend to have people leave before early retirement age or at an age when they feel they have received the best use from the individual, especially since most of the people coming into a SERP are already into their mid- to late forties and early fifties. However, we can do anything we want. If we want vesting, we can put it in. Remember, we are not required to include it.

Disability Benefits -- I believe that disability benefits should be included in a SERP only to the extent that the current Long Term Disability (LTD) program is not meeting an executive's needs, either because of some small monthly maximums (i.e., \$3,000, \$4,000, or \$5,000) when our executive is earning around \$20,000 to \$30,000 a month, or it provides an inadequate LTD benefit, or the definition of disability is so restrictive that management cannot use it as a tool to remove ineffective individuals. If the regular plan is not providing an appropriate benefit, and the company wishes to self-insure the difference between "adequate" and "inadequate," then I think the SERP is an excellent vehicle for providing a disability benefit. The benefit should then be a function of pay, not (as we typically do in our DB plans) a function of accrued retirement benefit. If an LTD plan is providing 60% of pay to a maximum of \$5,000, and our executives are earning \$300,000, the \$5,000 probably covers a mortgage payment. Give him a 60% benefit of pay under the SERP, offset by whatever the LTD benefit can provide.

Preretirement Death Benefit -- If the group term policies available to executives do not approach approximately four times pay without limits, then the SERP can be called upon to provide a benefit. However, if the SERP is going to provide a benefit, I also believe that the corporation's responsibility exists not to any beneficiary, but to legitimate dependents, spouses, and/or children. Therefore, I like to see a plan designed with a spouse's benefit in mind.

Postretirement death benefits are typically joint and survivor benefits. Fifty percent of the retirement benefits is continued to a spouse married at the time of retirement.

Dependent Child's Death Benefit -- In the event of death, either pre- or postretirement, a provision that I have been adding to some plans lately is a flat dollar per month, \$1,500 per month, to each dependent child, whether or not there is a surviving spouse. It is generally payable to age 18, or 25 if a fulltime student, or for life if physically or mentally disabled. It's a generous benefit, not terribly expensive, and rounds out the package.

Form of Payment -- Generally speaking, we have a fully subsidized joint and survivor option for those who are terminating with a spouse. A lump sum

payment is something to consider in order to eliminate the possibilities of a loss of benefits in the event of takeover or bankruptcy.

Change of Control -- In the event of change of control, what might happen to a SERP? Many times the change of control rules are written in employment contracts or a special parachute agreement. Lately, these are being written into the SERP documents in the event of a double trigger, a change of control as defined, 20% ownership by someone else, or a hostile takeover, and a termination of employment within a period of time. Remember, that plan is going to pay up upon termination of employment. But we want one that is a result of the change of controls -- mostly that an acceleration of the benefit payment, it may be an assumption of all future service or continuation of pay with or without a salary scale, would produce immediate lump sum payment of the present value of an age 65 benefit. I think it's important that we make sure that we define within the document the difference of the benefit as created by the change of control over what that individual would have received had they just terminated at that point in time.

MR. PHILIP J. BIELUCH: The Financial Accounting Standards Board recently issued a revised statement of accounting principals for deferred taxes. This FAS 96, "Accounting for Income Taxes," changed the conceptual basis for accounting for income taxes. Almost all existing practices in the area of income tax accounting were replaced by this statement.

Instead of looking at the profit and loss statements to calculate the additions and subtractions to the reserve for deferred income taxes, companies must now look at the assets and liabilities shown on the balance sheet. If the tax basis differs from the book value for accounting purposes, you have what is called a "temporary difference." FAS 96 must be adopted by corporations for fiscal years beginning after December 15, 1988, but we anticipate earlier adoptions since the statement allows corporations to take advantage of the new U.S. corporate tax rate of 34%.

FAS 96 requires that a corporation calculate deferred tax liabilities based on a temporary difference that will result in taxable income or deductible amounts in future years. The assumption, which is a critical one, is that no book income is ever earned in the future, even though the books were kept on a going-concern basis. This is required. The balances on the company's year-end book and tax balance sheet are used to create a series of make-believe tax returns into the future until all temporary differences are reversed.

FAS 96 also states that you can book a tax asset only if you can carry back the tax deduction to the current or past years in which you have taxable income. Consequently, most deferred compensation deductions cannot be recognized as assets because they occur well beyond the three-year carry back allowed under the current U.S. tax law.

This accounting affects not only the deferred compensation, but two other important items in the corporate-owned life insurance marketplace. The first is the nonqualified deferred compensation liability of the corporations. The second is cash value of life insurance assets.

Deferred compensation balances on a pretax basis are going to significantly increase the liability for these balances on a corporation's books. New salary deferrals will generally need to be established on a pretax basis.

Insurance products that we have seen in this area are single premium deferred annuities quoted on a special quote basis similar to the lump-sum buy-out pension plan. These annuities would fund the deferred compensation balances and they would be purchased by the corporation, but the executive would be the owner. They would be purchased at negotiated rates based on the size and the requirements of the annuities. They would create taxable income to an executive in the current year, but this would have an advantage of taking into account the wide disparity between the maximum corporate deduction of 34% and the maximum personal tax bracket of 28%. Even if the bonus to purchase the annuities was "grossed up" to remove the effect of the taxes, the corporation would still pay less than one dollar for every dollar of deferred compensation liability removed from the balance sheet. If the benefits are not grossed up, there would be no adverse consequences with FAS 96 on the balance sheet.

FAS 96 also requires that the tax payable at surrender of a life insurance policy be booked as a deferred tax liability in any given year. This will show less corporate gain from life insurance and, in fact, on a fully borrowed policy, where the corporate gain was typically the same as the cash flow, we would now see negative earnings on the policy even though there has always been a positive amount of cash flow borrowed from the policy.

One of the design changes we have seen companies make within the corporateowned life marketplace to improve corporate earnings, is to purchase additional insurance in the years where there is cash value in excess of the corporation's basis in the contract. The additional insurance amounts would be paid as death benefits in the given years and these benefits would be shown as tax-free on these companies' statements.

Corporate-owned life insurance which had previously been used to fund the executive benefits, has had its attractiveness reduced. Prior programs that were put in place did not live to pay off the benefits promise. This is because a lot of these were sold in a tax bracket of 50% with projected interest rates of 14% or 15% on the loan amounts. The benefit promises from these programs will need to be looked at more closely over the next year.

Another issue with these benefits is security versus nontaxability. Payments outside a qualified plan are often made out of a corporation's general assets and subject to the claims of general creditors if the company goes bankrupt. Thus, an executive's supplemental retirement plan, deferred compensation arrangement, or excess plan may vanish because it is unsecured. Attempts to secure the payment by fixing the right to payment generally results in current taxation to the executive. As a result, many executives in the past have preferred to gamble that their special payments will ultimately be made rather than incur current taxation. With the uncertainty as to payment of these amounts in a fluctuating business climate, and the expectation of smaller payments from a qualified plan as a result of recent tax legislation, executives have been looking for a way to secure these payments without current taxability.

Rabbi Trusts have been one response to the quest for securing the deferred compensation promise. The term is one spawned by the 1980s and is a handy phrase to describe an irrevocable trust guainteeing payments to the executive but subject to the claims of creditors of the employer and therefore not subject to current taxation to the executive. The first such arrangement was for a rabbi who sought to preserve his deferred compensation arrangement with such a trust; hence the derivation of the name.

Combatting the notion of current taxability for a secured deferred promise involves two aspects: constructive receipt and economic benefit.

The IRS regulation dealing with constructive receipt specifically provides that a taxpayer is taxed on income not actually reduced to his or her possession if it is credited to the taxpayer's account, set apart for the taxpayer, or otherwise made available so that the taxpayer may draw on it. However, income is not constructively received if the taxpayer's control of its receipt is subject to substantial limitations. The mandate of this regulation is clear: don't let the taxpayer currently get the money or the right to the money.

The doctrine of economic benefit is more interesting but harder to pin down. In its basic form stated by the Supreme Court, if an economic benefit that is the equivalent of cash has been conferred upon an employee, the employee will be required to include the value of that benefit in current gross income.

A Rabbi Trust is a nonqualified trust within the meaning of Section 402(b) because it does not meet the qualification requirements of Section 401(a). Under Section 402(b), employer contributions to a nonqualified trust on behalf of an employee are included in the employee's gross income in the year of contribution, but only to the extent that the employee's interest is substantially vested at the time the contribution is made. If the individual is vested in the employer contributions when they are made, the individual has current taxation and the Rabbi Trust does no good. So the problem is to make sure that the employer contributions to the Rabbi Trust are not substantially vested.

The history of letter rulings for Rabbi Trusts has an interesting life of its own. After a long period of suspension of rulings, the IRS has again begun to issue rulings of approval. The current position taken is similar, but not identical, to the earlier rulings. The rulings permit the use of Rabbi Trusts as unfunded vehicles provided that (1) the plan is considered "unfunded" for purposes of Title I of ERISA, and (2) state law will not interfere with the trustee's ability to pay creditors.

A Rabbi Trust is a nonqualified taxable trust, treated as a grantor trust and is subject to the claims of the company's general creditors. Such claims must be enforceable under federal and state law.

A Rabbi Trust is irrevocable or becomes irrevocable in certain circumstances, and has an independent trustee who must make payment of amounts to executives under the terms of the trust (i.e., retirement), assuming the trust has assets. The company is considered the owner of the trust and must include trust income, deductions, and credits in figuring its income tax liability. If there are current distributions of income to employees by the trust, this may also limit the includability of trust income in the employer's gross income. The employer's deduction is allowable in the year the executive is taxed on the distribution. If more than one employee participates in the trust, separate accounts should be maintained or there will be no deduction allowed.

There is no current taxation to the participant, but taxation occurs only when the amounts are paid. Why? (1) There is no constructive receipt, because nothing is "set apart" since it is subject to the claims of creditors. (2) There is no economic benefit because there is nothing secured to be valued. (3) There is no transfer of property to the participant because a promise to pay is not property.

Is the Rabbi Trust an ERISA plan? Although not a welfare plan, it may be a pension plan subject to ERISA. ERISA defines a pension plan as a plan that provides retirement income to employees or results in the deferral of income to retirement or beyond. A Rabbi Trust may do this, or it may not, depending on the plan design.

Another vehicle that we have seen to secure the benefits are surety bonds. This is where an employee buys a surety bond from an independent insurance company to protect (insure against) the payment of an unfunded deferred compensation arrangement by the employer. A private letter ruling says the employee has no constructive receipt of the amount of deferred compensation if he pays the premium from the bond himself. The unanswered questions are: (1) To what extent may the employer be involved, either in arranging for the bond or in giving the financial guarantee? (2) What will an insurance company require of an employer in order to issue the bond to the employee, and will this create taxable income to the employee? There are still no answers, little usage, and much interest.

Also letters of credit are a different source of third-party guarantee. The bank would have an unsecured claim against the employer if the bank were to pay the deferred compensation. The issues involved are the degree to which this is permitted by banking regulations, the degree to which the letter of credit is nonnegotiable and nontransferable, and the degree to which the IRS will find income.

In an escrow account, another version, the *company* sets up an escrow account at a bank and will make sufficient contributions to the escrow account to fund the deferred compensation arrangement. The employees have no right to any of the assets of the escrow account, which is subject to the claims of the employer's creditors. The income and deductions of the escrow account are attributable to the employer.

In a private letter ruling, the IRS held that the employees received no current income. It is interesting that if the employer defaulted in funding the escrow account, the amount therein would become payable to the participant.

The future of unfunded vehicles of this type is somewhat unclear. Two favorable letter rulings have at last been issued on Rabbi Trusts, but not on the other types of vehicles. It thus becomes more difficult to quantify the business risk. Clients should be advised to submit a private letter ruling request anyway.

A recent TPF&C survey about Rabbi Trusts showed that approximately 50% of the respondents had a Rabbi Trust or were planning on establishing one; 15% were contemplating nonqualified trusts;, and about 14% were looking at other forms. Third-party guarantees were only currently being used by 1% of the respondents and had an average cost of a letter of credit of 5% of the guarantee payable annually.

MR. ALAN D. LEVIT: Mr. Bieluch mentioned that two ways to fund these arrangements are Rabbi Trusts and corporate-owned life insurance (COLI). He also made remarks about accounting. Accounting for a nonqualified executive deferred compensation plan is covered by FAS 87. This corresponds to 87's general rule that if it looks like a pension plan, smells like a pension plan, or does anything else like a pension plan, we should treat it like a pension plan.

As most of you probably know, under FAS 87 we do our accounting based on a projected unit credit method, where we assign the value of benefits based on service to date and earnings at retirement.

The interesting questions involve assigning benefits in a SERP. It is often easy, because at times a SERP says that we are going to accrue the benefits over a given number of years, and so it is fairly easy to assign a level of benefit each year. What is more creative is when a SERP says that the executive will be paid a given amount, say 60% of earnings, at retirement. At that point, you must look at the general ruling of FAS 87, which says that if a pension plan doesn't assign a benefit by years of service, or assigns a ridiculous level—like everything accrued in the last year of service—then the allocation should be prorated over the entire average future working service of an executive's working lifetime. More accurately, what this means in a given situation is that you can come up with two radically different costs depending on how you design the document.

Let's take a situation where someone is hired at age 50. You want to make sure that at age 65 this individual receives 60% of earnings at retirement from all sources. You also have another officer at age 40. There are two ways to handle this. One is to accrue the benefits over 15 years so that at age 65, your 50-year-old executive will have his full benefit. The second way is to say you are going to have a 60% benefit at retirement and have it accrue pro rata over service. What we have found when we did these studies is that the costs of doing it the second way are dramatically less than the cost of doing it the first way. The only problem that you run into in doing it the second way, where you assign benefits pro rata over the entire working lifetime of the executive, is that you may have an executive who wants to retire early and at that point he hasn't accrued a full benefit. A way that this would normally be handled would be for the board of directors to grant that particular executive unreduced, full early retirement benefits at actual retirement. You have to absorb more cost at that time, but again, we normally find, depending on all the assumptions, that the cost of doing it on this pro-rata-by-working-lifetime way turns out to be less and in most cases the employer is looking for a lower cost.

The next interesting point to talk about in terms of accounting for SERPs is the kind of assets that are being used. As Mr. Bieluch mentioned, two of the most popular assets that are used to fund SERPs are Rabbi Trusts and COLI. When you talk about COLI, the answer is fairly clear. COLI may be a neat asset for an insurance salesman and may even be a very valuable asset for a company, but when it comes to FAS 87, it's not worth anything.

Assets under FAS 87 must be separately segregated only to pay benefits for the beneficiary, and COLI does not ordinarily do that. Any unfunded plan that is funded by COLI will normally show zero assets in terms of the FAS 87 reconciliation standpoint.

The more interesting situation is with a Rabbi Trust. What does a Rabbi Trust really say? They say that we're going to take some money and put it in another pocket. This pocket can be used in one of two ways. It can either be used to pay off the benefits that we promised, or it can be used to pay off our creditors if we go bankrupt.

Let's take a company that is totally solvent. We believe, although we haven't tried it with any accountants yet, that in a totally solvent company you can

make a very good argument that there is no material chance that the company will go insolvent during the time that the obligation is to be paid. The Rabbi Trust can be counted as an asset, just like any other qualified trust, because the assets have clearly been segregated and they are not going to be used for anything except to pay the benefits to the beneficiary.

This actually gets down to the real point about accounting for unfunded deferred compensation plans for executives, or for anyone else. When we're talking about actuaries normally funding and filling out Schedule Bs, we have an obligation to plan participants, and we have a legal obligation when we sign our names. When we're talking about doing work for FAS 87, the people who are really on the line are the accountants. Normally, we will know more about FAS 87 than the accountants, and that is because the accountants have to worry about FAS 1 through 86, in addition to 89 through whatever. We only need to worry about two or three opinions. The point is that we are in a position where we can give the client good advice, have the client make a statement, and in many cases convince the accountant to do what we would like them to do and have him be the one who is really subject to the responsibility.

The only other point about assets and SERPs is that to the extent that you do not have assets or the assets are COLI, or some other kind of arrangement that doesn't qualify as an asset under FAS 87, the SERPs will be accounted for as unfunded plans on the reconciliation statement. Beginning next year there may be a minimum liability or even a reduction in shareholder's equity, because the SERP is not fully funded on accrued benefits.

I would now like to talk about the assumptions that are used to evaluate SERPs under FAS 87. The basic framework that you have to look at is that assumptions for the nonqualified plans must be consistent with the assumptions for the qualified plans. It's not at all unusual to see identical assumptions used for the same plans, but there are several assumptions that can differ.

One of the assumptions that can differ, but rarely does, is the discount rate. It is easy to argue that the settlement rate that you can receive for nonqualified annuities is going to be less than the settlement rate you can receive for qualified annuities. That is an easy argument to defend, but it is rare that a company wants to show a high SERP expense. We thus have a good case that we almost never make.

Another assumption that often differs for the executive plans, and with good justification, is the salary scale, where we feel the executive will be receiving better raises than the rank and file. Kettrement age for the executive ranks may be earlier or it may be later than the retirement age that is used for the rank and file. Assumptions that almost never differ are the mortality, although often at the top it's a hard job and they die more quickly and the Consumer Price Index (CPI) increase.

One last comment on accounting is more of a question than it is a statement of fact. Most of the DC SERPs and most of the plans that make up for the \$7,000 limit can really be accounted for under FAS 87 as defined benefit plans. After all, they only pay a benefit at retirement or termination, and it's very often the case where the executive has payment options, say a 10-year option. In many cases, the company will show a smaller expense accounting for these defined contribution SERPs as a defined benefit plan, than the company would show accounting for them as a defined contribution plan.

I would like to talk about taxation. First of all, when we talk about regular unfunded plans that are available to executives of a private sector, the rules are very clear. There is no deduction for the company until the benefit is paid and there is no tax to the executive until the benefit is paid. It's nice and simple and you don't have to worry about it. The more interesting possibilities come when you start talking about tax-exempt employers who do not care about deductions and when you talk about funded SERPs.

The first thing to realize with tax-exempt employers is that under tax reform, SERPs are technically no longer allowed. All deferred compensation arrangements under tax-exempt employers fall under Section 457. Section 457 does talk about what happens when you have plans that defer more compensation than is allowed under the regular 457 rules, which is about \$7,500 a year. The answer there is that whenever an executive of a tax-exempt employer defers compensation or receives deferred compensation of more than \$7,500, the executive is taxed on the value of that benefit as soon as it is no longer subject to a substantial risk of forfeiture. In case we were going to try to make some waves out of substantial risk of forfeiture, the code goes ahead and defines what they mean. What they mean is contingent upon the performance of significant future services.

Most tax-exempt SERPs are grandfathered under the old law, but in a new SERP for an executive of a tax-exempt employer, the minute he is assured of receiving a payment stream he is taxed on the present value of that payment stream. This leaves the executive in a situation where he has a little money and a big tax bite -- normally not a very enticing possibility. The only way that can be gotten around is for the executive to pick a date at which point he wants the benefit to be nonforfeitable, with the understanding that if he were to terminate before that date, there would be no benefit paid. So there is a definite security issue that is involved if the executive wants to play any kind of game with the tax laws.

There are some 403(b) annuities and regular tax shelter annuities available to executives. Unlike the qualified plan or the private sector, these annuities can basically be offered on a discriminatory basis without having to worry about the Average Deferral Percentage (ADP) test. The problem with the 403(b) annuities is that they are now limited to \$9,500. So there is limited value that can happen there.

One of the more interesting avenues right now is what they call 403(c) annuities. These are annuities that are turned over to executives, and as soon as they are turned over the executive is taxed on the cash value. What the public employer would do is deliberately buy an annuity with a high payment stream, but a low cash value.

These things work in theory, but there are a couple of big practical problems. The first is that finding these kinds of annuities is difficult. There are not that many insurance companies that provide them. The second is that because of the constructive receipt laws, there must be at least two taxable years that have elapsed between the time that the annuity has been purchased by the public sector employer and the time that the annuity has been turned over to the executive.

Finally, I would like to talk about funded SERPs. We have already talked about the Rabbi Trust as far as the IRS is concerned. That is not a funded SERP so

there are no tax problems with that particular kind of arrangement. Some executives are more concerned with security. They may be more interested in having a secular trust set up in their name. In this case, the executive must pay the tax on the amounts as they are vested. However, the employer receives his deduction earlier.

The real problem with secular trusts is that the earnings on these trusts are actually taxable to the employer. The employer must pay the tax on those earnings and when the executive receives the benefit, the earnings are not part of the basis so the earnings are taxed twice. One other thing to keep in mind about a secular trust is that the amount of income that is replaced by the secular trust can be less than it would have been from a regular unfunded trust because part of the earnings are tax-exempt.

I have also seen a twist on these secular trusts which I like to call a tax-paying trust. This is a situation where a secular trust is set up and the executive is taxed on the vested amounts that go in. In this case, it's the trust itself that pays the tax by making distributions back to the executive in order to pay the tax. It's an unusual angle, and once again the amount that is actually paid by the trust at retirement does not have to be as big, because part of the benefits at the end are not taxed. Again, you do have the double taxation problem, but this kind of arrangement may be appealing to executives who do not have the wherewithal to pay the taxes on the trust money as it goes in.

MR. RICHARD J. ANDERSON: Mr. Harris has asked me to give you the basic provisions of our nonqualified deferred compensation plans. The first plan we have is a basic executive supplementary retirement plan. It's unfunded and recalculates a participant's benefit to include any bonus that the individuals had during the same period under which their basic qualified retirement plan is calculated.

Our basic retirement plan is a best three years out of the last ten final average pay plan. Otherwise, it's a straightforward mirror to the provisions of the qualified plan. The election that is made under the qualified plan follows in the executive supplementary retirement plan with the exception that there is no lump sum benefit under this plan. That is for constructive receipt concerns.

Another aspect of this plan is that there is no benefit unless the individual obtains eligibility for immediate retirement -- a handcuffs concept. We have one exception to that, based on the environment at ARCO, and that is when individuals are terminated, either due to divestitures or to an involuntary reduction in force and they have a deferred vested benefit under the Alantic Richfield retirement plan. They would have an entitlement under this plan which they trigger under the ARCO basic plan. There is a cap on the total benefit that is payable under this plan of 65% of the total pay of the individual for their last year, plus the annual award that they received for that year. The board of directors wanted to put some limit on the outcome based on how large bonuses could get.

We have a defined benefit plan and it is the top-hat variety that we talked about. The plan is maintained primarily for a select group of management. We also have a provision in the plan that has occasionally been used. It is called a special supplemental benefit. People that transfer receive them. In my nine years with ARCO, three or four times benefits have been paid out of this plan. A special would be provided under this plan based on the benefits lost from the

predecessor company. The financing is unfunded, although ARCO is actively looking at the Rabbi Trust concept for this and the remaining plans that I discuss will be under the Rabbi Trust.

The last thing that I will talk about is disclosure. In this kind of a plan, the regulation by the Department of Labor and otherwise is minimal. You file a one-time statement, which we have done with this plan, with the Department of Labor and it shows up in our proxy. There are annual statements provided to the participants not required by ERISA. It is a communications effort to keep people up to date on their benefits. Finally, it is reported according to FASB 87.

The second concept that we have is picking up 415 limitations. Here we have two approaches. The first is a straight pick-up of the defined limitation under the retirement benefit plan of Atlantic Richfield Company. Again, it mirrors the provisions of our defined benefit retirement plan and expects no lump sum for the same reason that I just mentioned -- constructive receipt concerns.

There are also handcuffs on this one. There is no eligibility to this benefit unless the individual terminates with the right to receive an immediate retirement allowance. It is unfunded. The disclosures run the same way as I just described, except there is technically no disclosure at all to any federal government agencies for these plans. We do send the statement out for this one as we do for the supplementary retirement plan reported under FASB 87.

As far as the defined contribution side is concerned, what ARCO has done here is attempt to address the issue, if you will, at the front end rather than have any pick-up. We do not have an excess defined contribution plan. What the company did was look at its basic qualified defined contribution plans, such as a basic 401(a) profit sharing plan with matching company cash, or a deferred arrangement with an election of deferrals and a nonqualified 1% company contribution, and then a voluntary contribution to the retirement plan.

We have a formula for after-tax voluntaries in that plan. The analysis was made as to what individuals at what salary level, if they were to participate at a maximum under these plans, would have a cut on their \$30,000 limit of their defined contribution plan. The outcome was \$150,000. What we did was exclude any employee with a base salary of \$150,000 or higher from the 401(a) plan. However, they're still in the 401(k) plan. Then we provide them with a benefit under our executive supplemental savings plan. This is a top-hat plan which pays a straight 4% company payment to the individual, which is the maximum they could have received under the savings plan that they now have been excluded from. That is paid either annually or on a deferred basis, two years out or at retirement.

The elections are made pursuant to constructive receipt principles each plan year. An unfunded Rabbi Trust might be used for this plan and this is one that is under active review at ARCO, as are all of these. This plan is under the \$7,000 limit under 401(k). It went into effect in 1983. There is consideration as to whether or not this plan should be abandoned and people put back into the qualified plans. Some of the numbers used in the original analysis may not fit again, so it is under study.

This is not reported under FAS 87, but I am told it is reported as a current compensation expense and looks to the accountants like a straight compensation

from a regular bonus plan. It is an automatic lump-sum payment to the people who are fully eligible and immediately vested. There are otherwise no handcuffs issued here.

The last plan that we put into effect three months ago was a retirement plan for outside directors. It is a straightforward, nonqualified plan; again, with no ERISA impact for outside directors. They have a minor three-year cliff vesting, and the individual receives his final fee that he had from the companies as an outside director upon the later of age 65 or retirement and he receives it for 15 years. As every plan I have mentioned, it is described in the company's proxy, and otherwise communicated internally to the participants.

MR. BRADLEY C. FOWLER: Mr. Anderson, on your DC unqualified plan, it sounds like you don't require the executives to put in any of their own money.

MR. ANDERSON: That is correct.

MR. FOWLER: For those that like to defer retirement, what rate of return do you credit on the funds while they are deferred?

MR. ANDERSON: We credit them with the rate under what we call our unsegregated fund option of the basic savings plan, which is analogous to a straight money market with about a 7% return right now. That is what the interest is for the deferrals.

MR. FOWLER: Mr. Levit, is it true that you're not actually aware of an accounting firm allowing Rabbi Trust assets to be counted as assets for FASB 87?

MR. LEVIT: I am not aware of one.

MR. FOWLER: I have read a lot of annual report footnotes this year under FASB 87, and noted that the vast majority of large companies are not showing any plans where the assets are less than the accumulated benefit obligation. This would seem to imply that if they are following the requirements rigorously, they have no unfunded nonqualified plans or else they have been able to convince their auditors that they are sufficiently small as a portion of the total and that they do not have to disclose them. I would be interested in comments that anyone might have on that particular point.

MR. HARRIS: Based on statistics, probably most of the companies that you read with those footnotes have a program. So they probably have convinced the accountants that it's de minimis. However, there probably would be an earnings charge for it. If it's not de minimis from an earnings standpoint, why would it necessarily be de minimis from an asset standpoint? I really don't know how they're getting around it. Maybe someone in the audience who has helped write a footnote like that could help us with this one.

MR. CHRISTOPHER J. ENDRES: There is a deferred effective date for that particular provision. I believe it is 1989, so the companies have not had to do it yet. However, they are going to, and I think that is going to be the interesting test -- how that is treated in 1989 when that occurs.

MR. RICHARD H. SOLOMON: Would whoever is unfortunate enough to be the tax expert address questions I have on tax implications of payments from a SERP with respect to Social Security? What impact does that have on the reduction of

Social Security benefits because of outside income? What tax impact would there be on death benefits payable, as Mr. Harris said, in the form of life annuity from a SERP?

MR. HARRIS: That would be an ordinary income payment to the recipient of those particular death benefits. I guess that we would have that \$5,000 exclusion, but after that it would be all taxable income as received. As far as Social Security is concerned, these fall into the areas of nonqualified deferred compensation and effective in 1984, I believe, it is taxable when carned. That could potentially impact a director who may not necessarily be over the wage basis. It is something one could look out for.

There is something that we run across and that is what Mr. Levit was mentioning—the problems our nonprofits have with the application of Section 457 against almost anything once it exceeds the 403(b) amounts, which probably wipes out any availability for 457 benefits at all. There is an exclusion under 457 which says that a portion of benefits that are provided through a 402(b) trust are exempt from the rules of 457, as was pointed out when Mr. Bieluch was talking about 402(b) trusts, nonqualified trusts, and any amounts placed therein. Once vesting rules apply, these amounts would be immediately taxable to the executive. Also, 402(b) trusts are under ERISA, so minimum funding requirements apply to benefits promised under 402(b).

Putting this all together, if we provide a benefit through 402(b), we could avoid 457 problems. But since we have to fund the benefits under ERISA, and since someone will eventually become vested in that, we have exposed our executives to tax. However, governments and churches are exempt from ERISA funding requirements. A government entity, which is affected by 457, or a church or its divisions, such as hospitals or other organizations run by churches, could put a 402(b) trust in to provide deferred compensation, avoid 457 and not fund it, and therefore not expose the executive to the taxation. It is a real slim line. It seems to be able to work and it is something I would like you all to think about.

One more point is that the executive can only look to the trust for payment. The executive cannot pass the trust to the entity from which the promise is being made. It has to be passed off totally to that trust. Essentially, when a trust is as dry as possible, providing very little security, and then is terminally funded or pay-as-you-go funded, the executive then has a taxable event.

MR. IRWIN I. KENT: What is the status of individual employment contracts in a tax-exempt organization? Is that not a way of getting around the 457 problem and some of the other deferred compensation arrangements?

MR. LEVIT: I assume when you're talking about an individual employment contract, you're talking about a contract that specifies some payments at retirement. If that's the case, my_understanding is that that is a 457 plan and assuming the executive stops working, he is taxed on the present value of the promises that are now vested and are promised to be paid. Most individual employment contracts have been out there since before August 16, 1986, and they are grandfathered in. If you're starting one now, you have to be very careful. You would probably want a lump-sum payment as opposed to a series of payments to allow the retiring executive to pay the tax.

MR. HARRIS: If upon termination of employment at any time during the run of the contract, a benefit would otherwise be payable, we have a constructive receipt problem. We have vesting in the value and we would have a taxable event of the present value, even though the contract is yet to be exercised.

MR. DOUGLAS J. CAREY: I have a question on ordinary salary deferral plans. Have you seen any movement among organizations to terminate those plans this year to try to structure payments under lower tax rates? My experience has been that these plans typically allow the company to terminate them at its discretion and pay out all sums deferred. This might be an advantageous year of doing so. I just wondered if any of you have seen that happen with organizations that you work with. You might also address the legal ramifications of that to the extent that you would like to.

MR. HARRIS: I haven't seen any particular rush to do that. Let's talk about whether or not it actually makes sense. We have run a couple of models which seem to indicate that even though tax rates might be onerous in the future and might get worse, the tax shelter credit that the employer is giving tends to offset that, if the duration is any period of time - five or six years out, assuming an adverse movement in the tax rates. So that deferral is still a better option than taking it out in the current tax rate. Regarding any legal ramifications relative to the cancellation and the payout of the contract, one of the underlying principles in deferred compensation and the avoidance of constructive receipt, is that there has to be a legitimate business reason for not making the payment in the year that it should have been made, and deferring the payment to some later year. A legitimate business reason is not to get a better tax rate. We would always have that particular problem if it was deferred two years ago when we had our maximum tax rates and we would pay it out immediately assuming it was 28% before it came up to 33%, or whatever it was going to be the next year. We have to make sure that the deferral period has been long enough to not just get us over or get us through an unfavorable tax hurdle, but that is going to be in the eye of the beholder. Other than that there would be no legal ramifications.

MR. GARY L. PETERSEN: Mr. Harris, regarding death benefits in a SERP, what is the impact, if any, of Section 89 in relationship to those death benefits? Would they be included in the Section 89 testing?

MR. HARRIS: My quick answer is I don't think they would be included in Section 89 at all. They're not any form of short-term life insurance. However, they are death benefits.

MR. PETERSEN: Are these considered self-funded death benefits, in which case the benefits are income taxable when paid?

MR. HARRIS: I agree with that, yes, definitely. I think that was the question that we addressed before, other than the \$5,000 exclusion which I still think applies.

MR. JOHN W. PHELAN: Mr. Levit, do you have an opinion on whether insurance inside of a secular trust retains its tax advantage to the employee as a tax advantage in the death benefit and cash value?

MR. BIELUCH: I think insurance purchased by a secular trust has a few caveats to be aware of. What is the insurable interest in the secular trust to that

employee? I think we still have an insurable interest issue. That's probably the biggest issue around it. You also get into the fact that we're looking for insurance being sold to Voluntary Employee Beneficiary Associations (VEBAs). This is sort of the same thing. Then you get to why did you buy the insurance? The answer you get is in order to avoid the unrelated business income tax. There's a determination letter that Canada Life received late last year for a VEBA that was buying life insurance as an asset. I point out that in the determination letter the VEBA itself actually had life insurance as one of the benefits being provided. I'm not sure what the answer would have been if that wasn't true.

MR. WILLIAM W. BUSH, III: If you have a nontaxable institution, like a symphony or a hospital, can't you set up a Rabbi Trust which has a substantial risk of forfeiture to age 65, for example, which will not interfere with 457 benefits?

MR. LEVIT: Keep in mind how substantial risk of forfeiture is defined in the law. Substantial risk of forfeiture is a benefit that is contingent upon performance of future services. It does not have anything to do with Rabbi Trusts or whether you can lose the benefit. If you have a symphony or a hospital where they have a plan for their members where if they leave at age 64 1/2, they receive nothing, you are perfectly fine. Your 64-year-old employee may not be crazy about it, but you don't have any tax problems.

MR. HARRIS: The other thing also applies. If they leave at age 66, they're taxed at 65.

MR. BUSH: So let's say you have one of these. Let's say you are funded. You set up a funded Rabbi Trust and you put real money into it. Who pays the tax on the interest income in the Rabbi Trust? Is there physically any tax due?

MR. LEVIT: I think the trust has to pay the tax.

MR. BUSH: So it would be unrelated business income?

MR. LEVIT: Correct.

MR. BUSH: Once again, if you had one of these, basically that dries up the cost of the plan.

MR. LEVIT: One way around that is to invest in tax-exempt securities.

MR. BUSH: But they don't yield as much as others. Then, presumably, you could also put some triggers in there which said that if you're fired before age 65, you're not eligible.

MR. LEVIT: You're o.k. Fired is o.k; death is o.k. I'm not aware of any others that are o.k.

MR. HARRIS: Early retirement does not work. Disability would be o.k.

MR. LEVIT: Anything for which the participant does not have any control over would be acceptable.

