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EXEMPT COMPENSATION ARRANGEMENTS UNDER ERISA

*By Randolph M. Goodman**
*and Laura E. Stone***

In passing the Employee Retirement Income Security Act of 1974 (ERISA),¹ Congress sought to provide comprehensive protection to employee benefit plan participants and beneficiaries.² To accomplish this purpose, the Act strictly regulates the funding and operation of plans³ and requires regular reporting and disclosure.⁴ ERISA also has introduced new fiduciary standards for those controlling plan assets⁵ and has created causes of action for plan participants.⁶

Enforced by at least three federal agencies,⁷ the Act is an enormously complex and far-reaching piece of legislation, making compliance difficult and expensive.⁸ Fortunately for employers desiring to offer some form of

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1. 29 U.S.C. §§ 1001 to 1381 (1976).

2. *See* 29 U.S.C. § 1001 (1976).

3. *See* ERISA §§ 201 to 211, 301 to 306, 29 U.S.C. §§ 1051 to 1061, 1081 to 1086 (1976).

4. *See* ERISA §§ 101 to 111, 29 U.S.C. §§ 1021 to 1031 (1976).

5. *See* ERISA §§ 401 to 414, 29 U.S.C. §§ 1101 to 1114 (1976).

6. *See* ERISA § 502, 29 U.S.C. § 1132 (1976).

7. The Department of Labor has primary responsibility for enforcement of the Act's reporting and disclosure requirements and its fiduciary obligations rules. The Internal Revenue Service is charged with administering ERISA's minimum standards with respect to participation, vesting, benefit accrual, and funding. The Pension Benefit Guaranty Corporation is responsible for the government's plan termination insurance program. At present, the Securities and Exchange Commission plays only a limited role in the regulation of employee benefit plans, since the antifraud provisions of the securities laws have been held inapplicable to an interest in a mandatory, noncontributory, defined benefit pension plan. *International Bhd. of Teamsters v. Daniel*, 99 S. Ct. 790 (1979).

8. In an attempt to make compliance with ERISA less burdensome and to improve administration of the Act by eliminating jurisdictional overlap, Reorganization Plan No. 4 of 1978 was adopted by the President, effective as of December 31, 1978, 43 Fed. Reg. 47713 (1978). *See* Exec. Order No. 12108, 44 Fed. Reg. 1065 (1979). Under the reorganization plan, the Department of the Treasury is assigned primary responsibility for prescribing min-

deferred compensation to their employees without incurring the Act's obligations, some employee benefit practices have been specifically exempted from ERISA's coverage.⁹ Additionally, other arrangements have been recognized as falling outside the wide scope of the Act.¹⁰ This article will discuss several of these alternatives,¹¹ including severance pay plans,¹² gratuitous payment programs,¹³ unfunded plans for management or highly compensated employees,¹⁴ and excess benefit plans.¹⁵

imum standards for pension plans with respect to participation, vesting, and funding, while the Department of Labor retains primary jurisdiction over the Act's fiduciary standards, including exemptions from ERISA's prohibited transaction provisions.

9. ERISA § 4(b), 29 U.S.C. § 1003(b) (1976), exempts from ERISA coverage governmental plans, church plans, plans maintained to comply with "applicable workmen's compensation laws or unemployment compensation or disability insurance laws," plans "maintained outside of the United States primarily for the benefit of persons substantially all of whom are nonresident aliens," and unfunded excess benefit plans. It should be noted, however, that some attempts have been made to extend the protection afforded by ERISA to plans covering public employees. *See, e.g.*, H.R. 14138, 95th Cong., 2d Sess. (1978) (introduced by Reps. John Erlenborn of Illinois and John Dent of Pennsylvania, 124 CONG. REC. H10,264 (daily ed. Sept. 20, 1978)). It also should be noted that not all of the arrangements discussed herein provide complete exemption from the provisions of the Act. In particular, the reporting and disclosure requirements and the administration and enforcement provisions have significantly broader application than the standards governing participation, vesting, benefit accrual, and funding. For example, unfunded plans for management or highly compensated employees are exempt from ERISA's participation, vesting, benefit accrual, and funding standards, pursuant to ERISA §§ 201(2) & 301(a)(3), 29 U.S.C. §§ 1051(2) & 1081(a)(3) (1976). In addition, these plans are exempt from ERISA's fiduciary responsibility rules under ERISA § 401(a)(1), 29 U.S.C. § 1101(a)(1) (1976). Such plans, however, remain subject to the Act's reporting and disclosure requirements, ERISA §§ 101 to 111, 29 U.S.C. §§ 1001 to 1031 (1976), as well as its administration and enforcement provisions, ERISA §§ 501 to 514, 29 U.S.C. §§ 1131 to 1144 (1976).

10. Under ERISA § 4(a), any employee benefit plan established or maintained by: (1) an "employer engaged in commerce or in an industry or activity affecting commerce"; (2) an "employee organization . . . representing employees engaged in commerce or in any industry or activity affecting commerce"; or (3) both, is subject to the Act. 29 U.S.C. § 1003(a) (1976). For further discussion of ERISA § 4(a), see notes 22-23 and accompanying text *infra*.

11. It is important to point out that this article will not discuss all possible deferred compensation arrangements not subject to the Act's coverage. There are other alternatives to ERISA. For example, the several types of plans expressly exempted from ERISA by § 4(b) of the Act, 29 U.S.C. § 1003(b) (1976), *see* note 9, *supra*, are not discussed herein.

12. A severance pay plan is a plan which provides compensation to employees upon termination of employment, generally without regard to the reasons for termination. *See* notes 51-68 and accompanying text *infra*.

13. A gratuitous payment program is a program under which an employer makes payments to retirees outside of a formal pension program. *See* notes 69-75 and accompanying text *infra*.

14. An unfunded plan for management or highly compensated employees is a benefit plan under which an employer makes payments out of general, unsegregated assets to a group of executive employees. *See* notes 76-95 and accompanying text *infra*.

15. An excess benefit plan is a plan under which an employer provides benefits in excess

I. GENERAL PRINCIPLES OF ERISA COVERAGE

The comprehensive regulatory scheme embodied in Title I of ERISA¹⁶ governs virtually all aspects of the administration and operation of private sector employee benefit plans. Title I, which is administered by the Department of Labor, contains the Act's reporting and disclosure requirements¹⁷ as well as its administration and enforcement provisions.¹⁸ In order to avoid the imposition of unreasonable eligibility requirements regarding age and years of service, Title I establishes minimum standards for pension plans with respect to plan participation and vesting.¹⁹ Another part of Title I sets minimum funding standards, requiring employers to fund current pension costs and to amortize past service costs and other liabilities.²⁰ Finally, Title I sets forth fiduciary standards, including the federal "prudent man" rule and the diversification requirement, which dictate the manner in which plan fiduciaries are to manage plan assets and otherwise operate the plan.²¹ These stringent standards make it important for plan sponsors and their advisors to consider the provision of benefits to employees through the use of compensation arrangements which are not covered by ERISA.

Subject to certain exceptions, Title I of the Act applies to any employee benefit plan established or maintained by an employer or by an employee organization which represents employees, engaged in commerce or in any industry or activity affecting commerce.²² ERISA defines the term "em-

of those permitted under the limitations for tax-qualified pension plans. ERISA § 3(36), 29 U.S.C. § 1002(36) (1976). See notes 96-110 and accompanying text *infra*.

16. ERISA §§ 2 to 514, 29 U.S.C. §§ 1001 to 1144 (1976). Title I of ERISA is applicable to the broadest class of employee benefit plans. See notes 22-23 and accompanying text *infra*. Title II, ERISA §§ 1001 to 1052 (codified in scattered sections of the I.R.C.), employs provisions similar to those in Title I but applies primarily to plans which qualify for tax exemptions under I.R.C. § 401. Title IV of the Act applies only to defined benefit pension plans. See ERISA § 4021, 29 U.S.C. § 1321 (1976). Title III of the Act attempts to coordinate ERISA enforcement among the various administrative agencies and does not bear on employee benefit plans directly. See ERISA §§ 3001 to 3042, 29 U.S.C. §§ 1201 to 1241 (1976).

17. ERISA §§ 101 to 111, 29 U.S.C. §§ 1021 to 1031 (1976).

18. *Id.* at §§ 501 to 514, 29 U.S.C. at §§ 1131 to 1144.

19. *Id.* at §§ 201 to 211, 29 U.S.C. at §§ 1051 to 1061. Vesting is the process by which an employee acquires full rights to his or her benefits. Under the terms of most plans, employees may start accumulating benefits early in their employment. The employee, however, will not be fully entitled to those benefits until he or she has put in a number of years of service. See D. MCGILL, FUNDAMENTALS OF PRIVATE PENSIONS 130-39 (1975).

20. ERISA §§ 301 to 306, 29 U.S.C. §§ 1081 to 1086 (1976).

21. *Id.* at §§ 401 to 414, 29 U.S.C. at §§ 1101 to 1114.

22. *Id.* at § 4(a), 29 U.S.C. at § 1003(a). Questions have arisen as to whether a particular arrangement is maintained by an employer or an employee organization. An example of a difficult determination is that involving the so-called multiple employer trust. Typically,

ployee benefit plan" to include an employee welfare benefit plan, an employee pension benefit plan, or any plan incorporating both types of arrangements.²³

An employee welfare benefit plan is any "plan, fund, or program . . . established or maintained by an employer or by an employee organization . . . for the purpose of providing for its participants or their beneficiaries, through the purchase of insurance or otherwise," certain enumerated types of benefits, including medical, surgical, or nonpension benefits described in section 302(c) of the Labor Management Relations Act of 1947.²⁴ In

this is an arrangement under which small employers group together, often through a third-party administrator, to pool their contributions in a single fund. The fund is then used to provide the employees with welfare benefits such as medical reimbursement. By spreading the risks over a large group of employers, it becomes possible to provide benefits comparable to those provided by larger employers. Since ERISA defines the term "employer" as including a "group or association of employers," *id.* at § 3(5), 29 U.S.C. at § 1002(5), some multiple employer trusts, *e.g.*, those maintained by groups of employers, are clearly encompassed within the statutory definition of an employee benefit plan. The issue is far less clear, however, in connection with other multiple employer trusts that are maintained by employers having no relation to each other and whose employees have no common relationship, *e.g.*, common union representation. These trusts are frequently established to avoid the application of state insurance laws which are preempted if the arrangement is an employee benefit plan maintained by an employee organization, specifically an "employees' beneficiary association" as defined in ERISA § 3(4), 29 U.S.C. § 1002(4) (1976). See Brummond, *The Legal Status of Uninsured Noncollectively-Bargained Multiple Employer Welfare Trusts Under ERISA and State Insurance Laws*, 28 SYRACUSE L. REV. 701 (1977). The courts have generally upheld the position of the Department of Labor that, unless there exists some commonality of interest among the employees with respect to their employment relationship, these arrangements do not come within the statutory definition of an employee benefit plan. See, *e.g.*, *Bell v. Employee Security Benefit Ass'n*, 437 F. Supp. 382 (D. Kan. 1977); *Hamberlin v. VIP Ins. Trust*, 434 F. Supp. 1196 (D. Ariz. 1977). See also U.S. Department of Labor Opinion Letters 77-59 A (August 26, 1977), 78-4 A (February 27, 1978), and 78-5 A (March 13, 1978).

23. ERISA § 3(3), 29 U.S.C. § 1002(3) (1976).

24. ERISA § 3(1) defines an "employee welfare benefit plan" as any plan, fund, or program which was heretofore or is hereafter established or maintained by an employer or by an employee organization, or by both, to the extent that such plan, fund, or program was established or is maintained for the purpose of providing for its participants or their beneficiaries, through the purchase of insurance or otherwise, (A) medical, surgical, or hospital care or benefits, or benefits in the event of sickness, accident, disability, death or unemployment, or vacation benefits, apprenticeship or other training programs, or day care centers, scholarship funds, or prepaid legal services; or (B) any benefit described in section [302(c) of the Labor Management Relations Act, 29 U.S.C. § 186(c) (1976)] (other than pensions on retirement or death, and insurance to provide such pensions).

29 U.S.C. § 1002(1) (1976).

Section 302(c)(5) of the Labor Management Relations Act exempts from the general prohibition against payments by employers to employee representatives payments by employers to trusts meeting certain criteria and maintained to provide "medical or hospital care, pen-

August 1975, the Department of Labor issued regulations clarifying the statutory definition of an employee welfare benefit plan.²⁵ These regulations identify certain practices which do not constitute welfare plans for purposes of Title I of the Act.²⁶ For example, a system of payroll deductions made by an employer for deposit in employee savings accounts does not provide any of the types of benefits contemplated by the ERISA definition of a welfare plan and, therefore, does not come within Title I's coverage.²⁷ Similarly, an industry advancement program,²⁸ having no employee participants and providing no benefits to employees or their dependents, does not qualify as an employee welfare benefit plan under Title I.²⁹

As a general rule, welfare plans are subject to most of ERISA's reporting and disclosure requirements.³⁰ Although welfare plans are expressly excepted from the application of ERISA's minimum standards for participation, vesting, benefit accrual, and funding,³¹ such plans are covered by the Act's fiduciary obligations rules and by its administration and enforcement provisions.

Also included within the statutory definition of employee benefit plans

sions on retirement or death of employees, compensation for injuries or illness resulting from occupational activity or insurance to provide any of the foregoing, or unemployment benefits or life insurance, disability and sickness insurance, or accident insurance." 29 U.S.C. § 186(c)(5)(A) (1976).

25. 29 C.F.R. § 2510.3-1 (1978).

26. Moreover, these regulations provide as follows:

In addition, the practices listed in this section do not constitute employee pension benefit plans within the meaning of section 3(2) of the Act, and, therefore, do not constitute employee benefit plans within the meaning of section 3(3). Since under section 4(a) of the Act, only employee benefit plans within the meaning of section 3(3) are subject to Title I of the Act, the practices listed in this section are not subject to Title I.

Id. at § 2510.3-1(a)(1). For a discussion of employee pension benefit plans, see text accompanying notes 32-36 *infra*.

27. 29 C.F.R. § 2510.3-1(a)(2) (1978).

28. An industry advancement program is a program maintained by an employer, or a group or association of employers, to promote the industry in which they are engaged. Although such a program may arguably benefit employees by promoting their industry, it usually does not have employee participants, nor does it provide benefits directly to employees or their dependents.

29. 29 C.F.R. § 2510.3-1(i) (1978). Remembrance funds—programs under which contributions are made to provide flowers, small gifts, or other such remembrances on the occasion of the death or sickness of employees or their family members—also do not constitute welfare plans for purposes of Title I. 29 C.F.R. § 2510.3-1(g) (1978).

30. *See, e.g.*, ERISA § 105, 29 U.S.C. § 1025 (1976) (requiring administrators of pension plans—not welfare plans—to furnish participants, upon request, a statement describing the participant's accrued benefits and the portion of such benefits that is nonforfeitable).

31. *See id.* at §§ 201(1) & 301(a)(1), 29 U.S.C. §§ 1051(1) & 1081(a)(1) (1976).

are pension benefit plans, funds, or programs established or maintained either by an employer or by an employee organization to provide retirement income or to defer income until the termination of covered employment.³² A particular plan's status will not be affected by the method of calculating the contributions made to the plan, the method of calculating the benefits under the plan, or the method of distributing benefits from the plan.³³ Regulations issued by the Department of Labor set forth a number of arrangements which are not considered to come within the statutory definition of an employee pension benefit plan, even though such practices may constitute welfare plans and thus be subject to Title I of ERISA.³⁴

Subject to limited exceptions for certain types of pension plans,³⁵ employee pension benefit plans within the meaning of ERISA are generally subject to all the provisions of Title I of the Act. These plans, therefore, must comply with the Act's participation, vesting, accrual, and funding requirements. These complex and costly requirements are in many instances better to avoid.³⁶ Discussed below are several arrangements frequently used by employers to provide deferred compensation but which,

32. ERISA § 3(2) defines an "employee pension benefit plan" as any plan, fund, or program which was heretofore or is hereafter established or maintained by an employer or by an employee organization, or by both, to the extent that by its express terms or as a result of surrounding circumstances such plan, fund, or program—

(A) provides retirement income to employees, or

(B) results in a deferral of income by employees for periods extending to the termination of covered employment or beyond, regardless of the method of calculating the contributions made to the plan, the method of calculating the benefits under the plan or the method of distributing benefits from the plan.

29 U.S.C. § 1002(2) (1976).

33. *Id.*

34. 29 C.F.R. § 2510.3-2 (1978). For example, a severance pay plan may not come within the definition of a pension plan, but may nevertheless be subject to ERISA as a welfare plan. *Id.* at § 2510.3-2(b). See notes 56-57 and accompanying text *infra*.

35. See, e.g., ERISA §§ 301(a)(8), 404(a)(2) & 407(b)(1); 29 U.S.C. §§ 1081(a)(8), 1104(a)(2) & 1107(b)(1) (1976) (exempting the "individual account plan"—defined by ERISA § 3(34), 29 U.S.C. § 1002(34) (1976), as "a pension plan which provides for an individual account for each participant and for benefits based solely upon the amount contributed to the participant's account . . ."—from the Act's funding standards, diversification requirement, and provisions regarding acquisition and holding of employer securities).

36. One example of the Act's complex and costly requirements is the minimum funding standard, which mandates not only that employers fund current pension costs, but also that they amortize past service costs and certain other liabilities. ERISA § 302, 29 U.S.C. § 1082(b)(2) (1976). The yearly amount due to the employee benefit plan must be determined actuarially and, in fact, must be paid into the plan. A failure to satisfy the requirement in any plan year may subject the employer(s) responsible for contributing to the plan to an excise tax on the amount of the "accumulated funding deficiency." I.R.C. § 4971.

under certain circumstances, may not constitute a pension or a welfare plan under ERISA and will not have to meet the Act's requirements.

A. Deferred Compensation Arrangements Which Do Not Constitute Employee Benefit Plans

It is often difficult to ascertain whether a particular deferred compensation arrangement will be subject to the Act. Although ERISA was enacted over four years ago and the Department of Labor has issued regulations clarifying the statutory definition of the term "employee benefit plan,"³⁷ the scope of ERISA coverage is still far from certain. Significant questions remain with respect to: (1) what constitutes a "plan, fund, or program" within the meaning of the Act;³⁸ (2) when an arrangement provides retirement income or results in a deferral of income to the termination of employment; and (3) who are employees.

As a general rule, an employee benefit plan must cover some employees.³⁹ ERISA merely states that an employee is "any individual employed by an employer."⁴⁰ Regulations issued by the Department of Labor exclude from the term "employee" an individual and his or her spouse with respect to their wholly-owned trade or business, whether or not incorporated, as well as a partner and his or her spouse with respect to the partnership.⁴¹ Although any determination of employee status for these purposes will depend on the facts and circumstances involved,⁴² a plan that includes only independent contractors and provides no benefits to employees is not covered by the Act.⁴³ Moreover, it should be noted that the Department of Labor will interpret the term "employee" for these purposes "not according to technical concepts derived from the common law of agency, but in the light of the protective purposes of ERISA."⁴⁴

Another question arising in connection with the classification of an arrangement is whether an employer must intend for the arrangement to

37. See 29 C.F.R. § 2510.3-3 (1978). See also 29 C.F.R. §§ 2510.3-1 & 2510.3-2 (1978) (interpreting terms "employee welfare benefit plans" and "employee pension benefit plan").

38. ERISA §§ 3(1) & 3(2), 29 U.S.C. §§ 1002(1) & 1002(2) (1976). See *Murphy v. In-exco Oil Co.*, 427 F. Supp. 1015 (S.D. Tex. 1977) in which the court held that a gratuitous, supplemental compensation program to employees did not constitute a pension plan within the meaning of ERISA.

39. 29 C.F.R. § 2510.3-3(b) (1978).

40. ERISA § 3(6), 29 U.S.C. § 1002(6) (1976).

41. 29 C.F.R. § 2510.3-3(c) (1978).

42. The Internal Revenue Service applies a similar "facts and circumstances" test in determining an individual's status as an employee or an independent contractor. See, e.g., *Treas. Reg. § 31.3401(c)-1*.

43. U.S. Department of Labor Opinion Letter 75-40 (April 17, 1975).

44. U.S. Department of Labor Opinion Letter 77-75 A (September 21, 1977).

provide retirement income or result in a deferral of income, or whether intent is irrelevant. For example, bonus payments by an employer to some or all of its employees will not be treated as a pension plan unless there is a systematic deferral of income to the termination of covered employment "or so as to provide retirement income to employees."⁴⁵ A problem could arise in the case of a program under which bonuses would be paid in a succeeding year, yet certain employees retire or terminate their employment after the bonuses are awarded but before they are paid. Under these circumstances, it would seem that an employee pension benefit plan should not be considered to exist, but this result is certainly not clear, and, in all likelihood, the Department of Labor will not always treat intent as a determinative factor.⁴⁶

In determining whether an arrangement constitutes an employee benefit plan for purposes of Title I, however, the most difficult questions arise when attempting to qualify an arrangement as a "plan, fund, or program" within the meaning of the Act. In particular, there is a problem in deciding whether an arrangement benefitting only one employee is, or could under certain circumstances be, an employee benefit plan. This problem frequently arises in two situations. In the first, an employer and an individual employee negotiate a contract providing the employee with deferred compensation. Such agreements are often executed for the purpose of deferring a portion of the employee's income until a time when the employee will be assumed to have a lower effective tax rate than he does at the time of negotiation.⁴⁷ Other objectives for such contracts might be to benefit an employee who, perhaps because of his age when hired, is not eligible to participate in the employer's general pension plan, or to compensate an employee who changes employment, thereby forfeiting substantial benefits accrued under the pension plan of his prior employer. In the second situation, the employer maintains an arrangement under which more than one employee is eligible to receive deferred compensation, but in fact only one employee does receive it.

It seems relatively certain that there is no employee benefit plan in the first situation. The Department of Labor has indicated clearly that the provision of pension benefits to an employee pursuant to an individual employment contract is not an employee pension benefit plan and, there-

45. 29 C.F.R. § 2510.3-2(c) (1978).

46. The Department has not addressed this question, but neither ERISA nor the regulations issued thereunder appear to make intent a determinative factor.

47. See Revenue Act of 1978, Pub. L. No. 95-600, § 132, 92 Stat. 2763, regarding the taxable year of inclusion in income of amounts covered by "private deferred compensation plans."

fore, cannot constitute an employee benefit plan for purposes of ERISA.⁴⁸ What is not clear, however, is whether the result would differ if the employer were to enter into employment contracts with each of its employees providing for deferred compensation, particularly if the employment contracts were identical or if one contract were executed for a number of employees. It is difficult to discern at what point, if at all, such a group arrangement would be treated as an employee benefit plan. It seems probable that the Department of Labor would consider a plan to exist once a discernible pattern of such contracts emerged and it became apparent that these were not individually negotiated contracts designed to meet specific aims.

The second situation—arrangements under which more than one employee is eligible to participate, but only one employee actually does—is far less clear. It is certain that the Internal Revenue Code recognizes arrangements under which only one employee participates as a “plan.”⁴⁹ Although the Department of Labor has not taken a firm position on this question, neither ERISA nor the regulations issued thereunder appear to require participation by more than one employee. Hence, it seems likely that such an arrangement would be treated as an employee benefit plan. This result might be different if it were reasonably certain that only one employee would actually participate and receive benefits. Nonetheless, this same arrangement might also be classified as an unfunded plan for management or highly compensated employees.⁵⁰

In sum, it is clear that at least certain contractual and other arrangements through which employers provide deferred compensation to employees are not covered by ERISA. It is even more clear, however, that many significant questions remain unanswered with regard to the boundaries of this exclusion from coverage.

B. Severance Pay Plans

Employers frequently provide additional compensation to employees upon their separation from employment by means of a formal program or informal practices. Generally, such compensation is provided without regard to the reasons for termination. The amount of severance compensation is typically based upon the rate of pay of the employee prior to termination and the length of service of the employee.

48. U.S. Department of Labor Opinion Letters 76-79 (May 25, 1976) and 76-110 (September 28, 1976).

49. I.R.C. § 404(a)(5). See also Rev. Rul. 55-81, 1955-1 C.B. 392; Rev. Rul. 72-4, 1972-1 C.B. 105.

50. See notes 80-98 and accompanying text *infra*.

In February of 1979, the Department of Labor issued a final regulation setting forth the circumstances under which a severance pay plan will not be considered an employee pension benefit plan.⁵¹ The regulation states that a plan providing severance benefits on account of the termination of an employee's service will not be considered an employee pension benefit plan if: (1) the benefits are not contingent, directly or indirectly, upon the employee's retiring; (2) the total amount of severance benefits does not exceed the equivalent of twice the employee's annual compensation for the year immediately preceding termination; and (3) all such payments to any employee are completed within twenty-four months after the termination of the employee's service.⁵² For this purpose, the regulations define "annual compensation" as the total of all compensation—regardless of whether paid in cash—either actually paid as consideration for the employee's services for the year, or which would have been so paid at the employee's usual rate of compensation had the employee worked the full year.

Under an exception stated in the regulation, the twenty-four month limitation on payments does not apply if an employee is terminated in connection with a "limited program of terminations."⁵³ In this case, payments to the employee must be completed within the later of twenty-four months after the termination of the employee's service, or twenty-four months after the employee reaches normal retirement age. A "limited program of terminations" is defined as a written program to terminate employees, scheduled to be completed upon a fixed date (or on the occurrence of one or more events), and specifying in advance the number, percentage, or classes of employees to be terminated.⁵⁴ The purpose of the exception is not entirely clear. A prior proposed regulation indicates, however, that a limited program of terminations may result from a complete or partial discontinuance of the employer's operations, such as a plant shutdown, department curtailment, or phaseout of certain job classifications.⁵⁵

The final regulation raises numerous questions for employers and merits several comments. Most important is the consequence of meeting, or failing to meet, the conditions of the final regulation. The regulation states explicitly that an arrangement meeting its terms shall "not be deemed to constitute an employee pension benefit plan or pension plan."⁵⁶ The regu-

51. 44 Fed. Reg. 11761 (1979) (to be codified at 29 C.F.R. § 2510.3-2(b)).

52. *Id.* (to be codified at 29 C.F.R. § 2510.3-2(b)(1)).

53. *Id.* (to be codified at 29 C.F.R. § 2510.3-2(b)(1)(iii)(A)).

54. *Id.* (to be codified at 29 C.F.R. § 2510.3-2(b)(2)(ii)).

55. Proposed 29 C.F.R. § 2510.3-2(b), 43 Fed. Reg. 10580 (1978).

56. 29 C.F.R. § 2510.3-2(b)(1) (1978).

lation does not address the question of whether a plan meeting the terms of the regulation would constitute an "employee welfare plan" within the meaning of section 3(1) of ERISA. Supplementary information issued with the regulation by the Department of Labor, however, suggests that in "virtually all cases" a severance pay plan will constitute an employee welfare plan even if the plan meets the terms of the regulation.⁵⁷

The regulation also offers no guidance on whether a severance pay plan that does not meet the terms of the regulation will automatically be considered a pension plan. An earlier proposed regulation had attempted to determine the status of a severance pay plan failing to meet the terms of the regulation by examining the "facts and circumstances" specifically related to the plan.⁵⁸ The Department of Labor, however, takes the position that although the final regulation does not explicitly provide a "safe harbor," a severance pay plan not meeting its conditions will not necessarily qualify as a pension plan.⁵⁹ This becomes particularly important when, for example, a severance plan inadvertently fails to meet the twenty-four month payment limitation, or when the amounts paid under the plan exceed twice the employee's annual compensation.

In addition to the foregoing, the final regulation creates two factual problems. The first of these is the requirement that payments may not be contingent, directly or indirectly, upon the employee's retiring. A prior proposed regulation provided that the exemption would apply only if the plan paid benefits upon termination of service "for reasons other than retirement."⁶⁰ The final regulation modifies this requirement and accounts for situations in which an employee by chance commences receiving severance benefits at or near the time of retirement. The question, however, is still one of fact, at least to the extent that an employee may be induced to retire by the promise of severance benefits. This difficulty in determining an employee's reason for retiring is further complicated by recent amendments to the Age Discrimination in Employment Act, which generally increase the mandatory retirement age to seventy.⁶¹

A second area in which a factual problem may arise is with respect to the determination of "annual compensation." The Department of Labor takes the position that fringe benefits are included in the determination of annual compensation, although the regulation does not explicitly address

57. 44 Fed. Reg. 11763 (1979).

58. Proposed 29 C.F.R. § 2510.3-2(b), 43 Fed. Reg. 10580 (1978).

59. 44 Fed. Reg. 11761 (1979).

60. Proposed 29 C.F.R. § 2510.3-2(b), 43 Fed. Reg. 10580 (1978).

61. Age Discrimination in Employment Act Amendments of 1978, Pub. L. No. 95-256, § 3(a), 92 Stat. 189 (amending 29 U.S.C. § 631).

the issue.⁶² Since fringe benefits may account for as much as 30-40 percent of an employee's remuneration,⁶³ the inclusion of fringe benefits is an important factor. However, the regulation remains unclear with respect to the determination of annual compensation. It is not certain whether the present value of unfunded deferred compensation should be included, since such amount would not be "paid" during the year. Further, the regulation provides no method for the valuation of fringe benefits. Many classes of fringe benefits are provided at little or no additional cost to the employer, yet have a significant value to the employee. Allowing employees personal use of company cars or offering employee discounts on purchases are common examples of such benefits.

One final observation is appropriate regarding the Department of Labor's treatment of severance pay plans. The current regulation is merely one chapter, and perhaps not the final chapter, on severance pay. On four occasions prior to the issuance of the current regulation, the Department issued pronouncements on severance pay plans. Each pronouncement differed significantly from the others. Initially, the Department of Labor proposed that a severance pay plan would not constitute an employee pension benefit plan, if "payment [was] made to employees on or after the date on which they terminate employment but where payment is completed before normal retirement age."⁶⁴ However, when it appeared in final form on August 15, 1975, this proposal was revised to provide that a severance pay plan would not constitute an employee pension benefit plan, if all payments were completed within one year of separation from service, and if the total payments to participants did not exceed the participant's annual compensation level.⁶⁵ Several detailed examples were given in the regulation.⁶⁶

Within eight months of issuing this "final" regulation, the Department of Labor reopened the issue by announcing in an April, 1976 departmental

62. 44 Fed. Reg. 11763 (1979).

63. The Wall Street Journal on January 9, 1979 reported that:

Fringe-benefit payments hit nearly 32% of wages and salaries paid in 1977, according to a study by the Chamber of Commerce, which says that proportion is up from less than 24% a decade earlier. The study says that the average private-sector worker received nearly \$400 a month in benefits.

Wall St. J., Jan. 9, 1979, at 1, col. 5.

64. Proposed 29 C.F.R. § 2510.3-2, 40 Fed. Reg. 24652 (1975).

65. 29 C.F.R. § 2510.3-2(b) (1978).

66. In one example, a plan provided for a lump-sum payment upon involuntary separation equal to 10% of pre-separation salary plus 2% thereof for each year of service. The example held that this plan constituted a pension plan, since an employee who was employed between the ages of 18 and 64 would receive 102% of pre-separation salary. *Id.* at § 2510.3-2(b)(iii).

release its plans to expand the scope of exempted severance pay plans.⁶⁷ The release stated that the revisions were necessary, given the negative impact on employer willingness to continue beneficial practices. In light of this reaction, the Department expressed its intention to expand the definition of severance pay to include payments upon separation from service not exceeding two years of final annual compensation, or extending for a period of more than twelve months beyond normal retirement age or the effective date of elected early retirement.

On March 10, 1978, some two years after the announcement, the Department of Labor withdrew the 1975 regulation and issued a new proposed regulation.⁶⁸ This proposal was generally even more liberal than the terms of the April 1976 announcement, and included fringe benefits in the compensation determination. The current regulation, adopted in February, 1979, has significantly revised the proposed regulation. Fortunately, the final regulation was made retroactive to January 1, 1975. Unfortunately, however, in view of the Department's previous difficulties, it would not be unreasonable to expect further revisions.

C. Gratuitous Payments to Retirees

In certain instances employers may wish to make payments to retirees either in the absence or outside of a formal pension program maintained by the employer. In the latter case, for example, the effects of inflation may diminish the value of regular pension benefits received by retirees, and employers may want to protect the relative values of retirement income. For a number of reasons, it may be desirable not to increase benefits under the formal program. One important revision is that such an increase in benefits may lock the employer into future benefit commitments.⁶⁹ As a result, the employer might prefer to pay amounts on an ad hoc basis, with no commitment to continue payments for any particular length of time.

On June 9, 1975, the Department of Labor issued proposed regulations containing definitions of the terms "employee pension benefit plan" and "employee benefit plan."⁷⁰ The Department did not mention gratuitous payments among those arrangements which it would not consider as an

67. U.S. Department of Labor Release 76-707 (April 26, 1976).

68. Proposed 29 C.F.R. § 2510.3-2(b), 43 Fed. Reg. 10580 (1978).

69. Other reasons why use of the formal program to supplement benefits may not be desirable include the cost and effort in amending plan documents and the possible discrimination problems under the Internal Revenue Code, if it is contemplated that officers, highly compensated employees, or shareholders are to be the recipients of such payments. See I.R.C. § 401(a)(4).

70. Proposed 29 C.F.R. § 2510.3-2, 40 Fed. Reg. 24652 (1975).

employee benefit plan or an employee pension benefit plan. Because of this silence in the proposed regulations, gratuitous payment arrangements could have been construed as constitution employee benefit plans subject to the requirements of ERISA Title 1. Consequently, the final regulations addressed the subject of gratuitous payments in defining an employee pension benefit plan as follows:

For purposes of Title I of the Act and this chapter the terms 'employee pension benefit plan' and 'pension plan' shall not include voluntary, gratuitous payments by an employer to former employees who separated from the service of the employer if:

- (1) Payments are made out of the general assets of the employer,
- (2) Former employees separated from the service of the employer prior to September 2, 1974,
- (3) Payments made to such employees commenced prior to September 2, 1974, and
- (4) Each former employee receiving such payments is notified annually that the payments are gratuitous and do not constitute a pension plan.⁷¹

The regulations are quite narrow in scope since they require that employees have been separated from service, and payments have commenced, prior to the September 2, 1974 enactment date of ERISA. In fact, except for those limited cases which meet the exception, the regulations may have the opposite effect from that intended. If an exception is needed to exempt gratuitous payments from ERISA coverage, then payment arrangements falling outside the exemption may fall inside ERISA coverage. Of course, it may be argued that an arrangement falling outside the exemption will not necessarily be covered by ERISA, but must be analyzed on its own facts to determine if it is an employee benefit plan.⁷² One would conclude, however, that a gratuitous payment arrangement would be an employee benefit plan in almost all instances, since such an arrangement provides the types of payments specifically contemplated by section 3(2) of ERISA, *i.e.*, "retirement income."

Subsequent to promulgating final regulations, the Department of Labor issued a news release indicating the Department's intention "to extend the cut-off date from September 2, 1974 to permit supplemental payments

71. 29 C.F.R. § 2510.3-2(e) (1978).

72. As noted previously, *see* text accompanying note 59 *supra*, the Department of Labor has stated explicitly with respect to severance pay plans that a plan which fails to meet the requirements of the regulations may still fall outside the scope of ERISA coverage.

outside a pension plan for persons who retire prior to the end of 1976.”⁷³ The release stated six conditions under which such supplemental payments would be exempt from ERISA coverage: (1) payments must come from the general assets of the employer; (2) they must not be part of an employee benefit plan; (3) they must not be communicated to employees prior to their retirement; (4) they must not be granted for more than one year at a time; (5) the employer must be under no legal obligation to make the payments; and (6) the recipients must be fully informed in writing of the conditions.⁷⁴

Several observations regarding the release are worthy of note. First, the cut-off date of the end of 1976 would give the new regulations limited utility for planning purposes. Second, the release imposed several new conditions for the payments to qualify, and dropped, or at least did not refer to, the condition that payments must commence before the cut-off date. Third, the release referred to “supplemental” rather than “gratuitous” payments. It is uncertain whether this represents a change in the position of the Department of Labor, so that only payments which are supplemental to some other retirement benefit would qualify.

Finally, the Department of Labor is currently examining the area of gratuitous payments and expects to issue new “safe harbor” rules for gratuitous payment plans.⁷⁵ While the Department has given no indication of the expected content of the regulations, hopefully they will allow for some form of gratuitous payments without a cut-off date by which either the employee must retire or payments must commence. Such a provision would permit employers to adjust retirement payments, at least to account for the effect of inflation or to compensate for extreme hardship situations encountered by retirees.

D. Unfunded Deferred Compensation Arrangements

Of all the compensation practices which are exempted in whole or in substantial part from ERISA coverage, perhaps the most frequently used are deferred compensation arrangements which are unfunded and maintained by an employer for management and highly compensated personnel. These arrangements have become a main method for providing deferred bonuses and other forms of supplementary compensation to key employees.

73. U.S. Department of Labor Release 76-707 (April 26, 1976).

74. *Id.*

75. The expectation of new regulations is contained in a December 1, 1978 speech by the Department of Labor's counsel for fiduciary responsibility reported by the Bureau of National Affairs. [1978] 232 DAILY TAX REP. (BNA) at G-6 to G-7.

Prior to the enactment of ERISA, there were very few restrictions on the form or method of operation of management compensation arrangements. Participants in a plan maintained for such employees could be selected in any manner and the formula for, and amount and timing of, benefits were generally unrestricted. The only restrictions at that time involved the avoidance of adverse tax consequences. Under the Internal Revenue Code, a participant in a plan other than one qualified under section 401 of the Code⁷⁶ must report the amount of employer contributions to a plan as income to the extent of the employee's vested interest in such amounts.⁷⁷ Thus, if the employer contributes to a trust or otherwise funds the plan, an employee participant will be taxed on his interest in the plan to the extent the employee's interest is funded and vested. Also, prior to 1976, deferred compensation was generally not eligible for the 50% maximum tax rate prescribed by the Code for "earned income."⁷⁸

ERISA altered entirely the rules for providing unfunded deferred compensation. As noted previously, the provisions of ERISA apply to any plan, fund, or program which provides retirement income or defers income to the termination of covered employment. There is no general exception from ERISA coverage for unfunded deferred compensation arrangements. Under certain circumstances, it may be reasonable to maintain that an unfunded deferred compensation arrangement is not covered by ERISA because it is neither an employee pension plan nor an employee welfare plan.⁷⁹ Absent the availability of such an argument, however, deferred compensation arrangements are subject to the provisions of Title I of ERISA, including reporting and disclosure, participation and vesting, funding, fiduciary responsibility, and administration and enforcement.

The Act provides that an unfunded plan "maintained by an employer primarily for the purpose of providing deferred compensation for a select group of management or highly compensated employees" will not be required to conform to the standards provided for participation, vesting, funding, and fiduciary responsibility.⁸⁰ The plan still will be subject to both the reporting and disclosure and the administration and enforcement provisions, but these are not onerous for plans meeting the exemption.⁸¹

76. See text accompanying notes 99-107 *infra*.

77. I.R.C. §§ 83 and 402(b).

78. I.R.C. § 1348; Treas. Reg. § 1.1348-3(b) (1976).

79. See text accompanying notes 24-36 *supra*.

80. ERISA § 201(2), 301(a)(3) & 401(a)(1), 29 U.S.C. §§ 1051(2), 1081 & 1101 (1976) (exempting such plans from the participation and vesting, funding, and fiduciary responsibility standards respectively).

81. The Department of Labor has issued a final regulation, 29 C.F.R. § 2520.104-23 (1978), which provides that the reporting and disclosure requirements for an unfunded de-

Although the unfunded arrangement exemption is frequently used, its scope is far from certain. These arrangements have not been the subject of Department of Labor regulations. Further, the legislative history of ERISA contains little explanation of the exemption. At present, the Department of Labor is working on regulations but does not consider the exemption to be of the highest regulatory importance.⁸² Despite this lack of attention, there are a number of critical uncertainties associated with the exemption. Most questions concern the definition of various terms used in the exemption. Three of these are particularly important and are discussed below.

1. Is the Plan "Funded"?

The term "funded" is not defined in ERISA, and no helpful legislative history exists to clarify its meaning. Further, the legislative history does not indicate the purpose for requiring a plan to be unfunded in order to meet the exemption.⁸³

Other Department of Labor regulations provide some guidance as to how the Department may interpret the term "unfunded." Temporary regulations issued under ERISA section 412, which requires that fiduciaries handling the assets of funded plans be bonded, incorporate by reference regulations issued under section 13 of the Welfare and Pension Plans Disclosure Act of 1958.⁸⁴ These welfare and pension regulations provide that a plan would be considered funded if plan assets are "segregated in any way from the general assets" of the employer.⁸⁵ Further, these regulations indicate that a plan will be considered funded if any benefits are provided

ferred compensation plan will be satisfied if the plan administrator provides plan documents to the Secretary upon request, and files a statement with the Secretary of Labor which includes the name and address of the employer, the employer identification number, a declaration that the employer maintains a plan or plans primarily for the purpose of providing deferred compensation to a select group of management or highly compensated employees, and a statement of the number of such plans and the number of employees in each.

82. As of April, 1979, attorneys with the Department of Labor Office of Pension and Welfare Benefit Programs have indicated that they anticipate the preparation of regulations in the future. They expressed a belief, however, that this area is not high priority insofar as most employees who participate in such plans would be able to protect themselves, since they would be part of a management or highly compensated group.

83. As noted, prior to ERISA most deferred compensation arrangements for key employees were not funded, generally to avoid adverse tax consequences to the participants. Of course, this would not serve as a reason for the unfunded requirement in the exemption. Perhaps the drafters of ERISA were concerned that, if a key employee plan could be funded, then these plans would be more attractive to employers, and would militate against the use of ERISA-covered plans.

84. 29 C.F.R. § 2550.412-1 (1978) (referring to 29 C.F.R. §§ 464.1 to 464.29 (1978)).

85. 29 C.F.R. § 464.3 (1978).

or underwritten by an insurance carrier or if, through the establishment of separate bank accounts or separate books and records, any assets are earmarked for the provision of benefits under the plan.⁸⁶

Another indication of a possible Department of Labor position may be noted from regulations issued under section 403(b)(4) of ERISA, which permits the Secretary of Labor to exempt certain plans from the requirement that all plan assets be maintained in trust.⁸⁷ The Notice of Proposed Rulemaking, issued with a proposed regulation under this section, provides that unfunded welfare benefit plans need not comply with section 403(a) and defines such plans as those under which benefits are paid out of the employer's general assets rather than from a segregated fund.⁸⁸

Finally, some indication of the meaning of the term "funded" in the appropriate context may be noted from a speech by William J. Chadwick, former acting administrator of pension and welfare programs at the Department of Labor. In October, 1976, Mr. Chadwick was reported as stating:

In general, the question of whether a plan is funded can be answered by applying a number of factors, but the most important consideration is not whether the plan is funded but whether employees under the plan have preferred status. If benefits are guaranteed or if an employee has a direct interest in an annuity or insurance contract, the plan could be considered to be funded.⁸⁹

Until the uncertainty of the funding requirement is clarified, it would appear prudent to avoid segregating funds in any manner or granting participants any rights in employer assets. Further, based on the temporary bonding regulations, it may be risky even to maintain separate financial books and records for the plan if there is any other evidence that assets have been segregated.

2. *What is a Select Group of Management or Highly Compensated Employees?*

The problem of identifying those employees entitled to participate in an exempt plan is frequently difficult. Neither ERISA nor its legislative history provides a firm indication of when an employee is a "management" employee, when an employee is "highly compensated," or when a plan covers a select group.

86. *Id.*

87. 29 U.S.C. § 1103(a) (1976).

88. Proposed 29 C.F.R. § 2550.403(b)-1, 39 Fed. Reg. 44456 (1974).

89. [1976] 200 DAILY TAX REP. (BNA) at G-3 (October 14, 1976).

A number of observations are appropriate in this regard. While management employees are not necessarily highly compensated, and vice versa, there are no obvious policy reasons which should prevent an exempt plan from covering both management and highly compensated employees. The "or" in the phrase "a select group of management or highly compensated employees" should not be interpreted as disjunctive. It also would seem that a plan could cover all management and highly compensated employees and still qualify for exemption. Thus, the participation of all of the targeted group would appear to be consistent with the exemption despite the use of the term "select group."

The most difficult determination is identifying employees to be considered as management or highly compensated. With respect to management, the Conference Report to ERISA provides, in discussing the exemption, that "if a 'phantom stock' or 'shadow stock' plan were to be established solely for the officers of a corporation, it would not be covered by the labor fiduciary rules."⁹⁰ In many large publicly held corporations, however, lower level officers do not perform management functions. Therefore, it is possible that the Labor Department would choose to ignore the legislative history and limit management employees only to those who perform management functions.⁹¹

Similar problems exist with respect to "highly compensated" employees. The Internal Revenue Code uses the term "highly compensated" in the context of providing that qualified plans may not discriminate in favor of certain categories of employees, including officers and the highly compensated.⁹² Many tax provisions use the term "highly compensated." For example, a recent provision in the Revenue Act of 1978 provides a definition of "highly compensated individuals" in setting forth antidiscrimination rules under which reimbursements from medical reimbursement plans will not be taxable to the recipient. This section defines a highly compensated individual as one who is one of the five highest paid officers, a shareholder

90. Conference Committee Report on ERISA, H.R. REP. No. 1280, 93d Cong., 2d Sess. 296, reprinted in [1974] U.S. Code Cong. & Ad. News 5038, 5076 to 5077. Phantom stock plans and shadow stock plans are plans in which the participating employees are awarded deferred compensation based on increases in value of the employer's stock. Actual shares, however, are not issued to the participants; rather the amount of appreciation is generally paid in cash.

91. An interesting analogy, and one which the Department of Labor may choose to follow, is the definition of "executive" employees contained in the regulations issued under the Fair Labor Standards Act, which exempts executive employees from overtime provisions. See 29 U.S.C. § 213(a)(1) (1976). That regulation states that an executive must have managerial duties, must have supervisory authority over other employees, and must be paid at least \$155 per week. 29 C.F.R. § 541.1 (1978).

92. I.R.C. § 401(a)(4).

who owns more than 10% of the stock of the employer, or a person who is among the highest paid 25% of all employees.⁹³

The Department of Labor has apparently also wrestled with the question of the meaning of the term "highly compensated." In his October 1976 speech, William J. Chadwick discussed the difficulties of setting standards to determine who is "highly compensated" for these purposes, particularly standards that are capable of being applied across the board.⁹⁴

Perhaps the most direct indication of the Department of Labor's position thus far is contained in four opinion letters issued by the Department on the exemption.⁹⁵ Each of these opinion letters was issued prior to 1977 and there was no analysis of the exemption in any of them. They give important insight, however, since the Department focused closely on the size of the targeted group and its salary, each in relation to the remainder of employees.⁹⁶

3. What Does the Term "Primarily" Mean?

The Act exempts unfunded plans maintained *primarily* to provide "deferred compensation for a select group of management or highly compensated employees." The use of the term "primarily" presents several interesting problems. Not only is its meaning uncertain, but it is also unclear whether it modifies and thereby limits the kind of coverage ("deferred compensation"), or personnel ("select group," or "management or highly compensated") targeted by the statute.

ERISA and its legislative history do not provide any indication of the

93. Revenue Act of 1978 Pub. L. No. 95-600, § 366, 92 Stat. 2763 (adding I.R.C. § 105(h)).

94. See note 89 *supra*. Mr. Chadwick suggested possible tests, such as "facts and circumstances," a functional and dollar test, a straight dollar approach, a percentage test, a percentage test with a dollar floor, and a densest mass test.

95. U.S. Dept. of Labor Opinion 75-63 (July 22, 1975); U.S. Dept. of Labor Opinion 75-64 (August 1, 1975); U.S. Dept. of Labor Opinion 75-69 (December 23, 1975); U.S. Dept. of Labor Opinion 76-100 (November 18, 1976).

96. In Opinion 75-63, the Department held a plan exempt from Parts 2, 3, and 4, when participants earned at least \$18,200; were exempt from the Fair Labor Standards Act as administrative, supervisory or professional employees; and were classified as key employees by the committee chosen to administer the plan. In Opinion 75-64, the Department held a plan was exempt which was limited to fewer than 4% of active employees, and their average annual compensation was more than \$28,000 compared to \$19,000 for all of the company's management employees. In Opinion 75-69, the Department held that a plan was exempt which covered 23 older employees (out of a total of 14,000 employees) who were all "management employees" with a salary range from \$19,286 to \$67,992. This plan was established to provide benefits to those employees who would not accrue sufficient benefits under the regular plan maintained by the employer. See also Department of Labor Opinion 76-100 (November 15, 1976), which provides that a plan in which all employees with three years service are eligible to participate does not qualify as an exempt deferred arrangement.

meaning of the term "primarily." Neither do the several opinion letters issued thus far by the Department of Labor. In a case involving whether an asset constitutes a capital asset for tax purposes, the word "primarily" has been defined by the Supreme Court to mean "principally" or of "first importance."⁹⁷ In providing an exclusion for executives from its overtime provisions, regulations issued pursuant to the Fair Labor Standards Act contain a definition of "primarily" as meaning "the major part, or over 50%."⁹⁸ Although there can be no certainty on this point, there would appear to be little reason for the Department of Labor to provide an interpretation significantly different than the foregoing ones.

The more important problem is discerning the term which "primarily" modifies. If it modifies "deferred compensation," then a plan could be exempt even if it provides some other form of benefit, *e.g.*, current cash payments, insurance, etc. If it modifies "select group," then the plan could provide benefits to those who are other than "select." Finally, if it modifies "management or highly compensated," then a plan could provide benefits to those who are other than management or highly compensated employees.

Although the ultimate position of the Department of Labor cannot be predicted, it is most likely that the Department would hold that the term "primarily" modifies "deferred compensation." Presumably the Department would have a much lesser interest in the type of benefit provided under an exempt plan than in the assurance that nonmanagement and nonhighly compensated employees, who may not understand nor be able to protect their interests, are unable to participate.

It is less certain, however, what a court would do if presented with the issue. As noted, the term "primarily" could be read to allow the exemption even when some nonmanagement or nonhighly compensated employees participate. Perhaps a court would hold that "primarily" modifies both "deferred compensation" and "management or highly compensated." A court or the Department of Labor could also apply a *de minimis* exception in cases in which only a few nonmanagement or nonhighly compensated employees participate.

E. Excess Benefit Plans

Section 401 of the Internal Revenue Code sets forth the requirements which a pension, profit-sharing or stock bonus plan must meet before it

97. *Malat v. Riddell*, 383 U.S. 569 (1966). Section 1221 of the Code, which defines the term "capital asset," excludes "property held by the taxpayer primarily for sale to customers in the ordinary course of his trade or business." I.R.C. § 1221.

98. 29 C.F.R. § 541.103 (1978).

will be considered "qualified."⁹⁹ In addition to meeting participation, vesting, and funding requirements, a qualified plan must not discriminate in favor of employees who are officers, shareholders, or highly compensated.¹⁰⁰ Further, a qualified plan is limited with respect to the amount of benefits that may be provided under the plan for any individual employee.¹⁰¹

The limitation on benefits for qualified plans is contained in section 415 of the Code, which was added by ERISA.¹⁰² That section provides that, in the case of a defined contribution plan,¹⁰³ the maximum contribution which may be made in a year on behalf of a participant is the lesser of: (1) \$25,000; or (2) 25% of the participant's compensation.¹⁰⁴ In the case of a defined benefit plan,¹⁰⁵ the maximum annual benefit which may be funded for a participant is, when expressed as an annual benefit, the lesser of: (1) \$75,000; or (2) 100% of the participant's average compensation for his high three years.¹⁰⁶ Finally, in the case where an employer maintains both a defined contribution plan and a defined benefit plan, the plans are subject to a combined limitation equal to 140 percent of the total of the separate limitations for the two types of plans.¹⁰⁷

While the limitations on the amounts which can be provided under a qualified plan are substantial, an employer may nevertheless desire to pro-

99. I.R.C. § 401. There are numerous advantages to obtaining qualification under the Internal Revenue Code. Most important among the advantages are that contributions by an employer are deductible when made, and benefits to participants are not taxed to the participant until actually distributed or made available. See I.R.C. §§ 404 & 402. In addition, distributions from qualified plans may qualify for exclusion from the gross estate for federal estate tax purposes. See I.R.C. § 2039(c).

100. I.R.C. § 401(a)(4).

101. *Id.* §§ 401(a)(16) & 415.

102. ERISA, Pub. L. No. 93-406, § 2004(a), 88 Stat. 832 (1974) (amending I.R.C. § 415).

103. In defined contribution plans, fixed amounts are paid into separate accounts maintained for each participant. On retirement the benefit that the participant receives is based solely on the amounts contributed to his account, increased by any investment income. ERISA § 3(34), 29 U.S.C. § 1002(34) (1976).

104. I.R.C. § 415(d)(1)(B) provides that the \$25,000 limitation is to be adjusted each year by the Secretary of the Treasury to reflect cost of living increases. For 1979, the limitation is \$32,700.

105. A defined benefit plan is defined in ERISA as a pension plan other than one in which each participant's benefit is computed solely on the amounts contributed to the participant's individual account and investment earnings or losses thereon. ERISA § 3(35), 29 U.S.C. § 1002(35) (1976). In a defined benefit plan, a participant's benefit is typically based on factors such as salary and years of service. See generally E. ALLEN, J. MELONE & J. ROSENBLUM, PENSION PLANNING 30-49 (3d ed. 1976).

106. I.R.C. § 415(d)(1)(A) provides that the \$75,000 limitation is to be adjusted each year by the Secretary of the Treasury to reflect cost of living increases. For 1979, the limitation is \$98,100.

107. I.R.C. § 415(e).

vide deferred compensation to its top employees in excess of the specified amounts. Accordingly, an employer may, adopt an "excess benefit plan" for this purpose.¹⁰⁸

Although a funded excess benefit plan remains subject to several of Title I's provisions, an excess benefit plan which is "unfunded" is specifically exempted from all of Title I of ERISA.¹⁰⁹ There are specific exemptions for funded excess benefit plans, however, from the participation, vesting, and funding standards.¹¹⁰ A funded plan would be subject to the reporting and disclosure requirements, fiduciary responsibility standards, and administration and enforcement provisions. To date, there have been no regulations issued on excess benefit plans. Since these plans have a narrow purpose and would cover only a very small group of highly compensated people, it is not surprising that they would not be the subject of much regulatory concern.

Although there are important problems of plan drafting and planning associated with excess benefit plans,¹¹¹ only several can be addressed within the scope of this article. As with the arrangement for management employees, the question of whether an excess benefit plan is funded is of considerable importance. There would appear to be little reason, however, to apply a different standard to excess benefit plans than to management employee plans.¹¹² Since the benefits to be provided under an excess benefit plan are "solely" those in excess of the limitations on section 415, there would be little dispute as to whether a particular plan were qualified. If a plan failed to provide only benefits in excess of those described in section 415, this plan could still qualify as an exempt plan for highly compensated employees.

II. CONCLUSIONS

Whether intentional or not, the scope of ERISA coverage is still—four years after the Act's passage—far from certain. The Department of Labor

108. ERISA § 3(36), 29 U.S.C. § 1002(36) (1976).

109. ERISA § 4(b)(5), 29 U.S.C. § 1003(b)(5) (1976).

110. ERISA §§ 201(7), 301(a)(9), 29 U.S.C. §§ 1051(7), 1081(a)(9) (1976).

111. An important problem of plan drafting concerns the cost of living adjustments. *See* notes 104 & 106 *supra*. Since the amount which can be provided under a qualified plan changes each year, the formula in an excess benefit plan must reflect the changing amount. There are also important tax planning considerations associated with excess benefit plans. Since distributions from an excess benefit plan would not be subject to certain estate tax and income tax advantages, *see* I.R.C. §§ 2039(c) & 402, consideration must frequently be given to the timing of distributions from the qualified and excess benefit plans.

112. Participants in either of these types of plans would be high-level employees who would be expected to bear the risk of nonfunding.

has clearly made substantial efforts to exempt from coverage employer practices which do not need the protection of ERISA coverage. In many areas, however, the Department apparently has not determined whether certain practices should be exempt and, consequently, has been tentative and inconsistent in its approach.

The purpose of ERISA would appear to be two-fold: to protect employees' interests and to promote the use of appropriate employee benefits practices. A balance between these two objectives should be considered in determining the scope of any statutory exemption or other exclusion from coverage. Thus, overzealous regulation serves only to decrease the likelihood that an employer will provide a benefit. This has certainly been the case in the area of gratuitous payment programs and severance pay plans. In the executive arrangement situation, the aim of protecting employees is not paramount; rather, the goal of the Department of Labor should be to define the scope of the exemption and not to hinder its use nor make it administratively impractical.

As a general matter, too little has been done thus far to clarify the scope of ERISA coverage. It is to be hoped that Congress, in considering the many legislative initiatives proposed for the amendment of ERISA, will give some attention to the types of benefit programs intended to be covered by the Act in the future.