

Summer 2002

## A Primer on the Taxation of Executive Deferred Compensation Plans, 35 J. Marshall L. Rev. 487 (2002)

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### Recommended Citation

Kathryn J. Kennedy, A Primer on the Taxation of Executive Deferred Compensation Plans, 35 J. Marshall L. Rev. 487 (2002)

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## ARTICLES

### A PRIMER ON THE TAXATION OF EXECUTIVE DEFERRED COMPENSATION PLANS

KATHRYN J. KENNEDY\*

#### ABSTRACT

The Enron scandal has piqued Congress' interest regarding the particulars of executive deferred compensation plans. While Enron's rank-and-file employees, participating in the company's qualified profit sharing plan, watched their life savings plummet in value as the company stock collapsed, Enron executives were selling off their company stock, receiving bonuses, and making withdrawals from their executive compensation plans. With respect to these executive deferred compensation plans, how could these insider Enron executives withdraw massive amounts of deferred compensation in advance of their company's bankruptcy, draining the employer's assets from its creditors? What were the provisions of these executive compensation plans? Were the particulars of these plans readily available to Enron's shareholders and employees, and to the public at large? The answers to these questions were not readily available when Congress inquired, which obviously caused even greater concerns. A variety of legislative proposals have been discussed ranging from corporate governance to tax law changes.

The author was asked to testify before the Senate Finance committee in April 2002 on the tax aspects of executive deferred compensation plans, inquiring how such plans are designed to avoid current taxation for its participants. By late June 2002, the Democrats in Congress initiated new "corporate governance" legislation that proposed to alter the taxation of executive

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compensation plans, but only for those plans funded with employer stock. While the Enron executives clearly held company stock that was sold in advance of the company's bankruptcy, it is not clear whether their executive deferred compensation plans used employer stock as the basis for payment. The Senate Finance Committee proposed legislation in mid-July, tightening the tax rules applicable to executive compensation plans in an effort to prevent future Enron-type scandals. This article is a by-product of the oral and written testimony provided by the author to the Senate Finance Committee in April. It is intended to summarize the existing *tax* rules applicable to these plans and to recommend whether tax legislation post-Enron is warranted or appropriate. Certainly corporate governance initiatives should be encouraged as a result of Enron; however, the author questions relying on the federal tax code to cure Enron's woes is the best avenue.

#### INTRODUCTION

The Internal Revenue Code<sup>1</sup> implicitly recognizes that it is the employer who determines the level and timing of an employee's compensation, whether this refers to current or deferred compensation. To the extent that a portion of that compensation is deemed "excessive," the Code may deny the employer's deduction. Corporate employers have legitimate business reasons for favoring the payment of *deferred* compensation to executives, in lieu of paying all compensation as *current* cash compensation. While the majority of rank-and-file employees would shudder at the idea of deferring a significant portion of their current compensation to a subsequent year, especially if the payment was further contingent upon subsequent job performance or forfeited upon subsequent employment with a competitor, it is common practice for employers to condition some executive deferred compensation upon such criteria. Such practices actually benefit the employer and its shareholders, by making the executive's compensation conditioned upon performance and forfeitable if the executive leaves the employer and works for a competitor. Although such arrangements may be negotiated individually between the executive and the employer under an individual employment agreement, deferred compensation arrangements made available to a select group of executives are considered employee benefit plans, and therefore subject to the rules of the Employees Retirement Income Security Act of 1974.<sup>2</sup>

ERISA was passed to impose substantive and regulatory rules to protect employees covered under various deferred compensation

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1. The Internal Revenue Code, 29 U.S.C., may be referred to as the "Code" in the text and may appear abbreviated as I.R.C.

2. This act may be referred to as ERISA in the text.

and fringe benefit plans; however various statutory and administrative exemptions were provided for executive deferred compensation plans, prefaced with the understanding that such executives were not in need of legislative protections.<sup>3</sup> As a result, there are no substantive regulations under ERISA regarding executive deferred compensation plans; and, this accounts for the wide variety in the types of executive compensation plans that are being used.

In contrast, *qualified* retirement and profit sharing plans that are available to the rank-and-file employees are regulated by ERISA and the Code. Such plans must limit the *maximum* amount of benefits or annual deferrals that may be accumulated, thereby necessitating the establishment of *nonqualified* retirement or profit sharing plans for executives if comparable replacement income is to be provided. In addition, as ERISA's and the Code's vesting schedules do not permit an employer to "handcuff" an employee for a significant period of time, executive deferred compensation plans may seek to impose a wide variety of "golden handcuff" provisions to limit the payment of the deferred compensation. The cumulative legislative changes in the maximum levels of benefits/deferrals under qualified plans, the statutory vesting schedules, and the more restrictive nondiscrimination tests imposed on qualified retirement or profit sharing plans have resulted in greater pressure on employers to adopt a variety of executive deferred compensation plans. Such growth has increased exponentially in the past twenty years.<sup>4</sup>

Recent popular press has decried the popularity of executive deferred compensation plans, pointing to the limitations on qualified plans under the tax code as the main culprit for promoting such plans.<sup>5</sup> The reality is that the tax code rules have taken a more *reactive* approach to the design and implementation of executive compensation plans, rather than a proactive stance. Some of this is historic, other is due to the I.R.S. Service's (the "Service") delay in promulgating rules to prevent tax abuses.

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3. Pub. L. No. 93-406, §§ 4 (b)(5), 201(2), 301(a)(3), 401(a)(1), 88 Stat. 29 (1974); 29 U.S.C. §§ 1003(b)(5) (2000), 1051(2) (2000), 1081(a)(3) (2000), 1101(a)(1) (2000).

4. See K.C. Swanson, *Elite Retirement Plans Are Expanding*, (April 16, 2002) (referring to William MacDonald's assertion that executive deferred compensation plans have increased in use by the Fortune 1000 firms from 10% in the 1980s to more than 86% in 2001) at <http://www.thestreet.com/funds/belowradar/10017460.html>. See also Clark/Bardes Consulting-Compensation Resource Group, *2001 Survey of Executive Compensation Plans* (referring for a summary of its 2001 survey of more than 20% of the Fortune 1000 companies regarding their executive deferred compensation plans), available at [http://www.crgworld.com/publications/2001\\_benefit\\_survey.pdf](http://www.crgworld.com/publications/2001_benefit_survey.pdf) (last visited Sept. 5 2002).

5. See *infra* note 23.

However, an employer's deductions for an executive's current and deferred compensation have always been subject to a reasonableness standard; thus if the compensation is deemed excessive and unreasonable, that excessive portion is denied a deduction.<sup>6</sup> In an effort to curb the payment of excessive severance benefits, Congress reacted in the 1980s by amending the Code to deny employer deductions for "excess parachute payments" (defined as severance payments paid as a result of a change in ownership or effective control that were in excess of a given base amount).<sup>7</sup> Congress also imposed a 20% excise tax on executives who were in receipt of such excess parachute payments.<sup>8</sup> Similarly, in an effort to dissuade excessive compensation packages, Congress reacted in the 1990s by disallowing employer deductions for certain executive compensation payments that exceeded \$1,000,000.<sup>9</sup> Neither legislative efforts have curtailed the sharp increase in executive bonuses and deferred compensation plans, as was the case in the Enron scandal.<sup>10</sup> Thus, one questions whether the Code is the proper vehicle for curtailing the use and growth of executive deferred compensation plans. Weeding out corporate greed may require more attention to the root of the problem, rather than bemoaning its fruits.

#### *Current Relevance*

ERISA's legislative and regulatory exemptions for executive deferred compensation plans provide employers with great flexibility as to individually designed plans without regard to ERISA's eligibility, vesting, distributions, and discrimination rules. Such exemptions were initially intended to limit an executive's substantive rights; however, in the context of the

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6. See I.R.C. § 162(a)(1) (2000) (permitting a deduction for "a reasonable allowance for salaries or other compensation for personal services actually rendered") and Treas. Reg. § 1.404(a)-1(b) (2002) (stating that "[i]n order to be deductible under section 404(a), contributions must be expenses which would be deductible under section 162" and denying a deduction for amounts in excess of a "reasonable allowance for compensation for the services actually rendered"). Those latter regulations were last amended in 1963 when I.R.C. § 404(a)(5) specifically referred to I.R.C. § 162 in determining whether an expense for deferred compensation would be allowable. While the Tax Reform Act of 1986 (Pub. L. No. 99-514, § 1851(b)(2)(C)(i)) removed the reference of I.R.C. § 162 from § 404(a)(5), the legislative history indicates Congress' intention to broaden § 404(a)(5) to refer to all forms of compensation. *Albertson's Inc. v. Comm'r*, 42 F.3d 537 (9th Cir. 1994).

7. See Pub. L. No. 98-369, 98 Stat. 494 § 67(a) (1984), (adding § 280G to the Internal Revenue Code).

8. See *id.* § 67(b) (1984) (adding § 4999 to the Internal Revenue Code).

9. See Pub. L. No. 103-66, 107 Stat. 312, § 13211(a) (1993) (adding subparagraph (m) to § 162 to the Internal Revenue Code which excepted performance-based compensation from this rule).

10. See *supra* note 4.

Enron bankruptcy, ERISA's exclusion may have afforded greater protections to the executives than available to the rank-and-file employees.

In the Enron case, many of the employees covered under the employer's *qualified* profit sharing plan lost their entire life savings as their designated investment of employer stock plummeted in value.<sup>11</sup> During this same time period, insider executives received enormous bonuses<sup>12</sup> and withdrew benefits from their executive deferred compensation plans.<sup>13</sup> Such withdrawals would have certainly drained cash from the employer, monies that would have otherwise been available to the rank-and-file as damages in subsequent lawsuits against the employer. Obviously that result is in direct conflict with the premise of ERISA to protect the rights of the covered participants and beneficiaries.<sup>14</sup>

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11. See *Enron Pension and Benefit Issues: Hearings of the House Education and Workforce Committee* [hereinafter "*Enron Pension & Benefits Hearings*"], 109th Cong. (Feb. 7, 2002) (excerpts from testimony from Rep. John A. Boehner, Committee Chair, "[o]n December 2, 2001, the Enron Corporation filed the largest bankruptcy petition in U.S. history. The next day, the company announced that it would lay off 4,000 of its 7,500 employees as part of a corporate restructuring program. The devastating losses in the company's employee 401(k) plan left many loyal Enron employees without their retirement security. The stories told by Enron's employees are heart-wrenching. The Enron collapse has sent chills down the spine of every American employee who has worked and saved for a safe, secure retirement"). See also The Gottesdiener Law Firm, *Enron 401k Plan Lawsuit* (last visited Sept. 5 2002) (alleging in the class action complaint against Enron Corporation that the participants lost retirement savings of approximately \$1 billion as a result of the Enron defendants who were plan fiduciaries), at <http://www.enronsuit.com>.

12. See Eric Berger, *\$680 Million Paid to Top Enron Execs in '01*, HOUSTON CHRON. June 17, 2002, available at <http://www.chron.com/cs/CDA/story.hts/special/enron/1457323> (last visited Sept. 5, 2002).

13. See *Enron Pension & Benefits Hearings*, *supra* note 11 (responding to inquiries from Rep. Culberson as to whether withdrawals were made from the rabbi trust pursuant to the deferred compensation plans to executives during the blackout period in which rank-and-file Enron employees could not withdraw their monies, Mr. Scott Peterson from Hewitt, the deferred compensation plan's recordkeeper, stated "[w]e were informed about certain accounts that in fact had been cashed out"). See also Eric Berger, *Deferred Payments Under Fire*, HOUSTON CHRON., Aug. 16, 2002, (stating that Enron paid cash compensation from deferred compensation plans worth at least \$32 million in October and November, 2000 to Enron executives who were still working for the company), available at <http://www.chron.com/cs/CDA/story.hts/special/enron/1538191> (last visited Sept. 5, 2002).

14. See Senate Finance Committee's Report on S. REP. NO. 1179 (Aug. 21, 1973) (noting the fiduciary responsibility provisions) (showing that the fiduciary's rule "which prohibits a fiduciary from jeopardizing the income or assets of a plan, fiduciaries will be subject to the usual trustees' duties such as (but not limited to) the duty to keep and render clear and accurate accounts, take and keep control of the plan property, protect the plan property from loss

While the Enron scandal may be the impetus for any subsequent legislation, any proposed legislation should also be reviewed in the context of the more typical employer context — executives that are not in control of the company's financial statements or of their accountants but are otherwise at risk from the employer's subsequent decision not to pay benefits pursuant to the plan. This article will describe what regulatory authority the Internal Revenue Service (IRS) and the Department of Labor (DOL) presently have to impose more rigorous rules on executive compensation plans, and whether additional legislation would be needed, as a result of the Enron scandal. Hopefully, the aftermath of Enron may cause the regulatory authorities to promote more rigorous requirements for executive compensation plans, especially in the context of executives who are insiders (as defined by the securities laws).<sup>15</sup> Such requirements would be welcome additions to protect the rank-and-file employees who may now find themselves in the position of unsecured creditors in lawsuits against their employer.

If Congress finds it necessary to legislate in this area, the author suggests that simply lifting the moratorium on the IRS's ability to issue certain types of guidance may be sufficient to empower the Service to make appropriate regulatory changes. Additional changes to the Code are not the proper vehicle for regulating *all* the particulars of executive deferred executive compensation plans. Greater disclosure of such plans by publicly held employers would certainly permit their shareholders and the public to monitor the level and particulars of such plans.

#### *What Are Nonqualified Executive Compensation Plans?*

Nonqualified executive compensation plans may be best understood by explaining what they are not. They are not *qualified* retirement or profit sharing plans (i.e., plans that satisfy the requirements of I.R.C. section 401(a)). The terms "nonqualified executive deferred compensation plan" does not appear in either the Code or ERISA, but is used by practitioners to refer to executive compensation plans that defer payment of benefits — usually until termination of employment, disability or retirement — which are not intended to be qualified under I.R.C. section 401(a).

*Qualified* plans must satisfy nondiscrimination rules to

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and damage, enforce claims of the plan and defend actions against the plan . . . and keep plan assets separate from other property." See *also* Jennifer A. Leahy, 34 SUFFOLK UNIV. L. REV. 595, n.4 & 5 (2001) (referencing, ERISA's legislative history under H. REP. NO. 93-533, at pt. 11 (1973)).

15. See 15 U.S.C. § 78(p) (2000) (defining an insider as any officer, director or beneficial owner of more than ten percent of a class of registered securities).

assure that highly paid employees are not treated more favorably with respect to benefits and coverage than the rank-and-file employees.<sup>16</sup> In addition, there are maximum limitations on benefits and deferrals on behalf of a given employee, both in the form of a cap on annual compensation and a cap on the dollar and percentage limits on benefits and deferrals.<sup>17</sup> Funding and fiduciary rules assure that the assets set aside for these plans are maintained for the *exclusive* benefit of the participants and beneficiaries,<sup>18</sup> and invested prudently by plan fiduciaries.<sup>19</sup> Such assets are protected from the employer's creditors in the event of bankruptcy or insolvency. In addition to these substantive protections, the Code also protects the employees from taxation until the time of *actual* distribution from the plan. There are legitimate policy reasons for providing such a tax subsidy for qualified retirement plans. Savings for retirement is promoted, and employees are able to retire with sufficient retirement income. It is possible that the improved general welfare actually strengthens the tax base while reducing pressures on the governmental safety net (e.g., Social Security). In providing such tax exceptions for *qualified* plans, the Code implicitly acknowledges that the typical rank-and-file employee, who has already rendered services, would not be willing to have the employer defer such payment unless there was a vested and secured right to receive such benefits in the future. Code section 401(k) provides an additional opportunity for the employee to defer his/her actual *current* compensation for subsequent payment without any adverse tax consequences, subject to the requirements of that section.<sup>20</sup> Given the maximum dollar limitations provided

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16. See I.R.C. § 401(a) (2000) (prohibiting nondiscrimination as to highly compensated employees, who are 5% shareholders of the employer or employees earning compensation in excess of \$80,000 (indexed)).

17. See I.R.C. §§ 415(b) & 415(c) (2000) (providing maximum dollar and percentage limitations applicable to benefits under defined benefit plans and deferrals under defined contribution plans) and I.R.C. § 401(a)(17) (2000) (providing an annual dollar cap on the amount of an individual's compensation that may be considered for benefit or deferral purposes).

18. See I.R.C. § 501(a) (2000) (providing for a tax-exempt trust for contributions made to a plan qualified under I.R.C. § 401(a)); I.R.C. § 401(a)(2) (2000) (prohibiting the trust to divert any part of its corpus or income other than for the exclusive benefit of the participants and beneficiaries), 26 I.R.C. §§ 403(a), 404(a) (2000); see also ERISA § 403(a) (2000) (requiring that plan assets be held in trust); see also ERISA § 404(a) (requiring the plan fiduciaries to discharge their duties solely in the interest of participants and beneficiaries).

19. 29 U.S.C. § 1104(a)(1) (2000) (corresponds to ERISA § 404(a)(1)(B)) (mandating the plan fiduciary to discharge his/her duties "with the care, skill, prudence, and diligence under the circumstances then prevailing that a prudent man acting in a like capacity and familiar with such matters would use in the conduct of an enterprise of a like character and with like aims.").

20. 26 I.R.C. § 401(k) (2000) (permitting a maximum deferral for 2002 of



to the qualified plan, the annual dollar limits applicable to Code section 401(k) deferrals<sup>21</sup> and the maximum dollar limitation imposed on an employee's annual compensation for purposes of the qualified plan,<sup>22</sup> executives and employers seek additional ways to defer current and supplemental compensation.

*Nonqualified* deferred compensation arrangements cannot rely upon the Code's preferential tax treatment. Such arrangements are generally agreements between the employer and its executives to defer a portion of the executive's presently-earned compensation to a subsequent year or to provide supplemental deferral compensation. These agreements may range from single employment contracts between an executive and the employer to plans covering numerous executives of the employer. The latter agreements are coined "executive deferred compensation" plans as the payment for the current services is deferred to the future without the kind of guarantees and security afforded to participants under qualified plans. In addition to having the deferral be non-vested and unsecured for tax reasons, the benefits themselves may be contingent upon future performance or forfeited upon the occurrence of certain events (e.g., subsequent employment with a competitor).

In a series of articles in *The New York Times* six years ago, executive compensation plans were highly criticized and described as providing tax loopholes for executives to amass large fortunes of deferred compensation from their employers to the detriment of rank-and-file employees and shareholders.<sup>23</sup> The Enron scandal has piqued interest again in executive compensation plans as many Enron executives have withdrawn monies from these plans prior to the Enron collapse, while many participants in the Enron qualified section 401(k) plan were unable to withdraw contributions invested in employer stock and lost their entire life savings as the company stock collapsed.<sup>24</sup>

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\$11,000; and increasing by \$1,000 annual increments due to cost of living adjustments until it hits \$15,000 in 2006, with annual cost of living adjustments then limited to annual \$500 increments).

21. See I.R.C. § 415 (providing for maximum dollar and percentage limitations for qualified defined benefit plans and qualified defined contribution plans) and I.R.C. § 402(g) (providing for a maximum dollar limit for deferrals made pursuant to a section 401(k) plan).

22. See I.R.C. § 401(a)(17) (2000) (providing an annual exclusion for compensation in excess of \$160,000, as adjusted for cost of living changes).

23. Christopher Drew & David Cay Johnston, *Rushing Away from Taxes: For the Wealthy, Death is More Certain than Taxes*, N.Y. TIMES, Dec. 22, 1996 at A1; Diana B. Henriques and David Cay Johnston, *Managers Staying Dry as Corporations Sink*, N.Y. TIMES, Oct. 14, 1996 at A1; Diana B. Henriques and Floyd Norris, *Rushing Away From Taxes: The Capital Gains Bypass*, N.Y. TIMES, Dec. 1, 1996 at A1; Melody Petersen, *Deferred Compensation for the Masses: A Plum at a Price*, N.Y. TIMES, Oct. 27, 1996 § 3, at 10.

24. See *supra* notes 11 and 13. See also Dan Feldstein & Eric Berger,

Legitimate concerns have arisen in Congress as to how and when executives are permitted to withdraw funds from executive compensation plans, especially in advance of the employer's bankruptcy. The Senate Finance Committee held hearings in the Spring of 2002 regarding corporate governance and executive compensation plans in light of the Enron demise.<sup>25</sup> By summer, the Democrats initiated a "corporate governance" proposal subjecting executives to immediate taxation under certain deferred compensation plans that were funded with employer stock and assessing a golden parachute excise tax if the plan was designed to protect those benefits in the event of employer bankruptcy or financial distress.<sup>26</sup> The Senate Finance Committee also has proposed legislative changes to curb abuses under executive compensation plans.<sup>27</sup>

In the foregoing context, the purpose of this primer is to examine how executive compensation plans are taxed and to highlight legitimate concerns that Congress may wish to address. The primer is limited to *private sector* corporations' executive compensation plans, which are funded neither by employer stock (or stock options) nor split dollar life insurance. Those latter issues warrant a separate article due to their complexities.

### General Tax Rules

The Code adopts a general "matching" rule for deferred compensation payable to an employee—the employer receives a deduction on deferred compensation when the executive takes the deferral into income.<sup>28</sup> The Internal Revenue Code provides an

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*Enron's Retired Get Burned, Too*, HOUSTON CHRON. Feb. 16 2002 available at <http://www.chron.com/cs/CDA/story.hts/special/enron/1258396> (last visited Sept. 5, 2002); The Gottesdiener Law Firm, *Enron 401k Plan Lawsuit* (last visited Sept. 5 2002) (reporting of losses of over \$1 billion by participants under the Enron § 401(k) plan due to the decline in the value of employer stock), at <http://www.enronsuit.com>.

25. See generally the list of witness testimonies for the hearing on Corporate Governance and Executive Compensation, held on April 18, 2002, before the Senate Finance Committee at <http://www.finance.senate.gov/sitepages/hearing/041802.html> (last visited Sept. 5, 2002).

26. See [www.house.gov/rules/matsui\\_036.pdf](http://www.house.gov/rules/matsui_036.pdf) (last visited Sept. 5, 2002) (subjecting performance-based compensation to the \$1,000,000 deductibility ceiling; denying a tax deferral for corporate insiders with executive compensation plans funded with employer stock; applying the golden parachute excise tax to deferral compensation plans if there is a major decline in the company's stock or bankruptcy).

27. *Description of Chairman's Modifications to the "National Employee Savings and Trust Equity Guarantee Act,"* THE JOINT COMMITTEE ON TAX'N, July 11, 2002, available at <http://www.house.gov/jct/x-74-02.pdf>.

28. I.R.C. § 404(a)(5) (2000). This is known as the "matching rule" whereby the employer's deduction must match the employee's inclusion of such amounts as taxable income for the same tax year. See also *Albertson's, Inc.*, 42 F.3d at 541 (noting that interest and earnings on compensation

exception to the general income tax rule such that an employee who receives a vested and funded right to receive deferred compensation under a qualified pension or profit sharing plans does not incur any current income tax consequences.<sup>29</sup> In addition, the employer who makes a contribution for the benefit of the employee receives a current deduction for such contributions to the underlying trust.<sup>30</sup> Thus, Congress provides a substantial tax subsidy for deferrals made under qualified retirement plans, both for the employer and the covered employees. Code section 401(k) provides an additional tax shelter whereby employees may contribute *pre-tax* contributions to a qualified profit sharing plan, delaying any tax on the contributions and the earned income until actual distribution from the trust. For deferred compensation plans that are not qualified under I.R.C. section 401(a), the employer deductibility rules of I.R.C. section 162 and the employee income tax rules of I.R.C. section 61 are applicable to any deferrals of compensation.<sup>31</sup>

For compensation deferrals under nonqualified plans, it may appear that the IRS is losing tax revenue because the employee is not presently taxed on such deferral. However, since the deferral is nonqualified, monies remain with the employer (until future distribution) and are taxed presently at the corporate tax rates. As the compensation accrues with interest but remains deferred, any earnings that the employer generates on the retained compensation is also taxable to the employer.<sup>32</sup>

The employee's taxation of such deferrals, if properly structured under an executive deferred compensation, is deferred until the actual receipt of the payments. During this time span, the deferrals must be unavailable, or if available, subject to substantial risk of loss or forfeiture.<sup>33</sup> To do otherwise will subject

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deferred under deferred compensation plans were also subject to the I.R.C. § 404(a)(5) matching rule).

29. See I.R.C. § 402(b) (2000), (subjecting the participant to tax when such amounts are actually distributed from the qualified plan).

30. I.R.C. § 404 (2000).

31. See I.R.C. § 162 (2000) (describing normal "ordinary and necessary" business expense rules regarding the employer's deduction for employee compensation). See also I.R.C. § 280G (2000) (describing imposition of a maximum limit on excess parachute payments that provide additional compensation to executives in the event of a "change of control" of the employer either through merger or acquisition).

32. See *Albertson's, Inc.* 42 F.3d at 541; see also 95 T.C. 415 (1990) (reversing its earlier decision and agreeing with the Tax Court's conclusion that a current deduction for an employer for the interest/earnings component of a nonqualified deferred compensation plan would be contrary to the intent of I.R.C. § 404(a)(5)).

33. Treas. Reg. § 1.451-2(a) (2002).

(Income although not actually reduced to a taxpayer's possession is constructively received by him in the taxable year during which it is

the employee to immediate taxation although actual receipt is delayed.

Thus, there is *no* massive tax loophole afforded by such nonqualified executive compensation arrangements. The IRS is receiving tax presently at the corporate level on these deferrals and on their earnings; taxation of the deferrals at the employee level is delayed until actual payment or until the substantial risk lapses. Indeed, the future taxability of the employee is offset by future deductibility to the corporation—approximately a “wash.” The IRS receives its tax now, not later.

If there are no tax advantages, why do we have these executive deferred compensation plans? There are legitimate reasons why such plans are popular:

- For the executive, such plans may provide for the gap at retirement between the level that can be provided under the qualified retirement plan and the replacement income level that is desired. As Congress continues to impose limitations on deferrals under qualified plans (through compensation limits and maximum benefit/deferrals limits),<sup>34</sup> more pressure is certainly created to supplement the executive’s retirement benefit. These nonqualified arrangements also provide flexibility by permitting the executive to alter the timing of the receipt of such compensation and allowing the corporation continued use of the employee’s compensation during the period of deferral.
- For the corporation, an executive deferred compensation plan permits the amount of the executive’s compensation to be dependent on future performance; may be used as a retention device thereby providing for forfeitures for earlier departure or subsequent employment with a competitor (referred to as “golden handcuffs”); may be used as a recruitment device to hire mid-career executives who otherwise will lose benefits under their existing employer plans; and can be a useful early retirement tool in retiring executives. Qualified plans cannot achieve these objectives as vesting schedules are mandated by the Code and compensation cannot be dependent upon future performance.<sup>35</sup> In addition, executive deferred compensation

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credited to his account, set apart for him, or otherwise made available so that he may draw upon it at any time, or so that he could have drawn upon it during the taxable year if notice of intention to withdraw had been given. However, income is not constructively received if the taxpayer’s control of its receipt is subject to substantial limitations or restrictions.

*Id.*

34. See I.R.C. §§ 401(a)(17) and 415 (2000) (imposing compensation ceilings and maximum benefit/contribution ceilings for qualified defined benefit and defined contribution plans).

35. See I.R.C. § 411(a) (2000) (setting forth the appropriate vesting

plans involve less operational costs due to ERISA's simplified reporting requirements.<sup>36</sup> The flexibility afforded in the design and administration of executive compensation plans make them very attractive to employers.

- There exists a modest tax arbitrage between the top corporate rate of 36% and the top individual rate of 39.1%. So the tax code embodies a slim incentive to have income taxed sooner at the corporate rate, and later at the individual rate.

In order for the executive to delay taxation of deferrals under executive compensation plans, certain tax rules must be satisfied.<sup>37</sup> These rules are set forth in the Internal Revenue Code or regulations, and have been interpreted by the Service and the courts. The Service's application of some of these rules, especially regarding the executive's ability to alter the payment scheme, has been regarded as unduly restrictive,<sup>38</sup> whereas the courts provide

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schedules that may be used in a qualified plan); see I.R.C. § 414(s) (2000) (providing definitions of "compensation" for qualified plan purposes that do not include nonqualified deferred compensation).

36. See 29 C.F.R. § 2520.104-23 (2001) (requiring only a filing with the Secretary of Labor within 120 days of the plan's adoption of basic information—such as the name and address of the employer, a declaration that the employer maintains the plan for a select group of highly compensated employees, and a statement regarding the number of such plans and the number of employees in each. While the plan document need not be filed, it must be provided if requested by the Secretary).

37. These tax rules are: 1) the constructive receipt doctrine (set forth in Treas. Reg. § 1.451-2(a)); 2) the economic benefit doctrine (Gen. Couns. Mem. 35196 (Jan. 16, 1973); 3) § 83 requirements regarding property transferred to an individual in connection with the performance of services (Treas. Reg. § 1.83-3(e)); and, 4) the vested accrued benefit rule (I.R.C. § 402(b), 26 U.S.C. § 402(b) (2000)).

38. In 1978, the Service attempted to reverse its prior constructive receipt rules, through the issuance of Prop. Treas. Reg. § 1.61-16 (stating "if . . . payment of an amount of a taxpayer's basic or regular compensation . . . (or supplements to such compensation, such as bonuses or increases in such compensation) is, at the taxpayer's individual option, deferred to a taxable year later than that in which such amount would have been payable but for her exercise of such option, the amount shall be treated as received by the taxpayer in such earlier taxable year. For purposes of this paragraph, it is immaterial that the taxpayer's right in the amount payment of which is so deferred become forfeitable by reason of his exercise of the option to defer payment."). Congress reacted by passing § 132 of Pub. L. No. 95-600 (the Revenue Act of 1978), which provided that the tax treatment of private deferred compensation plans would be determined in accordance with principles set forth in regulations, rulings and case law which were in effect February 1, 1978. For an excellent discussion of the differences in opinions between the Internal Revenue Service and Congress see Richard S. Fischer, *Deferred Compensation: Born Again - For Now*, 37 N.Y.U. INST. ON FED. TAX'N 210, 210-86 (1979).

greater latitude in extending the payment provisions.<sup>39</sup> Given the courts' more liberal interpretation, it is understandable that the Service has not been actively litigating in this area. Congress may wish to give the Service more regulatory power if it feels the courts' interpretations are too lenient.

### General ERISA Rules

ERISA regulates all employee benefit plans, including retirement/profit sharing and welfare benefit plans, unless such plans are exempt. For retirement and profit sharing plans, there are substantive requirements relating to eligibility, vesting, participation, funding, and distribution of benefits. There are also reporting and disclosure requirements and fiduciary rules. An executive deferred compensation plan must fall within one of the exemptions provided under ERISA in order to ignore its requirements.

An executive deferred compensation plan that is an unfunded "excess benefit" plan is totally exempt from all of ERISA's substantive and procedural requirements.<sup>40</sup> However, very few executive deferred compensation plans are pure "excess benefit" plans as that term envisions plans maintained *solely* for the purpose of providing benefits for employees in excess of the maximum benefit and contribution limitations of I.R.C. section 415.<sup>41</sup> While employers are free to determine a qualified plan's benefit or allocation formula, the limitations of I.R.C. section 415 may prevent an executive from receiving the full amount of the benefit or allocation.<sup>42</sup> Thus an employer may provide for an excess

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39. See *Martin v. Comm'r*, 96 T.C. 814, 825 (1991) (affirming the taxpayer's change in payment schemes shortly before termination of employment); *Veit v. Comm'r* ("*Veit II*"), 8 T.C. 919 (1949) (permitting the taxpayer's election to change payment schemes even though the amounts were determinable); *Veit v. Comm'r* ("*Veit I*"), 8 T.C. 809, 818 (1947), *acq.* 1947-2 C.B.4 (permitting the taxpayer's deferral election even though most of the services had been performed as the amount due was not definitely determinable); *C.E. Gullet v. Comm'r*, 31 B.T.A. 1067 (stating that "the doctrine of constructive receipt is to be sparingly used; that amounts due from a corporation but unpaid, are not to be included in the income of an individual reporting his income on a cash receipts basis, unless it appears that the money was available to him, that the corporation was able and ready to pay him, that his right to received was not restricted, and that his failure to receive resulted from exercise of his own choice.").

40. 29 U.S.C. § 1003(b)(5) (2000) (corresponds to ERISA § 4(b)(5)).

41. *Id.* See also 29 U.S.C. § 1002(36) (2000) (corresponds to ERISA § 3(36)) (defining an "excess benefit plan" as "a plan maintained by an employer solely for the purpose of providing benefits for certain employees in excess of the limitations on contributions and benefits imposed by section 415 of the Internal Revenue Code of 1986 on plans to which that section applies, without regard to whether the plan is funded.").

42. See I.R.C. § 415 (2000) (limiting benefits payable from a qualified defined benefit plan to the lesser of \$160,000 (indexed) or 100% of final

benefit plan intended to work in tandem with the qualified plan by providing benefits in excess of those limited by I.R.C. section 415 (i.e., to the extent full benefits or deferrals may not be realized under the qualified plan due to the maximum limitations of I.R.C. section 415, the excess benefit plans provides for the difference).

When ERISA was passed, I.R.C. section 415 was the sole limitation on the level of benefits or allocations for qualified retirement or profit sharing plans. However, with the Tax Reform Act of 1986, Congress added another limitation to the level of benefits or deferrals by adding I.R.C. section 401(a)(17), which imposed a maximum dollar amount of an employee's compensation which could be considered under the plan.<sup>43</sup> Suddenly, an executive's benefits under the qualified plan were no longer limited *solely* by I.R.C. section 415. However, ERISA's exemption for "excess benefit" plans was not amended to reflect this new distinction. Thus, ERISA's exception for "excess benefit" plans has limited applicability as nonqualified plans designed as supplemental plans work in tandem with the qualified plan to provide benefits or deferrals restricted by both I.R.C. sections 415 and 401(a)(17).

Even though a complete exemption may not be available, ERISA provides additional exemptions for certain of the substantive and procedural requirements for other types of executive deferred compensation plans. Unfunded pension plans intended for "a select group of management or highly compensated employees" are exempt from ERISA's participation, vesting, and distribution requirements;<sup>44</sup> minimum funding standards;<sup>45</sup> and fiduciary rules.<sup>46</sup> These types of plans are commonly referred to as "top hat" plans, and by their very nature, must be discriminatory. The DOL studied the issue of what employee group would be considered as members of the top hat group, but issued little guidance on the subject.<sup>47</sup> It appears that the Code's definitions of

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average pay, beginning at normal retirement age, as a life annuity or joint & survivor annuity for married participants and limits allocations under qualified defined contribution plan to the lesser of \$30,000 (indexed) or 100% of compensation).

43. See Pub. L. No. 99-514, 100 Stat. 208S § 1106(d)(1) (1986) (amending I.R.C. § 401(a) by inserting a new paragraph (17)).

44. 29 U.S.C. § 1051(2) (2000) (corresponds to ERISA § 201(2)).

45. 29 U.S.C. § 1081(a)(3) (2000) (corresponds to ERISA § 301(a)(3)).

46. 29 U.S.C. § 1101(a)(1) (2000) (corresponds to ERISA § 401(a)(1)).

47. See 57 Fed. Reg. 16, 977 (April 27, 1992) (noting that the project of determining what group constituted a "select group of management or highly compensated" was withdrawn on Feb. 24, 1992). The DOL provided guidance as to what constitutes a top hat plan:

Congress recognized that certain individuals, by virtue of their position or compensation level, have the ability to affect or substantially influence, through negotiation or otherwise, the design and operation of their deferred compensation plan, taking into consideration any risks

“key employees” and/or “highly compensated employees” (used for qualified plan purposes) are not necessarily applicable in determining ERISA’s top hat group.<sup>48</sup> While the top hat exception does not appear as a statutory exemption under ERISA’s reporting and disclosure requirements, the DOL regulations provide an administrative exemption for such plans from many of the reporting and disclosure requirements.<sup>49</sup> Thus, any documents setting forth the terms of the top hat plan are not required to be filed with the DOL for public inspection, nor are such documents made available to employees and shareholders of the employer. In the wake of the Enron scandal, the DOL may wish to revisit these regulations and impose more stringent disclosure rules for top hat plans. The above exemptions for excess benefit or top hat plans also require that such plan be *unfunded*, a term that is not defined by ERISA. Although ERISA was passed in 1974, it was not until 1985 that the DOL stated its position as to what constitutes an “unfunded” plan for purposes of these exemptions.<sup>50</sup> The DOL has indicated that the use of a trust to provide benefits from a top hat plan does not render the plan funded for ERISA purposes, if the trust assets are subject to the claims of the employer’s creditors.<sup>51</sup>

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attendant thereto, and, therefore, would not need the substantive rights and protections of Title I [of ERISA].  
DOL Adv. Op. 90-14A (May 8, 1990).

48. See DOL Adv. Op. No. 75-63 (July 22, 1975) (affirming that coverage of key employees who earned over \$18,200 and were “exempt” constituted a top hat plan); DOL Adv. Op. No. 75-64 (Aug. 1, 1975) (noting that a plan covering key executives and managerial employees representing less than 4% of the number of active employees and earning an average compensation of more than \$28,000 compared to \$19,000 for all other management employees was a top hat plan). Compare DOL Adv. Op. No. 85-37A (Oct. 25, 1985) (declining to hold that a plan covering employees “on the executive payroll” and numbering 50 out of 750 total employees was a top hat plan).

49. 29 C.F.R. § 2520.104-23; see *supra* text accompanying note 36.

50. 13 Pens. & Ben. Rep. (BNA) 702 (1986):

[T]he Department is generally of the view that any determination of ‘funded’ or ‘unfunded’ status of a plan of deferred compensation requires an examination of the surrounding facts and circumstances, including the status of the plan under non-ERISA law. With particular regard to the development of regulations concerning ‘top-hat’ plans, the Department recognizes, and must ensure, that employers design and maintain these plans only for a select group of management or highly compensated employees, that is, employees who may not need the substantive protections of Title I of ERISA.

*Id.*

51. The various “rabbi trust vehicles”:

[W]ere devised and predicated on consideration of tax code provisions, regulations and doctrines concerning the deferral of income. In the absence of pertinent legislative history defining ‘unfunded’ for purposes of Title I of ERISA, the Department believes that the case of ‘Top-Hat’ plans (as well as excess benefit plans) the positions adopted by the



Case law affirms such result by holding that setting aside assets in order to provide deferred compensation does not render the plan funded, provided these assets are subject to the claims of the employer's creditors.<sup>52</sup> Thus, the DOL affirmed that a top hat plan that is unfunded for tax purposes will be regarded as unfunded for ERISA purposes, providing an exemption from ERISA's various requirements as well as avoiding any current taxation for covered executives, the best of both worlds.

### *Specific Tax Rules for Executive Deferred Compensation Plans*

There are four potential ways of imposing taxation on benefits accrued under an executive deferred compensation plan prior to actual receipt by the executive: (1) the property rules of I.R.C. section 83; (2) the "constructive receipt" doctrine of I.R.C. section 61; (3) the "economic benefit" doctrine of I.R.C. section 61; or (4) the "vested accrued benefit" tax under I.R.C. section 402(b). Application of any one of these theories may result in immediate taxation to the executive on amounts deferred under an executive deferred compensation plan. Hence, particular attention must be

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Service regarding the tax consequences to trust beneficiaries of the creation of, or contributions to, a 'rabbi trust' should be accorded significant weight under Title I. Thus, it has been the working premise of the Department that a 'Top-Hat' Plan or excess benefit plan would not fail to be 'unfunded' solely because there is maintained in connection with such plan a 'rabbi trust.'

*Id.* See also DOL Adv. Op. 92-13A (May 19, 1992) (indicating that the Service's position regarding the tax consequences to trust beneficiaries covered under a rabbi trust "should be afforded significant weight under Title I [of ERISA]"); DOL Adv. Op. 91-16A (Apr. 5, 1991) (stating that the Department's position that a top hat or excess benefit plan is not regarded as unfunded solely because it is maintained in connection with a rabbi trust); DOL Adv. Op. 90-14A (May 8, 1990) (noting that the plan was not funded as the employee-participants had no interest in any assets of the employer, other than unsecured general creditors); DOL Adv. Op. 89-22A (Sept. 21, 1989) (finding that the plan was unfunded as all benefits were payable from the employer's general assets and the participants' rights were no greater than those of other unsecured creditors and were not subject to assignment, attachment, transfer or encumbrance). See also Letter from Elliot I. Daniel, Asst. Admn'r for the Department of Labor to Richard H. Manfreda, Chief, Individual Income Tax Branch, IRS, (Dec. 13, 1985) (reprinted in Howard Pianko, *Nonqualified Deferred Compensation: Rabbi Trust Planning Issues*, in the *16 Annual Employee Benefits Inst.* 106, 121, & 123 (1986) (PLI 1986)).

52. See generally *Belsky v. First Nat'l Life Ins. Co.*, 818 F.2d 661 (8th Cir. 1987); *Northwestern Mutual Life Ins. Co. v. Resolution Trust Corp.*, 848 F. Supp. 1515 (N.D. Ala. 1994); *Miller v. Heller*, 915 F. Supp. 651 (S.D.N.Y. 1996); *Bruno v. Hershey Foods Corp.*, 964 F. Supp. 159 (D.N.J. 1997); *Moore v. Acme Corrugated Box Co.*, No. 97-2150, 1997 U.S. Dist. LEXIS 11722 (E.D. Pa. 1997), *aff'd without opinion*, 182 F.3d 904 (3d Cir. 1999); *Carrabba v. Tom Thumb Food & Drugs, Inc.*, No. 4:96-CV-651-A, 1997 U.S. Dist. LEXIS 21026 (N.D. Tex. 1997).

made in the drafting of these plans to avoid such result. Obviously the worst result for an executive is immediate taxation on amounts that have been deferred and are not currently available to pay the resulting tax.

While all four tax doctrines are theoretically applicable, the use of one or more of the doctrines generally depends on how the executive deferred compensation plan is designed. Since there are no prescribed rules for designing these plans, there could be an infinite number of design possibilities. However, three types of designs are currently most popular: (1) a salary reduction plan whereby executives *elect* to defer current compensation (e.g., bonuses) until a future date *or* the employer defers the payment of compensation until certain performance criteria have been satisfied; (2) mirror Code section 401(k) nonqualified plans which permit the executive to make a single deferral under the nonqualified plan and a subsequent distribution to the section 401(k) plan equal to the maximum deferral allowed under that plan,<sup>53</sup> with the ability to obtain additional employer matches and earnings on such amounts; and (3) supplemental executive retirement plans (known as SERPs) that are typically funded solely through employer dollars to provide additional compensation at some future date with or without various handcuffs (i.e., provisions that provide for a forfeiture of benefits upon certain events, such as the executive's premature resignation or subsequent employment with a competitor) or to provide additional excess retirement benefits that cannot be provided through the employer's qualified plans. The overall total or complete variety of executive deferred compensation plans maintained by Enron is unknown; however, we do know that Enron executives were able to defer up to thirty percent of their income and all of their bonuses under a deferred compensation plan.<sup>54</sup> As the various tax rules are explained, their application to

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53. The Service's position regarding tandem I.R.C. § 401(k) plans has developed through a series of private letter rulings. See Priv. Ltr. Rul. 93-17-037 (Feb. 1, 1993) (affirming a single election prior to January 1 of the calendar year in which the compensation would be earned under the nonqualified plan with a subsequent election no later than January 31 in the following year to have a certain amount contributed to the Section 401(k) plan), which was subsequently withdrawn by the Service in Priv. Ltr. Rul. 94-14-041. *But see* Priv. Ltr. Rul. 95-30-038 (July 28, 1995) (affirming the use of a "wrap-around" 401(k) election whereby the executive's election to defer a certain percentage under the 401(k) plan could be automatically applied to the nonqualified mirror 401(k) plan without any adverse constructive receipt issues).

54. See Eric Berger, *Deferred Payments Under Fire*, HOUSTON CHRON., Aug. 16, 2002 (stating that Enron permitted executives to defer up to 30% of income and all of their bonuses under a deferred compensation plan that was similar to a § 401(k) plan, available at <http://www.chron.com/cs/CDA/story.htm?special/enron/1538191> (last visited Sept. 5, 2002)).

one or more of these particular types of executive deferred compensation plan will also be discussed.

### *Application of § 83*

I.R.C. section 83 was added in 1969 to modify both the common law timing and character treatment of certain deferred compensation payments.<sup>55</sup> Its target was the transfer of property for the performance of compensation in hopes of converting ordinary income into capital gains, as well as the postponement of the timing of taxation.<sup>56</sup> Under the prior rules, property could be transferred to an executive subject to restriction, thereby permitting future appreciation to be taxable as capital gains when the property was later sold, in lieu of reporting income at the time the property was transferred.<sup>57</sup> As the payment of cash compensation, either presently or deferred, does not present any appreciation potential, I.R.C. section 83 was limited to *property* transferred which had the potential for future appreciation (e.g., stock or stock options).<sup>58</sup>

If the executive deferred compensation plan merely provides for the employer's promise to pay cash benefits at some future date, the Service's regulations state that the executive's benefit is "unfunded and unsecured" and therefore is *not property* for Code § 83 purposes.<sup>59</sup> The Tax Court has interpreted "unfunded and unsecured" for this purpose as follows: "funding occurs . . . [o]nly at

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55. Tax Reform Act of 1969, Pub. L. No. 91-172, 83 Stat. 487 (1969) (codified as amended at I.R.C. § 83 (1990)).

56. For an excellent background of the history of I.R.C. § 83, see Carter G. Bishop & Marian McMahon Durkin, *Nonqualified Deferred Compensation Plans: A Review and Critique*, 17 WM. MITCHELL L. REV. 42 (1991). The rules of I.R.C. § 83 provide that *property* transferred by an employer in connection with the performance of services will be taxable to the employee in the first tax year in which he/she has rights to such property that are (1) transferable or (2) no longer subject to a substantial risk of forfeiture. I.R.C. § 83(c) states that property is only transferable if it can be transferred free of forfeiture risk and that a risk of substantial forfeiture exists if the employee performs future services to keep the property. Thus, unless the employee can sell the property subject to the forfeiture risk, he/she will be taxed on the value of the property when the forfeiture restriction lapses. I.R.C. § 83(b) provides an election for the executive to accelerate the taxation of the transfer of property to the initial transfer date; thereafter, any subsequent appreciation will be taxed as capital gains when the property is ultimately sold. If the employee forfeits the property, the I.R.C. § 83 regulation provide the employee with a loss deduction (equal to the amount paid for the property) instead of the income previously taxed.

57. Treas. Reg. § 1.421-6(d) (1966).

58. See S. REP. NO. 552, 91st Cong., 1st Sess. 500, *reprinted in* 1969 U.S.C.C.A.N. 2027 (noting that § 83 was targeted to correct an abuse in the taxation of restricted non-statutory employee stock plans).

59. See Treas. Reg. § 1.83-3(e) (noting that a guarantee to pay does not make the employer's promise secured as it is still only a promise to pay).

the time when the beneficiary obtains a nonforfeitable economic or financial benefit in the *trust or insurance policy*," and security requires more than just the employer's promise to pay.<sup>60</sup> As long as the executive's rights under the deferred compensation plan are no greater than that of an unsecured general creditor and the executive has no preferred rights over any assets of the employer in conjunction with the deferrals, § 83 is not applicable.

Thus for purposes of this article, I.R.C. section 83 will not be applicable to the types of executive deferred compensation plans being discussed. However, the applicability of I.R.C. section 83 may be highly relevant if such plan was "funded" with life insurance (granting the executive with certain rights and benefits)<sup>61</sup> or with stock or stock options. Then such plan may be regarded as funded or secured for Code § 83 purposes, thereby subjecting the executive to taxation once he/she has the ability to assign the property free of forfeiture risk<sup>62</sup> or when the property is no longer subject to a substantial risk of forfeiture.<sup>63</sup> Only prohibiting assignment of his/her property rights or subjecting those property rights to a "substantial risk of forfeiture" can further delay the taxation for the executive if property is involved.

It should be noted that there is a different timing rule applicable to executive deferred compensation plans for FICA tax purposes. Those rules are similar to those of I.R.C. section 83 and may subject the deferrals to FICA tax immediately regardless of whether there is any current federal income tax consequences.<sup>64</sup>

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60. *Childs v. Comm'r*, 103 T.C. 634, 651 (1994), *aff'd per curiam*, 89 F.3d 856 (11th Cir. 1996) (emphasis added).

61. *See Frost v. Comm'r*, 52 T.C. 89, 91 (1969) (imputing immediate taxation due to an executive deferred compensation plan which provided life insurance which paid the face value to the employee's estate in the event of death prior to age 65 and transferred the value of the policy to the employee upon attainment of age 65, disability or termination of employment). *But see* Rev. Rul. 68-99, 1968-1 C.B. 193 (refusing to apply the economic benefit on life insurance purchased for the executive compensation plan as the employer was the beneficiary and the employee received no benefits under the policy).

62. *See* Treas. Reg. § 1.83-3(d) (noting that property is transferable for § 83 purposes if the individual has the right to select, assign, or pledge his interest in the property).

63. *See* Treas. Reg. § 1.83-3(c)(1) (stating that property is subject to a substantial risk of forfeiture if the rights to such property are contingent upon future performance, or refraining from performance).

64. *See* § 3121(v)(2) of The Social Security Amendments of 1983, Pub. L. 98-21, § 324(b), 97 Stat. 65 (1983), created a special timing rule for deferred compensation benefits, subjecting them to taxation at the later of (1) the time of the performance of services or (2) when such benefits are no longer subject to a substantial risk of forfeiture. Thus for these benefits that are not subject to any substantial risk of forfeiture, benefits are taxable under FICA when the services are performed. For many executives, this will result in Medicare tax of 1.45% on all such amounts (as there is no maximum taxable wage base used on the medical portion of the FICA tax rate). However, if such benefits are

### *Application of the Constructive Receipt Doctrine*

I.R.C. section 61 taxes cash or any fair market value of property received for compensation for services by an employee in the tax year of receipt. This includes fees, commissions, fringe benefits and similar items received as compensation for services.<sup>65</sup> The *constructive receipt* rule dates back to Article 67 under the Revenue Act of 1913 that was added to reduce a taxpayer's attempt to defer the reporting of income by delaying the receipt of property.<sup>66</sup> Under the timing rules of I.R.C. section 451(a), compensation to a cash-basis taxpayer is taxable when it is either *actually* received or *constructively* received.<sup>67</sup> The regulations impose taxation on such compensation if it "is credited to his account, set apart for him, or otherwise made available so that he may draw upon it at any time."<sup>68</sup> Thus as a tax-planning tool, a taxpayer must comply with the constructive receipt rules to delay taxation of the receipt of benefits, as opposed to avoidance of any tax.

The purpose of the constructive receipt rule is to impose current taxation if the taxpayer has an unfettered control in

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subject to a substantial risk of forfeiture, the FICA payments are delayed until the risk lapses; if the lapse occurs at the executive's retirement, this will subject the entire amount of the benefits to FICA taxes.

65. I.R.C. § 61(a)(1) (2000). *See also* Treas. Reg. § 1.61-2(a).

66. Pub. L. No. 254, § 213, 40 Stat. 1057, 1065 (1919) (codified as amended in scattered sections of 26 U.S.C.) Defining "gross income" as:

[I]nclud[ing] gains, profits, and income derived from salaries, wages, or compensation for personal service . . . of whatever kind and in whatever form paid, or from professions, vocations, trades, businesses, commerce, or sales, or dealings in property, whether real or personal, growing out of the ownership or use of or interest in such property; also from interest, rent, dividends, securities, or the transaction of any business carried on for gain or profit, or gains or profits and income derived from any source whatever. The amount of all such items shall be included in the gross income for the taxable year in which received by the taxpayer.

*Id.*

67. *See* I.R.C. § 451 (2000), (providing "[t]he amount at any time of gross income shall be included in the gross income for the taxable year in which it is received by the taxpayer, unless, under the method of accounting used in computing taxable income, such amount is to be properly accounted for as a different period"). To prevent the cash basis taxpayer from manipulating the timing of the receipt of income the regulations provides that a cash basis taxpayer is taxed on income when it is received or could be constructively received. Treas. Reg. § 1.451-2(a) (2002).

68. *See* Treas. Reg. § 1.451-2(a) (stating "[i]ncome although not actually reduced to a taxpayer's possession is constructively received by him in the taxable year during which it is credited to his account, set apart for him, or otherwise made available so that he may draw upon it at any time, or so that he could have drawn upon it during the taxable year if notice of the intention to withdraw had been given.). "However, income is not constructively received if the taxpayer's control of its receipt is subject to substantial limitations or restrictions." *Id.*

determining when income will be taxable. In Rev. Rul. 60-31, the Service limited the application of this doctrine to situations where the employer was ready, willing and able to pay the compensation to the employee, but payment was not made due to the employee's failure to request such compensation.<sup>69</sup> The taxpayer could not deliberately turn his/her back on the receipt of income and postpone the tax year for inclusion of income.<sup>70</sup> The two key elements in the constructive receipt doctrine focus on whether the employee's right to receive the deferral is restricted and whether he/she is able to exercise choice regarding the timing of the benefits.<sup>71</sup>

### *Timing of the Deferral under the Constructive Receipt Doctrine*

Timing rules under the constructive receipt doctrine are relevant for executive compensation plans that are designed as "salary reduction" plans or supplemental plans, permitting employee *elections* to defer a set percentage of current or supplemental compensation. The constructive receipt doctrine requires that an employee's *election* to defer compensation be made in a "timely" fashion. The Service has long maintained that the election to defer must be made *before* the period of service that involves the rendering of services.<sup>72</sup> In this regard, the "period of

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69. Rev. Rul. 60-31, 1960-1 C.B. 174, *modified by* Rev. Rul. 64-279, 1964-2 C.B.121, is the cornerstone ruling by the Service regarding the doctrine of constructive receipt, in which it states "[u]nder the doctrine of constructive receipt, a taxpayer may not deliberately turn his back upon income and thereby select a year for which he will report it . . . [n]or may a taxpayer, by private agreement, postpone receipt of income from one tax year to another." *Id.* In addition, constructive receipt applies to the employee when "the money was available to him, that the corporation was able and ready to pay him, that the right to receive was not restricted, and that his failure to receive resulted from exercise of his own choice." *Id.*

70. *See* Childs v. Comm'r, 103 T.C. 634, 654 (1994), *aff'd per curiam* 89 F.3d 856 (11th Cir. 1996) (stating "[u]nder the constructive-receipt doctrine, a taxpayer recognizes income when the taxpayer has an unqualified, vested right to receive immediate payment."). "Generally, there must be an amount that is immediately due and owing that the obligor is ready, willing, and able to pay. The amount owed must either be credited to the taxpayer or set aside for the taxpayer so that the taxpayer has an unrestricted right to receive it immediately, and the taxpayer being aware of these facts, decides to accept the payment" *Id.* *See also* Bank of Chattanooga v. Comm'r, 29 B.T.A. 63, 67 (1933); Basila v. Comm'r, 36 T.C. 111, 116 (1961); Young Door Co., E. Div. v. Comm'r, 40 T.C. 890, 894 (1963).

71. In 1978, the Service attempted to reverse its ruling on constructive receipt by proposing regulations that would subject an employee's election to defer compensation, regardless of whether the election was made irrevocably prior to the date of service, to taxation. Due to the public response, Congress prohibited the Service in the Tax Reform Act of 1978 from altering the constructive receipt rules in effect on February 1, 1978 for taxable entities. Revenue Act of 1978, Pub. L. No. 95-600, § 132, 92 Stat. 2763 (1978).

72. *See* Veit v. Comm'r, 8 T.C. 809, 816 (1947), *acq.*, 1947-2 C.B. 4 (stating

service" refers to the tax year of the employee, which is generally the calendar year.<sup>73</sup> As discussed below, the courts have taken a less restrictive approach, permitting deferral elections *after* the rendition of services provided that the employee does not yet have an unfettered right to receive the compensation.

In *Veit v. Commissioner* ("Veit I"),<sup>74</sup> the Tax Court held that a parties' *subsequent* agreement to change the date of distribution for deferred compensation could be made without causing the monies to be constructively received. Under an original salary agreement made at the beginning of 1939, Veit agreed that a portion of his compensation would be determined using company profits for 1939 and 1940 and subsequently paid in 1941.<sup>75</sup> In November of 1940, the parties agreed to defer the 1940 portion until 1942. As of that time, the amount of Veit's share in the 1940 profits was not yet ascertainable, nor available for withdrawal.<sup>76</sup> The Tax Court rejected the Service's application of constructive receipt for the 1941 tax year as the parties had entered into an arm's length contract prior to 1941 to defer Veit's share of the 1940 portion.<sup>77</sup> According to the court, to apply the constructive receipt doctrine in 1941 to Veit would require it to hold that the subsequent agreement between the parties was "a mere subterfuge and a sham for the purpose of enabling petitioner to postpone his income tax . . . to another year."<sup>78</sup> Due to the bona fide agreement between both parties, the court affirmed the delay of taxation of such amounts until actually received.

In a similar case, *Oates v. Commissioner*, the Tax Court did not agree with the Service's application of the constructive receipt doctrine as the parties entered into a similar *subsequent* agreement that altered the mode of distribution.<sup>79</sup> In that case, several insurance agents (including Oates) agreed to the payment of deferred compensation based on renewal commissions in varying amounts from 1944 through 1946.<sup>80</sup> The employer later

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the Service maintained that the taxpayer's initial decision regarding the timing for payment of future benefits had to be made prior to the rendition of any services.). In that case, the agreement had originally provided that a portion of the 1940 profits would be paid in 1941 to the taxpayer; however in November 1941, the parties agreed to a subsequent deferral of payment until 1942. *Id.* See also Rev. Proc. 71-19, 1971-1 C.B. 698 and Rev. Proc. 92-65, 1992-2 C.B. 428.

73. Rev. Proc. 92-65, 1992-2 C.B. 428.

74. 8 T.C. 809, 818 (1947), *acq.*, 1947-2 C.B. 4.

75. *Id.* at 810-11.

76. *Id.* at 815.

77. *Id.* at 816.

78. *Id.*

79. 18 T.C. 570, 584-85 (1952), *aff'd* 207 F.2d 711 (7th Cir. 1953), *acq.* 1960-1 C.B. 5.

80. *Id.* at 582 (paying renewal commissions in the amount of \$33,174.98 in 1944, \$60,754.62 in 1945 and \$41,858.80 in 1946).

amended the plan, with the consent of the agents' association, to permit the agents to make an irrevocable election in 1944 to stay under the original distribution scheme or to take the deferrals in the form of \$1,000 over 180 months.<sup>81</sup> The Service attempted to impute income to Oates, a cash basis taxpayer, who had elected for the extended payment scheme, on the *full* amount of the commissions during the years 1944, 1945 and 1946, in lieu of the actual payments received over the 180 months.<sup>82</sup> The Tax Court rejected the Service's application of the constructive receipt doctrine and affirmed the parties' subsequent alteration of the contract in 1944 to alter the distribution scheme.<sup>83</sup> The Service subsequently acquiesced to the *Veit I* and *Oates* decisions, noting that the subsequent elections to change the timing of benefits were made before the benefits were ascertainable or pursuant to a bona fide contract between the parties.<sup>84</sup>

Two other constructive receipt cases subsequently followed *Veit I* and *Oates*, in which the Service's position was not affirmed by the Tax Court. In the case of *Martin v. Commissioner*,<sup>85</sup> executives who were participants of a deferred compensation created in the 1960's and 1970's were given the option of exchanging benefits under that plan with benefits under a new "shadow" stock plan. The new plan offered the choice between lump sum or annuity form of payment at retirement. Several of the executives switched to the new stock plan, elected the annuity form of payment and retired. Because the executives were provided the choice between a lump sum and annuity form under the new plan, the Service held that they were in constructive receipt of the lump sum amount. The Tax Court disagreed, dismissing the application of the constructive receipt doctrine where the deferred compensation plan has been superseded by a subsequent bona fide plan.

In *Veit v. Commissioner* (known as "*Veit II*"), the Service focused on a two-year contract entered into during 1939 between the parties for the payment of compensation based on profits, and the 1940 portion of profits would be payable in 1942.<sup>86</sup> By the end of 1940, the 1940 profits were ascertainable. Then in December 1941, the parties agreed to pay the 1940 profits in five annual installments instead of two payments in 1942. The Service held that the 1940 profits were constructively received in full in 1942 as the subsequent agreement to extend the deferral period was entered into just five days before the end of the 1941 tax year

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81. *Id.* at 583-84.

82. *Id.*

83. *Id.* at 584.

84. *See supra* notes 74 and 79.

85. 96 T.C. 814 (1991).

86. 8 T.C.M. 919, 922 (1949).



when the amounts were ascertainable. The Tax Court disagreed, noting that under the existing arrangements Veit did not have the power to demand or withdraw the full amount of the 1940 profit in 1942, and therefore were not in constructive receipt of such amounts.<sup>87</sup>

The Service did not acquiesce to the *Martin* and *Veit II* decisions, but recognized that its position in those cases (i.e., that compensation cannot be deferred once it has been earned) would not be defensible in light of the Tax Court cases.<sup>88</sup> The Service continues to enforce its position (regarding the *timing* of the voluntary election) in the context of plans requesting a favorable private letter ruling.<sup>89</sup> In the first of two revenue procedures on the issue, the Service stated that any election to defer receipt of compensation "must be made before the beginning of the period of service for which the compensation is payable . . ." in order to obtain a favorable ruling.<sup>90</sup> In its second revenue procedure, the Service inserted the word "generally" into this requirement, raising in the minds of practitioners whether a deferral election could be altered during the tax year but only with respect to compensation earned from services *after* the election.<sup>91</sup> Due to the adverse Tax Court rulings, the Service has not litigated in this area, resulting in some ambiguity for employers drafting the terms of executive deferred compensation plans.

### *Salary Deferral Elections*

At the same time as the issuance of Rev. Proc. 71-19, the Service was also grappling as to whether salary deferral elections made by employees, under either a qualified or a nonqualified plan, should be taxed at the time of the deferral as opposed to the actual time of receipt. By 1978, the Service issued proposed regulations under I.R.C. section 61 which would have imposed *immediate* taxation on any salary deferrals made pursuant to an

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87. *See id.* (noting "... there was never a time when the [amount] was unqualifiedly subject to petitioner's demand or withdrawal.")

88. *See* Gen. Couns. Mem. 35,196 (Jan .16, 1973) (stating that "[t]he position of the Service has generally been that income cannot be deferred once it has been earned . . .") "It is questionable whether the Service could defend such a position in litigation . . . Based on these cases and the long standing acquiescence, it cannot be stated that a deferral of compensation is only valid if entered into before the performance of services." *Id.*

89. Rev. Proc. 71-19, 1971-1 C.B. 698, *as amplified* by Rev. Proc. 92-65, 1992-2 C.B. 428.

90. *Id.* at § 10.05 (permitting two exceptions to the general rule: (1) in the year the plan is established, a participant may make an election to defer compensation for services rendered after the election and within 30 days of the plan's effective date and (2) in the first year of eligibility, a participant may elect to defer compensation for services performed subsequent to the election and within 30 days after reaching eligibility).

91. Rev. Proc. 92-65, 1992-2 C.B. 428.

employee's *voluntary* election.<sup>92</sup> Such rule would be applicable regardless of whether the deferral was subject to a substantial risk of forfeiture.<sup>93</sup> *If such proposal had been finalized, executive compensation plans funded through employee deferrals would be nonexistent today.*

Congress' reaction to these proposed regulations was swift, specifically affirming the use of elective deferrals under qualified plans through the addition of I.R.C. section 401(k)<sup>94</sup> and stating that the taxation of income under nonqualified deferred compensation plans would be governed by the principles set forth in regulations, rulings, and judicial decisions that were in effect on February 1, 1978.<sup>95</sup> This legislative directive has resulted in a moratorium on the Service's issuance of rulings in the constructive receipt area, even though that topic has not been listed as a no-ruling area of interest.<sup>96</sup> Absence of formal guidance from the Service has resulted in host of creative methods to test the use of the constructive receipt doctrine in executive deferred compensation plans. If Congress wishes the Service to regulate more broadly in this area, it should lift this moratorium and direct the Service to issue guidance to stem the abuses in this area.

#### *Substantial Risk of Forfeiture under the Constructive Receipt Doctrine*

The Service makes an *exception* to its constructive receipt rules; thereby permitting elections to be made *after* the beginning of the performance of services *provided* the deferral is subject to a "substantial risk of forfeiture."<sup>97</sup> Such risk must impose "a significant limitation or duty" on the expected payment to the employee (e.g., continued employment with the employer for at least two years).<sup>98</sup> If the payment is subject to forfeiture due to a

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92. See Prop. Treas. Reg. § 1.61-16, 43 Fed. Reg. 4638 (February 3, 1978) (stating that "payment of an amount of a taxpayer's basic or regular compensation fixed by contract, statute, or otherwise (or supplements to such compensation, such as bonuses, or increase in such compensation) is, at the taxpayer's individual option, deferred to a taxable year later than that in which such amount would have been payable but for his exercise of such option, the amount shall be treated as received by the taxpayer in such earlier taxable year."). "For purposes of this paragraph, it is immaterial that the taxpayer's right in the amount payment of which is so deferred become forfeitable by reason of his exercise of the option to defer payment." *Id.*

93. *Id.*

94. Revenue Act of 1978, Pub. L. No. 95-600, § 131, 92 Stat. 2763 (1978).

95. *Id.* at § 132.

96. See, e.g., Rev. Proc. 99-3, 1999-1 I.R.B. 103.

97. Rev. Rul. 60-31, 1960-1 C.B. 174, *modified by* Rev. Rul. 64-279, 1964-2 C.B. 121. See also *Childs v. Comm'r*, 103 T.C. 634, 654 (1994), *aff'd per curiam* 89 F.3d 856 (11th Cir. 1996).

98. I.R.C. § 83(c)(1), 26 U.S.C. § 83(c)(1) (2000), and Treas. Reg. § 1.83-3(c)(1).

specific event (e.g., subsequent employment with a competitor), such event must be a definite and realistic possibility.<sup>99</sup> This determination is a question of fact.<sup>100</sup> Under the Service's proposed regulations under I.R.C. section 61 which were repudiated by Congress, voluntary deferrals of salary would be subject to *immediate* taxation regardless of whether the deferral was subject to a substantial risk of forfeiture.<sup>101</sup> If Congress lifts the moratorium on the Service's issuance of constructive receipt guidance, it is not anticipated that the Service would attempt to tax voluntary deferrals of salary under executive compensation plans that were subject to a substantial risk of forfeiture.

The use of forfeiture provisions may be limited depending on the type of executive deferred compensation plan under examination. If the executive is electing to defer current or supplemental compensation that has *already been earned*, it was quite unlikely that the executive would be willing to agree to a subsequent forfeiture of such earned income. However, the use of forfeiture provisions may be quite useful in SERP-type arrangements that are funded through employer contributions, not employee elections. Subjecting executive deferred compensation to continued employment and/or to performance under specific criteria may be beneficial to the employer and avoids current taxation to the executive as it represents a substantial risk of forfeiture. Forfeiture of a valuable right to payment is also considered a substantial limitation for constructive receipt purposes.<sup>102</sup> This latter example is best understood in the context of a stock appreciation right plan that is not within the scope of this article.<sup>103</sup>

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99. See Rev. Proc. 71-19, 1971- 1 C.B. 698, as amplified by Rev. Proc. 92-65, 1992 - 2 C.B. 428, (stating "[a] substantial forfeiture will not be considered to exist unless its conditions impose upon the employee a significant limitation or duty which will require a meaningful effort on the part of the employee to fulfill and there is a definite possibility that the event which will cause the forfeiture could occur").

100. See *Childs v. Comm'r*, 103 T.C. 634, 654 (stating that "[t]he doctrine of constructive receipt is essentially a question of fact.>").

101. See *supra* note 92.

102. Rev. Rul. 80-300, 1980-2 C.B. 165.

103. See *id.* (examining whether an employee's stock appreciation right ("SAR") under an executive deferred compensation plan resulted in constructive receipt when the employee had the opportunity to exercise the right or when the employee actually exercised the right and ruling that the employee was not in constructive receipt of his SAR until he actually exercised such right, as the *exercise* resulted in a forfeiture of his rights to obtain future appreciation of the stock and thus constituted a substantial risk of forfeiture). It is not known whether the Service would render a similar conclusion if the employee's deferred benefit was cash but was structured to fluctuate based on market indicators or designated investments. One could argue that the employee was not in constructive receipt of such benefits until he/she requests the distribution, which would then forego the right to any future appreciation

From the Service's perspective, the use of possible forfeiture provisions may seem to be infinite depending on the employer in question (e.g., non-compete clauses, availability of consultation, continued employment, etc.) and therefore problematic in formulating a set of concrete rules. Coupled with Congress' imposed moratorium, the Service has had little desire to promulgate new rules or litigate in this area.

For executives who are controlling shareholders of the employer, the Service will not issue an advance ruling for executive deferred compensation plans using forfeitures for such individuals, as the employee's control of receipt of monies is not realistically subject to substantial risk of forfeiture.<sup>104</sup> Again, the Service's position has not met with an enthusiastic response from the courts. The Second Circuit will not automatically presume the corporation and the shareholder as a single entity, thereby permitting discussion as to whether the shareholder-executive could have acted independently from its employer.<sup>105</sup>

Obviously, situations such as Enron, where the executives were not necessarily controlling shareholders but certainly were insiders, cause concern for Congress as such individuals undoubtedly were in a position to take advantage of any distribution provisions that were available under their covered executive compensation plans. By bestowing greater regulatory authority to the Service, rules dealing with insider executives could be addressed.

#### *Withdrawal Rights under the Constructive Receipt Doctrine*

In enunciating the doctrine of constructive receipt, the Service has focused on whether the taxpayer has an unrestricted right to receive the monies.<sup>106</sup> Clearly, the executive's *unfettered right to withdraw monies* from an executive deferred compensation plan would result in immediate taxation. What withdrawal rights short of an unfettered right would be permissible? As the constructive receipt rule focuses on the employee's exercise of control, the Service has permitted premature withdrawals in the

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of the market or the designated investments.

104. Rev. Proc. 2001-3, 2001-1 I.R.B. 111, § 3.01(34). See Also Rev. Rul. 72-317, 1972-1 CB. 128 (holding that the controlling shareholder/employee was in constructive receipt of deferred salary payments due to his power to distribute salary as he saw fit).

105. Casale v. Comm'r, 247 F.2d 440 (2d Cir. 1957); Congleton v. Comm'r, 38 T.C.M. (CCH) 584 (1979).

106. See Rev. Rul. 60-31, 1960-1 C.B. 174, 178, *modified by* Rev. Rul. 64-279, 1964-2 C.B. 121 (limiting the application of the constructive receipt doctrine to cases where "the money was available to him, that the corporation was able and ready to pay him, that the right to receive was not restricted, and that his failure to receive resulted from exercise of his own choice."). See also Rev. Rul. 70-435, 1970-2 C.B. 100.

event of “unforeseeable emergencies”<sup>107</sup> and will advance a private letter ruling for such withdrawals under an executive deferred compensation plan.<sup>108</sup> Such emergencies must be caused by an event that is outside the control of the employee and would result in severe financial hardship to the employee if not granted.<sup>109</sup> This hardship withdrawal feature appears similar, but not identical, to the one used in section 401(k) plans and is fairly restrictive in nature.

The Service has also consented to the use of *certain events* (commonly seen in qualified plans) that may be used under the terms of an executive deferred compensation plan as triggering events for the employee to receive or otherwise accelerate payments under the plan, without resulting in any premature taxation until the actual time of payment. In Rev. Rul. 60-31, the Service approved of the use of the following events for the employee to access payment of benefits: attainment of a certain age; partial or total incapacitation; performance of services for a certain period of time; termination of employment; or, change from

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107. See Rev. Proc. 92-65, 1992-2 C.B. 428, § 3.01(c) (stating that an “[u]nforeseeable emergency must be defined in the plan as an unanticipated emergency that is caused by an event beyond the control of the participant or beneficiary and that would result in severe financial hardship to the individual if early withdrawal were not permitted.”). The plan must further provide that any early withdrawal approved by the employer is limited to the amount necessary to meet the emergency.” Compare with Treas. Reg. § 1.401(k)-1(d)92(iv)(A) (permitting hardship distributions for a dependent’s college expenses or a homeowner’s purchase expenses) with Treas. Reg. § 1.457-2(h)(4) (prohibiting distributions for college and home situations).

108. See Priv. Ltr. Rul. 90-31-024 (May 7, 1990) (reviewing regulation 1.451-2(a) for the proposition that income is constructively received, and taxable, in the year it is credited to the taxpayer’s account, set apart for the taxpayer, or “otherwise made available so that the taxpayer may draw upon it at any time or could have drawn upon it during the taxable year if notice of intention to withdraw had been given”); Priv. Ltr. Rul. 88-47-054 (Nov. 25, 1988) (allowing payments of benefits under plan in the case of an “unforeseen emergency,” such as a “severe medical emergency which creates a severe financial hardship that cannot reasonably be relieved by insurance or the participant’s personal resources”); Priv. Ltr. Rul. 83-33-036 (May 16, 1983) (defining “unforeseen emergency” as a “severe financial hardship resulting from events beyond the control of the participant”); Priv. Ltr. Rul. 85-27-039 (Apr. 18, 1985) (concluding that participants of an unfunded deferred compensation plan need not report deferred amounts until the taxable year(s) when the amounts are actually paid or otherwise made available).

109. See § 3 Rev. Proc. 92-65, 1992-2 C.B. 428 (stating that the Service relies on the Treas. Reg. § 1.457-2(h)(4) in defining severe financial hardship “resulting from a sudden and unexpected illness or accident of the participant . . . arising as a result of events beyond the control of the participant.”). Compare Treas. Reg. § 1.401(k)-1(2)(iv)(A) (permitting hardship distributions for a dependent’s college expenses or a homeowner’s purchase expenses) with Treas. Reg. § 1.457-2(h)(4) (prohibiting distributions for college and home situations).

full-time to part-time employment.<sup>110</sup> The Service views these limitations on receipt of income as *substantial* and thus has decided not to impose the doctrine of constructive receipt. As the doctrine focuses on the “will and control of the taxpayer” in receiving the compensation, triggering events that are *outside the control* of the employee should limit which events are permissible.<sup>111</sup> Given the necessary authority to act, the Service may certainly decide to limit the list of triggering event for insiders and controlling shareholders.

#### *Application of the Economic Benefit Doctrine*

While the constructive receipt doctrine assumes that the taxpayer is in receipt of income but narrows its focus as to *when* (i.e., its timing) such income is received, the economic benefit doctrine focuses on whether the taxpayer has any ownership or other “economic benefits” in property (i.e., something with property rights) that should warrant any taxation at all (i.e., property rights).<sup>112</sup> Thus, it clearly looks at *property* that the taxpayer may have an interest in or has received in connection with the executive deferred compensation plan. Property exists for this purpose if the employee is conferred an economic benefit that is equivalent to cash.<sup>113</sup> According to the Supreme Court, I.R.C. section 61 “is broad enough to include in taxable income any economic or financial benefit conferred on the employee as compensation whatever the form or mode.”<sup>114</sup>

In the context of executive compensation plans, the issue then becomes whether an employer’s promise to pay future benefits is

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110. Rev. Rul. 60-31, 1960-1 C.B. 174, *modified by* Rev. Rul. 64-279, 1964-2 C.B.121.

111. *See* *Furstenberg v. Comm’r*, 83 T.C. 755, 791 (1984) (stating that “[t]he doctrine of constructive receipt is based on the principle that income is received by cash method taxpayers ‘when it is made subject to the will and control of the taxpayer. . .’” (quoting *Loose v. United States*, 74 F.2d 147, 150 (8th Cir. 1934)). *See also* Treas. Reg. § 1.451-2(a) (explaining the constructive receipt doctrine taxes the individual when the income “is made subject to the will and control of the taxpayer” and indicating that the use of a triggering event that imposes a material limitation or restriction of the employee would not result in the application of constructive receipt).

112. *See* *Comm’r v. Smith*, 324 U.S. 177, 181 (1945) (noting that the use of the economic benefit doctrine would eliminate any distinction between a cash-method versus accrual-method taxpayer if the value of a mere promise to pay future benefits could be valued and taxable currently to a cash-basis taxpayer).

113. *See* *Sproull v. Comm’r*, 16 T.C. 244, 247 (1951) *aff’d per curiam*, 195 F.2d 541 (6th Cir. 1952) (applying the economic benefit doctrine where the employer placed assets in an interest bearing trust for the benefit of an employee, which was not subject to any risk of forfeiture and therefore would be paid to the employee).

114. *See supra* note 112.

an economic benefit subject to current valuation and therefore subject to immediate taxation. If such issue was determined *solely* on the basis of economic grounds, certain employer's (e.g., IBM, GM) mere promise to pay future benefits could certainly be valued and taxable, whereas another employer's promises (e.g., Ma and Pa's grocery store) may not be readily ascertainable and therefore not taxable. The Service decided not resort to a pure economic analysis for this purpose but instead to a more black-and-white rule, holding that *any* employer's mere promise to pay future deferred benefits is not property for this purpose.

In the case of *Minor v. United States*,<sup>115</sup> the court applied the economic benefit doctrine by asking whether the plaintiff (Dr. Minor) had the current right to receive a future benefits which were subject to current valuation. In order for the doctrine to be utilized, the court stated that (1) the employer's promise must be "capable of valuation," and (2) if so valued, the employee's interest had to be nonforfeitable and secured against the employer's creditors.<sup>116</sup>

In the context of executive deferred compensation plans that are the premise of this article, the economic benefit doctrine is not applicable. It does become relevant if the employer decides to purchase specific assets in connection with the executive deferred compensation plan (e.g., annuity contracts or insurance policies) or to contribute assets to a trust for the benefits of the executives. Under this doctrine, benefits under an executive deferred compensation plan become immediately taxable to the executive only if the plan is funded, such that rights in a funding asset or vehicle are transferred to the executive and the executive's interest in such funds is vested.<sup>117</sup> The economic benefit theory then applies because vested amounts have been irrevocably set aside with a third party for the benefit of the executive. No longer are the promises tied to the employer's mere promise to pay (i.e., assets have been set aside) and such promises are secured for the benefit of the executive and not the employer's creditors. If the funding of such plan involves contributions to a *trust* (nonqualified or not) for the benefit of an employee, such deferrals are also subject to the rules of I.R.C. section 402(b).<sup>118</sup> Thus, to avoid any current income tax consequences, the executive's promise for deferred compensation benefits must remain an *unsecured* promise of the employer's, subject to the claims of its creditors.

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115. 772 F.2d 1472 (9th Cir. 1985).

116. *Id.* at 1474 (citing Rev. Rul. 60-31, 1960-1 C.B. 174, 179).

117. *Sproull v. Comm'r*, 16 T.C. 244, 247-48 (1951), *aff'd* 194 F.2d 541 (6th Cir. 1952) and Rev. Rul. 60-31, 1960-1 C.B. 174, *modified by* Rev. Rul. 64-279, 1964-2 C.B. 121, Situation 4.

118. 26 I.R.C. § 402(b) (2000).

### *Application of the Vested Accrued Benefit Rules*

If the executive's deferred compensation plan has escaped funding and taxation thus far, the vested accrued benefit rules of I.R.C. section 402(b) are not applicable. The Service has applied I.R.C. section 402(b) when the employer utilizes a non-exempt trust for an underlying deferred compensation plan and then contributes to the trust for the payment of the promised vested benefits.<sup>119</sup> I.R.C. section 402(b)(1) requires that such amounts be treated as gross income in accordance with the rules of I.R.C. section 83.<sup>120</sup> If the amounts are determined to be property within the meaning of I.R.C. section 83, the tax rules of I.R.C. section 402(b) tax the covered employees on the increase in the value of the "vested accrued benefit" under the trust, as opposed to the employer contributions to the trust.<sup>121</sup>

Thus, if the executive's interest under an executive deferred compensation plan is not regarded as property for Code § 83 purposes (*i.e.*, subject to substantial risk of forfeiture or nontransferable),<sup>122</sup> it will not be taxable for I.R.C. section 402(b) purposes.

### *Application of the Various Tax Rules to Popular Executive Compensation Plans*

Following this introduction to taxation rules, the remainder of this article will review the various popular forms of executive compensation plans and discuss which tax rules are applicable. Let's start with the most basic type of executive deferred compensation benefit, and then add various layers of security for the executive, examining the resulting tax consequences. Under an executive deferred compensation plan where the executive has *only* an unfunded and unsecured promise from the employer to pay compensation at some future date in time, no current taxation results to the executive until the actual receipt of income. The unfunded and unsecured promise to pay benefits has been deferred, generally to a future date (e.g., death, disability, retirement). An employer's mere promise to pay deferred benefits is not funded as no assets are set aside for the executive, and is

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119. Rev. Rul. 57-37, 1957-1 C.B. 18, *modified by* Rev. Rul. 57-528, 1957-2 C.B. 263. *But see* Philip R. Bosco, *Rulings: Secular Trusts, Rabbi trusts, S-Corporation FICA, and Revised Per Diem*, 5 BENEFITS L. J. 2, 271 (1992) (commenting that some employee benefits practitioners have questioned the Service's use of I.R.C. § 402(b) to secular trusts, noting that its application should be confined solely to Section 401(a) tax-exempt trusts that later lose their tax-exempt status).

120. 26 U.S.C. § 402(b)(1) (2000).

121. *See id.* (stating that "the value of the employee's interest in the trust shall be substituted for the fair market value of the property").

122. I.R.C. § 83(a)(1) (2000).



not secured if its payment is subject to the claims of the employer's creditors. An unfunded and unsecured promise to pay from the employer is not taxable under either the constructive receipt nor economic benefit rule. Neither has any property been transferred to the executive, making I.R.C. sections 83 and 402(b) also inapplicable.

Now let's start adding various levels of security for the executive and test whether such assurances change the applicable taxation of the executive's deferred benefits.

**RIGHT OF WITHDRAWAL:** The first layer of security that an executive may wish to add to this unfunded and unsecured promise is the right to receive "premature" withdrawals in advance of the future date of expected payment. While the Service permits voluntary withdrawals for "unforeseeable contingencies," such a right must be conditioned upon hardship and is narrowly applied. Could the *employer* have discretion as to the timing and manner of distribution? While the Service initially approved of such a provision without any adverse tax consequences to the executive, it later retreated from that position.<sup>123</sup> In a revenue procedure issued in 1992, the Service now requires the employer to provide a formula or instructions under the terms of the plan if distributions are subject to earlier withdrawals.<sup>124</sup>

However, if the executive and the employer wish to permit greater withdrawal rights under the plan such that the executive can voluntarily accelerate the payment of the deferrals to an earlier date, the Service requires that the withdrawal right be restricted or conditioned upon the occurrence of certain triggering events.<sup>125</sup> The executive's unfettered right to withdraw deferred benefits would result in constructive receipt, thereby taxing him/her as if the payments were actually made, even though he/she chose not to actually take the money.<sup>126</sup>

In Rev. Rul. 60-31 discussed earlier, the Service approved of a variety of triggering events for purposes of accelerating the payment of deferrals with no adverse tax consequences for the executive: attainment of a certain age; becoming partially or totally incapacitated; completion of a certain period of service; termination of employment; and reduction in hours worked from

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123. See Priv. Ltr. Rul. 87-39-031 (June 29, 1987) (permitting the employer under a rabbi trust agreement discretion as whether to distribute the executive's benefit in a lump sum or a 10-year installment). This ruling was later modified by Priv. Ltr. Rul. 88-30-069 (May 5, 1988).

124. Rev. Proc. 92-64, 1992-2 C.B. 422.

125. Treas. Reg. § 1.451-2(a) (2002).

126. See *Non-qualified Plans Discussed by IRS Official*, RIA EXECUTIVE COMPENSATION & TAX'N COORDINATOR, Jan. 1996, at 6 (indicating that the mere existence of certain triggering provisions may cause the executive to have immediate taxation).

full-time to part-time.<sup>127</sup> In a series of private letter rulings, the Service expanded this list of triggering event to include change of control of the employer;<sup>128</sup> decrease of employer's net worth below \$10 million;<sup>129</sup> or employer's liquidation.<sup>130</sup>

Under the constructive receipt and economic benefit doctrine, such arrangement avoids any immediate tax to the executive as such events are presumed to be outside the control of the executive. Although an executive's termination of employment or retirement may very well be within his/her control, the presumption is that the executive would not terminate his/her employment simply to trigger payment under the plan. If the triggering event occurs and payment is required by the employer to the executive, the executive owes income tax only at the time of *actual* receipt of the payments.

The Enron scandal certainly highlights whether the use of "triggering events" in executive compensation plans should be modified in the context of an executive who is an insider.<sup>131</sup> The actions of certain Enron executives highlight the fallacy of presuming that an insider would not terminate employment

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127. See Rev. Rul. 60-31, 1960-1 C.B. 174, *modified by* Rev. Rul. 64-279, 1964-2 C.B. 121 and Rev. Rul. 70-435, 1970-2 C.B. 100.

128. See Priv. Ltr. Rul. 95-08-014 (Nov. 22, 1994) (permitting the acceleration of benefit payment upon "the voluntary termination of the plan by a corporate successor"); Priv. Ltr. Rul. 92-04-012 (Oct. 23, 1991) (describing plan that provided for the payment of retirement benefits upon participant's death, total disability or termination of employment resulting from retirement or change in control); Priv. Ltr. Rul. 87-46-052 (Aug. 19, 1987) (permitting payments after an involuntary termination following a change of control); Priv. Ltr. Rul. 84-18-095 (Jan. 31, 1984) (allowing deferrals to become immediately payable upon a change of control).

129. See Priv. Ltr. Rul. 95-08-014 (Nov. 22, 1994) (permitting a trigger for the plan if "the Company's net worth falls below \$10,000,000").

130. See Priv. Ltr. Rul. 84-35-031 (May 24, 1984) (authorizing, "[i]n the event that the employer is liquidated, pursuant to a transaction whereby no successor corporation assumes the assets and liabilities of the Employer, the entire value of the [deferral] is to be paid to the Employee . . . in one lump sum").

131. See Tech. Adv. Mem. 8828004 (Apr. 12, 1988) (applying the constructive receipt doctrine in the context of a controlling shareholder).

A taxpayer who is a controlling shareholder . . . is in a position to direct the corporation to do his bidding. He may at anytime modify the terms of the deferral agreement, accelerate payments, or direct that any assets held by the corporation to provide funds to pay its obligations under the agreement be immediately distributed to the employee (himself). In reality, there is nothing standing between the taxpayer and the income. It is available at will. . . Taxpayer here . . . possessed the full power to transfer full ownership of the annuity contract to himself whenever he wished, to change the investment, or to accelerate payments under the plan. The deferred amounts were available to him so that he could have drawn upon them at any time.

*Id.*

simply to accelerate payment under an executive compensation plan. Given their particular inside knowledge about the employer's actual financial health, losing one's employment was far more economically preferable to losing all executive deferred compensation benefits. Should the employer later become bankrupt (as was the case with Enron), there is a "look back" provision under the bankruptcy rules for payments made to insiders within one year of bankruptcy.<sup>132</sup> Normally, the bankruptcy trustee may recover transfers of property made by the employer within 90 days of bankruptcy in order to restore the bankruptcy priority rules.<sup>133</sup> However, in the case of a transfer of property to an *insider* (including cash payments), the 90-day period is extended to one year.<sup>134</sup> State fraudulent conveyance laws also support a similar approach, but vary on the time-period used to reach "fraudulent" transfers.<sup>135</sup> These bankruptcy rules treat certain payments to executives as preferential transfers, and therefore, voidable. Such amounts may then become subject to receivership by the bankruptcy courts. However, to the extent such distributions were widespread among the insider executives and already spent by such insiders, the look-back protection is simply illusory.

In the case of Enron, cash withdrawals from deferred compensation plans were made to executives in October and November, 2001, just weeks before Enron's December 2, 2001, filing for bankruptcy.<sup>136</sup> Therefore, the bankruptcy courts should have no problems treating these withdrawals as voidable and using the proceeds for Enron creditors. It is not clear, however, whether cash withdrawals from deferred compensation plans were made in 2000 to Enron executives, which would escape the reach of the bankruptcy courts.

The Service has ruled that it will not issue an advance ruling to executive compensation plans using triggering events to

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132. 11 U.S.C. §§ 547(b) and 101(58) (2000). For a full discussion of applicability of the state fraudulent conveyance laws and federal bankruptcy laws see Denis A. Keleinfeld, *Administration of Trusts in Florida, Offshore Trusts*, Fla. Bar Ass'n 2001 at ch.15 (discussing the applicability of the state fraudulent conveyance laws and federal bankruptcy laws). See also *Bank of Am. N.A. v. Moglia (In re Outboard Marine Corp.)*, 278 B.R. 778 (N.D. Ill. 2002) (denying any priority interests for rabbi trust beneficiaries in the context of the employer's bankruptcy).

133. 11 U.S.C. § 547(b) (2000).

134. 11 U.S.C. § 101(58) (2000). See *id.* at § 101(31) (defining "insider").

135. 37 *Am. Jr. 2d Fraudulent Conveyances* § 1 (1968).

136. See *supra* note 13 (regarding news reports from the Houston Chronicle) and [http://www.enron.com/corp/pressroom/chapter\\_11/faq.html](http://www.enron.com/corp/pressroom/chapter_11/faq.html) (last visited Sept. 5, 2002) (noting the date of December 2, 2001 as the date of filing for bankruptcy in the twelfth question listed in the Frequency Asked Questions About Chapter 11 filing).

accelerate payment for *controlling shareholders*.<sup>137</sup> However, some cases and rulings indicate the application of the constructive receipt doctrine covering controlling shareholders depends upon the various facts and circumstances.<sup>138</sup> *None of the case law or rulings focus on whether the constructive receipt rules should be modified where the executive is an insider, perhaps assuming that the securities laws adequately deal with the issue.* However, the securities laws focus on insider trading of company stock and an employee's investment in employer stock, not necessarily on executive compensation plans that do not rely upon company stock as the underlying asset.<sup>139</sup> While securities law does require disclosure of executive and director compensation for publicly traded firms, it summarizes the compensation packages for at most five individuals and does not require the particulars of the executive deferred compensation packages to be explained.<sup>140</sup>

In light of the Enron scandal, it is not known whether the Service will revise the use of triggering events under the constructive receipt doctrine as providing a "substantial risk of forfeiture" to avoid current taxation. *The Service certainly has the regulatory authority to treat controlling shareholders and insiders similarly, as they both are in a position to use their unique knowledge about the employer for their own financial benefit.* If

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137. Rev. Proc. 96-3, 1996-1 C.B. 456, 461 § 3(30).

138. *Childs v. Comm'r*, 103 T.C. 634, 654 (1994), *aff'd per curiam* 89 F.3d 856 (11th Cir. 1996); *see also* Rev. Rul. 60-31, 1960-1 C.B. 174, 178, *modified* by Rev. Rul. 64-279, 1964-2 C.B. 121; Rev. Rul. 70-435, 1970-2 C.B. 100.

139. *See* 15 U.S.C. § 78(b) (2000) (referring to potential liabilities for officers, directors and 10% shareholders under the short swing profit provisions). While the SEC has refused to issue no-action letters for nonqualified deferred compensation since 1991, it had issued a number of favorable no-action letters regarding nonqualified deferred compensation plans. *See* Dean Witter Financial Services Inc. Deferred Compensation Plan SEC No-Action Ltr. (February 4, 1985), St. Paul Companies, Inc. SEC No-Action Ltr. (Feb. 25, 1988), and Wells Fargo & Company SEC No-Action Ltr. (May 5, 1986). *Compare* informal SEC comments at [http://www.crgworld.com/transcripts/chat\\_010718.html](http://www.crgworld.com/transcripts/chat_010718.html) (last visited Apr. 13, 2002) (noting its consideration of revising its historical position due to the changes in the design of nonqualified plans and the expansion of the number of employees participating in such plans). *See also* SEC Release No. 33-6188, *reprinted in* Maldonado, *Securities Law Aspects of Employee Benefit Plans*, 362 TAX MGM'T (BNA) at B-905, n.21 (Feb. 1, 1980) (requiring registration "only where a plan is both voluntary and contributory and invests in securities of the employer an amount greater than that paid into the plan by the employer") (emphasis in original). Thus, using employer stock as a benchmark to measure an executive's investment performance would not require registration of the plan.

140. *See* SEC Release No. 33-6962, *reprinted in* Kroll, *Deferred Compensation Arrangements*, 385-3rd TAX MGM'T (BNA), at B-1206 (requiring compensation information for the company's chief executive officer and the four highest paid individuals for the last completed fiscal year whose salary and bonus exceed \$100,000).

the determination of the constructive receipt doctrine in such contexts is dependent upon the facts and circumstances, this approach becomes difficult to administer. However, the Service could require that plans covering such individuals apply for an advance letter ruling; thereby conditioning the triggering events on certain criteria unique to the employer. Alternatively, Congress could simply mandate that certain triggering events (e.g., termination of employment, voluntary retirement, reduction from full-time employment to part-time employment) are simply not available to controlling shareholders and/or insiders as voluntary triggering events.

WITHDRAWALS, HOW MUCH: An alternative design to provide greater security to executives is to permit unlimited withdrawal rights for the executive under the deferred compensation plan but impose a substantial forfeiture upon the exercise of such withdrawal rights. Such penalties are commonly referred to as "hair cut" provisions (e.g., loss of 10% in one's account balance or suspension of future participation if a voluntary withdrawal is made).<sup>141</sup> The Service has issued some guidance in this area, but its rulings were confined to *qualified* plans. Before 1982, deferrals for participants under qualified plans were subject to the constructive receipt doctrine.<sup>142</sup> The Service routinely approved letter ruling requests for qualified plans that imposed a penalty (e.g., 5%, 6% or 10%)<sup>143</sup> or imposed a participation suspension, in

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141. See generally Rev. Rul. 55-423, 1955-1 C.B. 41; Rev. Rul. 80-157, 1980-1 C.B. 186.

142. See 26 U.S.C. § 402(a) (2000) (amending it to limit taxation to "amount[s] actually distributed"); see also Treas. Reg. § 1.402(a)-1(a)-(1) (2002) prior to the amendments made by the Economic Recovery Tax Act of 1981 ("ERTA"), Pub. L. No. 97-34, 95 Stat. 172 (1981).

143. See Priv. Ltr. Rul. 84-47-052 (Aug. 21, 1984) (affirming the use of a 6% penalty); see also Priv. Ltr. Rul. 82-41-017 (July 9, 1982) (affirming the use of a 5% penalty combined with a 12-month suspension from plan participation); Priv. Ltr. Rul. 81-23-097 (May 12, 1981) (affirming the use of a 6% penalty); Priv. Ltr. Rul. 81-07-013 (Nov. 1980) (affirming the use of a 6% "offset amount" in instances when the value being withdrawn exceeded participant's tax basis); Priv. Ltr. Rul. 80-37-056 (June 18, 1980) (affirming the use of a 6% penalty); Priv. Ltr. Rul. 80-26-043 (Apr. 2, 1980) (affirming the use of a 6% penalty); Priv. Ltr. Rul. 80-20-145 (Feb. 26, 1980) (using a 10% forfeiture penalty for withdrawals); Priv. Ltr. Rul. 80-10-076 (Dec. 13, 1979) (affirming the use of a 6% penalty); Priv. Ltr. Rul. 80-09-067 (Dec. 6, 1979) (affirming the use of a 6% penalty); Priv. Ltr. Rul. 79-25-108 (Mar. 23, 1979) (affirming the use of a 6% penalty); Priv. Ltr. Rul. 78-35-060 (May 31, 1978) (using the greater of 6% or \$50 forfeiture penalty for withdrawals); Priv. Ltr. Rul. 78-19-021 (Feb. 8, 1978) (using a 6% forfeiture penalty for withdrawals). *But see* Treas. Reg. § 1.451-2(a) (2002) (approving a penalty of 25% as a significant limitation for constructive receipt purposes). See Jennifer Roof, *Hair Cut Plans: A Viable Means for Executive Compensation Planning?*, 5 J. DEFERRED COMP. 2, 20 (2000) (discussing the use of hair cut provisions in nonqualified deferred compensation plans).

the event of a participant's voluntary withdrawal.<sup>144</sup> Nonqualified executive deferred compensation plans have adopted similar rules to avoid constructive receipt for executives who make premature withdrawals from those plans. Accordingly, executives' deferred compensation plans have been designed to give executives the right to withdraw any or all of their accrued benefit or account balance, provided that they forfeit a given percentage of those benefits and/or be suspended from future participation under the plan for some period of time.<sup>145</sup>

The Service has not explicitly authorized the use of hair cuts in an executive deferred compensation plan and will not issue an advance private letter ruling for an underlying trust funding such plan as such terms deviate from the exact language of their model trust.<sup>146</sup> If litigated, the question for the court is whether a forfeiture of a given percentage and/or suspension from future participation for a fixed period of time is an adequate "substantial limitation or restriction" to avoid the application of constructive receipt. Certainly an argument can be made that a 10% financial penalty may be a sufficient limitation as Congress has affirmed the use of a 10% premature tax penalty to dissuade early distributions from qualified plans.<sup>147</sup>

In the context of the Enron scandal, it appears that the underlying executive compensation plan used a hair cut penalty of 10% to permit premature withdrawals by its executives.<sup>148</sup>

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144. See Rev. 58-230, 1958-1 C.B. 204 and Priv. Ltr. Rul. 80-37-056 (June 18, 1980) (approving a six-month suspension) and Rev. Rul. 77-34, 1977-1 C.B. 276 (approving a 12-month suspension). The ABA Section of Taxation, Employee Benefits Committee, has recommended that the executive's right to withdraw benefits does not result in immediate constructive receipt if the withdrawal results in a financial penalty, suspension from participation in future deferrals for one year, or a combination of the two. See *A.B.A. Sec. Tax'n, Committee on Employee Benefits, Report on the Proposed Restatement of the Service's Procedural Guidance for the Issuance of Advance Rulings on the Application of the Doctrine of Constructive Receipt to Nonqualified Deferred Compensation Arrangements*, 50 TAX LAW. 217, 233 (1996).

145. William L. MacDonald, *Giving Your Rabbi Trust a "Haircut,"* AM. MGMT. ASS'N'S COMP. & BENEFITS REV. (May-June 1993), available at <http://www.rabbitrust.com/AMAarticle.html>. (last visited Sept. 6, 2002).

146. See § 4, Rev. Proc. 92-64, 1992-2 C.B. 422 (providing that a "request for a ruling must be accompanied by a representation that the trust conforms to the model trust language contained in this revenue procedure, including the order in which sections of the model trust language appear, and that the trust adopted does not contain any inconsistent language, in substituted portions or elsewhere, that conflicts with the model trust language").

147. See the legislative history regarding I.R.C. § 72(t) (2000), at H.R. Rep. No. 779, 93d Cong., 2d Sess. 116 (1974) (noting that 10% would "be a substantial deterrent to prevent an owner-employee from treating his retirement plan as a tax-free savings account from which he can withdraw prior to retirement").

148. See *supra* note 13 (regarding news reports from the Houston

Certainly hair cut penalties of 5% to 10% would be nominal forfeitures in light of a pending bankruptcy or insolvency where the executive stands to lose 100% of benefits due to creditors' preferences. While the bankruptcy courts may be able to reclaim some or all of these amounts, cash has been diverted from the company at the very time it was most needed. Due to the legislative moratorium, the Service may be unable to rule adversely on the use of hair cut penalties in executive compensation plans; however, requiring such plans which cover controlling shareholders and/or insiders to apply in advance for a ruling would provide an opportunity to review the actual penalties proposed under the plan. The author certainly recommends the use of a higher threshold penalty for controlling shareholders and/or insiders in order to make the forfeiture more meaningful.

*Adding Another Layer of Security: Securing the Assets  
(Rabbi Trusts)*

While the above rules provide greater access for executives to monies under executive deferred compensation plans, they do not protect the executive from other risks: (1) the employer's later "change of heart" (employer's refusal to pay benefits in bad faith or without cause); (2) the risk of later "cash flow" problems for the employer; (3) a change of control or potential change of control (announcement of a take-over bid) by a new employer, or (4) a change in the employer's financial condition. Executives have sought ways of "securing" against some or all of these risks without triggering adverse income tax consequences. Such security provisions must attempt to avoid the property rules of I.R.C. section 83 and the rules of I.R.C. section 402(b) governing employer contributions to non-exempt trusts.

The first Service private letter ruling addressing this issue provided assurances against the employer's later "change of heart," in the context of a trust established for a rabbi by his congregation.<sup>149</sup> The Service approved of the congregation's use of a trust for its rabbi (thereafter coined the "rabbi trust"), whereby employer assets could be set aside or segregated for the express

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Chronicle).

149. See Priv. Ltr. Rul. 81-13-107 (Dec. 31, 1980) (concluding that because the assets of the subject trust remained susceptible to creditors' claims and were not paid or made available to the rabbi, the funding of the trust would not be a taxable event to the rabbi). See also Gen. Couns. Mem. 39,230 (May 7, 1984) (permitting individual accounts to be established for the participants of the executive compensation plan under the terms of a trust, held by an unrelated bank, where the trust remained subject to the claims of creditors). Thereafter, the Service suspended rulings on rabbi trusts as it and the DOL were studying the issue of as what constitutes "funding" for ERISA and Code purposes.

purpose of satisfying its obligations under the executive deferred compensation plan, securing that the monies would be there when promised. However, the assets in the rabbi trust had to be available to the employer's creditors in the event of bankruptcy or insolvency; if such creditors' preferences were not given, the rabbi had a *secured* promise to pay from the employer, thereby resulting in immediate taxation.<sup>150</sup> For tax purposes, the rabbi trust is treated as an employer grantor trust, whereby income, losses, and deductions flow back to the employer.<sup>151</sup>

Under the constructive receipt rules, the executive's right to receive payments from the rabbi trust is subject to a substantial forfeiture risk as they are subordinate to the claims of the employer's creditors in the event of bankruptcy or insolvency. While the underlying assets of the rabbi trust would be regarded as property for §§ 83 and 402(b) purposes and under the economic benefit doctrine, there is no immediate taxation to the executive as his/her rights are subject to a substantial risk of forfeiture. Modifying the executive's right by allowing the executive the right to assign or transfer any assets under the rabbi trust would then "fund" the plan for Section § 83 purposes, resulting in immediate taxation.

The Service suspended the issuance of rulings on rabbi trusts during the mid-1980s while the DOL was studying the issue as to whether the use of such trusts caused the underlying executive compensation plan to be "funded" for ERISA purposes. After the DOL ruled that the use of a rabbi trust would not cause the plan to be funded for ERISA purposes, the Service resumed its rulings.<sup>152</sup> Due to the popularity of rabbi trusts, the Service issued a model rabbi trust in 1992, which was intended to serve as a safe harbor for employers utilizing trusts as a means of securing the promises under its executive compensation plans.<sup>153</sup> The model language sets forth mandated, alternative, and optional provisions.<sup>154</sup> Under

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150. *Id.* See also Priv. Ltr. Rul. 84-18-105 (Jan. 31, 1984) (determining that an interest in the subject deferred compensation arrangement did not constitute property for the purposes of § 83 because trust estate assets were not set aside from claims of the corporation's creditors), and Priv. Ltr. Rul. 85-09-023 (Nov. 28, 1984) (approving the use of bank or escrow accounts in lieu of irrevocable trusts).

151. I.R.C. §§ 671-77 (2000).

152. See DOL Adv. Op. 91-16A, *supra* note 51.

153. See § 3 of Rev. Proc. 92-64, 1992-2 C.B. 422 (indicating that the model trust "is intended to serve as a safe harbor for taxpayers that adopt and maintain grantor trusts in connection with unfunded deferred compensation arrangements. If the model trust is used in accordance with this Revenue Procedure, an employee will not be in constructive receipt of income or incur an economic benefit solely on account of the adoption or maintenance of the trust. However, the desired tax effect will be achieved only if the nonqualified deferred compensation arrangement effectively defers compensation").

154. *Id.* at § 5.



the terms of the revenue procedure, an independent third-party corporate trustee must be used; the trust may be revocable or irrevocable; and the trust may require annual employer contributions. The Service will provide exceptions to the provisions of such safe harbor or its alternate trust provisions only in rare and unusual circumstances.<sup>155</sup>

In lieu of using a rabbi trust for additional security, executives have relied upon third-party guarantees to make the promised payments in the event of the employer's bankruptcy or insolvency.<sup>156</sup> While executives have used surety bonds,<sup>157</sup> letters of credit,<sup>158</sup> and indemnity insurance,<sup>159</sup> shadow trusts, agency agreements, and escrow arrangements,<sup>160</sup> and secular trusts;<sup>161</sup> the most popular security device, however, remains the rabbi trust.<sup>162</sup>

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155. *Id.* at § 3 (stating that "rulings will not be issued on unfunded deferred compensation arrangements that use a trust other than the model trust, except in rare and unusual circumstances").

156. See I.R.S. Notice 2000-56, 2000-2 C.B. 393 (noting that a parent corporation may guarantee its subsidiary's obligation under an executive deferred compensation plan without any adverse tax consequences to the executives as the unfunded and unsecured promise is now simply a promise made by two entities instead of one).

157. See Priv. Ltr. Rul. 84-06-012 (Nov. 3, 1983) (permitting the employee's purchase of a surety bond with an independent insurer to pay the unfunded and unsecured nonqualified deferrals in the event of the employer's default without conferring any economic benefit on the employee). In studying the applicability of the economic benefit doctrine, a third party's guarantee of the employer's promise could be an economic benefit to the employee if such guarantee were purchased by the employer, instead of the employee (as was the case under the ruling). While the employee's purchase of the surety bond provides greater security to the executive, it is not flowing from the employer and thus there were no adverse tax consequences. In 1986, the IRS suspended rulings on surety bonds in order to study the issue, but lifted the suspension in 1993 with another private letter ruling. Under Priv. Ltr. Rul. 93-44-038 (Aug. 2, 1993), the Service approved of certain executives' purchase of insurance to guarantee the employer's promise under the deferred compensation plan, even though the plan was funded with a rabbi trust. Since the Service found no involvement by the employer in the purchase of such insurance, there were no adverse tax consequences for the executives due to the insurance. Despite the Service's favorable ruling, surety bonds have little practical importance today due to the unavailability of such insurance vehicles.

158. See Tech. Adv. Mem. 9443006 (Apr. 29, 1994) (employer's purchase of a letter of credit secured by its general assets to assure the payment of vacation pay was property under I.R.C. § 83 for the employees who were the beneficiaries under the letter of credit).

159. See Priv. Ltr. Rul. 93-44-038 (Nov. 5, 1993) (affirming that the employee's purchase of indemnification insurance with an independent insurer to pay the nonqualified deferrals in the event the employer was unable to do so did not result in any economic benefit to the employee).

160. These arrangements may permit the employer to retain investment control over the assets even though a third party holds the assets for the benefits of the executives.

161. See Rev. Proc. 92-64, § 3, *supra* note 146.

162. See, e.g., the results of the Clark Bardes Consulting - Compensation

Employers have also utilized a variety of non-cash methods to provide some security to executives under the rabbi trust prior to the triggering event, including use of employer stock<sup>163</sup> and use of a warrant to issue employer stock.<sup>164</sup> Such methods may prove to be costly and cumbersome, and may raise corporate law and securities issues.<sup>165</sup>

As there is no requirement that the rabbi trust be irrevocable nor that a minimum level of assets be maintained, employers do not have to fund the trust at its inception. The assets are not provided the same tax benefits as assets under qualified retirement plans (which accumulate tax-free until distribution). Instead, the rabbi trust is treated as an employer asset and therefore, its assets are taxed to the employer as earned at the corporate tax rates (unless invested in tax-exempt vehicles).<sup>166</sup> Benefits are then paid to the executives when due under the deferred compensation plan and taxed at the time of receipt, unless used for the benefit of the employer's creditors in the event of bankruptcy or insolvency.

While some rabbi trusts may not require advance funding of the deferrals, the underlying plan may attempt to mirror the employer's section 401(k) plan and provide a variety of investment options to the executives to ascertain future investment performance. As long as the executive has no economic or property interests in such investments, the executive's right to direct investments under the executive compensation plan does not result in any taxable economic benefit to him/her.<sup>167</sup>

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Resource Group's 2000 Executive Benefit Survey (noting that 83% of respondents indicated that their executive compensation plans used some security device, the rabbi trust being the most common), *available at* <http://www.clarkbardes.com/crg/knowledgecenter/protected/executivebenefitsurveys/2000benefitsurvey.pdf>. (last visited Sept. 5, 2002).

163. *See* Priv. Ltr. Rul. 92-35-006 (Aug. 28, 1992) (permitting rabbi trusts to use employer stock); *see also* Rev. Proc. 92-64, 1992-2 C.B. 422 (allowing rabbi assets to be invested in "securities (including stock or rights to acquire stock) or obligations issued by the company"); I.R.S. Notice 2000-56, 2000-2 C.B. 393 (providing guidance when a parent corporation contributes stock to the rabbi trust for its subsidiary's employees).

164. *See* James S. Hutchinson & Michael L. Stevens, *Securing the Rabbi Trust Promise: Issuing a Warrant to Purchase Employer Stock*, 5 J. OF DEFERRED COMP. 3, 11 (2000).

165. *Id.* at 16-17. *See also* A. Richard Susko & Alan Wilmit, *Use of Stock-Based Rabbi Trusts as Feeder Entities for Various Employee Benefit Plans*, 339 PLI/TAX 129 (1993) (discussing rabbi trusts holding employer stock and concluding that whether a "rabbi trust holding employer stock will be subject to registration under the Securities Act will depend on an analysis of the particular plan at issue" and that "the presence of a rabbi trust generally should not affect the question of whether interests in the plan will be subject to registration").

166. I.R.C. §§ 671-677 (2000).

167. *See* Priv. Ltr. Rul. 95-05-012 (Feb. 3, 1995) (holding that a

### Offshore Rabbi Trusts

Under the IRS's model rabbi trust, the trust is required to be valid under state law and all of the substantive terms of the trust, including the creditors' rights clause, must be enforceable under state law.<sup>168</sup> Thus if the assets of a rabbi trust are established or moved offshore (i.e., outside the jurisdiction of the U.S. courts), the executives cannot rely on the protection of the Service's revenue procedure. However, moving the trust offshore provides an additional layer of asset security for the executive.<sup>169</sup> The use of an offshore rabbi trust, especially in a jurisdiction with strict asset protection laws, makes it far more difficult and costly for the employer's creditors to collect such assets in the event of bankruptcy or insolvency.<sup>170</sup>

While the Service has indicated informally that use of an offshore rabbi trust may subject the executive deferred compensation plan to taxation, it has yet to provide any formal guidance.<sup>171</sup> Given the ambiguity, some employers have been testing the waters in establishing such offshore trusts. While Congress' initial response to the use of offshore rabbi trusts may have been tempered, as rumors surface regarding the payment of bonuses to Enron executives that were then sheltered offshore to circumvent attachment, Congress is now focusing attention on such offshore trusts.<sup>172</sup>

### Security through the Use of a Secular Trust

Full security for the executive may be achieved by means of a "secular trust," which protects the executive, even against the risk of employer bankruptcy or insolvency.<sup>173</sup> The secular trust is an

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participant's right to designate investments under a trust established for the executive compensation plan did not trigger an economic benefit).

168. See Rev. Proc. 92-64 § 4 *supra* note 147.

169. See Michael P. Corry, *Time to Assess Your Company's Nonqualified Plans?*, 7 J. TAX'N EMPLOYEE BENEFITS 77 (1999) (noting that the benefit of an offshore trust "lies in its asset protection abilities." The trustees of such trusts may not have the power to revoke the trust or distribute assets to credits.).

170. See Gerald Nowotny, *The Use of Rastafarian Rabbi Trusts in Securing Non-Qualified Deferred Compensation and Executive Benefits*, 2 J. OF ASSET PROTECTION 6, at 41, July-Aug. 1997; Henry Ordower, *A Theorem for Compensation Deferral: Doubling Your Blessings By Taking Your Rabbi Abroad*, 47 TAX LAWYER 301 (Winter 1994).

171. See AALU Wash. Rep. Bull. 93-102 (Dec. 7, 1993) (reporting that the Service would no longer rule on rabbi trusts established in foreign countries or by foreign employers).

172. See U.S. Senate to Take Up Pension Reform, July 11, 2002, *available at* <http://www.forbes.com/newswire/2002/07/11/rtr658131.html> (last visited Sept. 7, 2002). (reporting that the Senate Finance Committee's proposed legislation would eliminate tax benefits under executive deferred compensation plans that were placed in offshore accounts).

173. See Priv. Ltr. Rul. 88-43-021 (July 29, 1988) (affirming the use of an

irrevocable trust, established and funded to provide the executive with *exclusive* rights under the trust. Such trust is *funded* for tax purposes as it clearly protects the executive against the risk of the employer's bankruptcy or insolvency. Thus, the executive is taxed immediately on the amounts contributed to the trust each year, and due to the application of I.R.C. section 402(b), on any increase in the executive's "vested accrued benefit" which may include a portion of the trust income and unrealized appreciation.<sup>174</sup> Such trust is not exempt from tax under I.R.C. section 501(a) as the underlying executive deferred compensation plan is not a qualified plan under I.R.C. section 401(a).<sup>175</sup>

Due to the adverse tax consequences for the executive, using a secular trust to "fund" the underlying executive compensation plan does not provide for any deferral of taxation of such income. Thus, their attractiveness was better understood when corporate tax rates exceeded individual income tax rates (which was the case prior to the adoption of OBRA '93). Then the tax saved by the employer's deduction for contributions made to the secular trust exceeded the income tax paid by the executive. If the executive's pay was grossed-up for the amount of the tax due, there was no downside for the executive. Now that the maximum individual income tax rates (ranging from 15% to 39.1%)<sup>176</sup> exceed the maximum corporate tax rates (ranging from 15% to 36%),<sup>177</sup> the secular trust is less appealing from a tax vantage point. The Service will issue favorable rulings regarding secular trusts, but has yet to issue a model secular trust document.<sup>178</sup> Use of secular

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irrevocable trust in which neither the employer nor its creditors have an interest); Priv. Ltr. Rul. 88-41-023 (July 9, 1988). The term "secular trust" has no technical definition, but is used by practitioners to contrast these trusts from rabbi trusts. See also Michael G. Goldstein & J. Kwiatek, *The Secular Trust*, 45 J. OF THE AM. SOC'Y OF CLU & CHFC 68-73 (Sept. 1991); Michael G. Goldstein, *The Secular Trust Revisited*, 47 J. OF THE AM. SOC'Y OF CLU & CHFC, 54-56 (Mar. 1993).

174. *Id.*

175. See Priv. Ltr. Rul. 92-06-009 (Jan. 7, 1992) (referencing I.R.C. § 402(b)(2)(A), which states the rule that if a reason a trust is not tax-exempt under § 501(a) is due to its failure to meet the requirements of § 401(a)(26) (or § 410(b)), then an employee will have taxable income equal to his/her vested accrued benefit at year's end); see also Priv. Ltr. Rul. 92-07-010 (Feb. 14, 1992) (denying grantor trust treatment for employer secular trusts, but instead taxing the trust on its income under I.R.C. § 641, and if such income stayed within the trust, subjecting the income to double taxation, at the trust's level and at the executive's level).

176. See I.R.C. § 1(b) (2000), as amended by The Economic Growth & Tax Recovery Act of 2001 ("EGTRRA"), see Pub. L. No. 107-16 (reducing the individual income tax rate from 39.6% to 38.6% for 2002-03, to 37.6% for 2004-05, and to 35% for 2006-10).

177. I.R.C. §§ 11, 1201 (2000).

178. Priv. Ltr. Rul. 90-31-031 (May 8, 1990) (approving a trust agreement under which company contributions are includible in the executive's gross

trusts may cause some problems under ERISA whose exemptions apply only to *unfunded* excess benefits or top hat plans. However, it is possible to structure the secular trust as an “employee grantor trust” whereby the executives are treated as the owners of the trust under I.R.C. section 677.<sup>179</sup> As ERISA requires the employee plans to be established or maintained by the employer, not the employees, it may be argued that such arrangements are not even *plans* for ERISA purposes.

#### *Hybrids Security Arrangements - Rabbicular Trust*

There are a variety of hybrid funding vehicles being marketed today that attempt to combine the best of the rabbi trust and the secular trust, in hopes of providing greater security for the executive without any immediate tax consequences. Once such vehicle is known as the Rabbicular Trust, melding the names of the rabbi and secular trusts together.<sup>180</sup> It is described as a rabbi trust with no resulting tax consequences to the executive, as the underlying plan and trust are subject to the claims of the employer’s creditors. Assets may be contributed to the rabbi trust either at its inception or upon the occurrence of a later triggering event. However, once a certain triggering event (e.g., change of

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income in the year contributed, and deductible by the company in the year contributed – where benefits payable are reasonable in amount); Priv. Ltr. Rul. 88-43-021 (July 29, 1988) (treating each participant as a grantor-owner and requiring that the participant include all income, deductions, and credits of the trust in computing taxable income); Priv. Ltr. Rul. 88-41-023 (Jul. 9, 1988) (same).

179. See Priv. Ltr. Rul. 95-48-014 (Sept. 22, 1995) (noting the general rule that under I.R.C. § 671, a grantor deemed the owner of a trust must include, in computing taxable income and credits, those items of income, deduction, and credits against tax attributable to the trust); see also Priv. Ltr. Rul. 95-48-015 (Aug. 29, 1995) (stating that under I.R.C. § 677, a grantor will be treated as owner of a trust “whose income without the approval or consent of any adverse party is, or, in direction of the grantor or a non-adverse party, or both may be (1) distributed to the grantor or the grantor’s spouse, or (2) held or accumulated for future distributions to the grantor or the grantor’s spouse”); Priv. Ltr. Rul. 94-37-011 (Sept. 16, 1994) (treating participant as owner of trust because “the entire income of the [t]rust will be distributed to or held or accumulated for future distribution to [p]articipant, the grantor, without approval or consent of any other party”); Priv. Ltr. Rul. 9337016 (Jun. 18, 1993) (treating employee as grantor of trust); Priv. Ltr. Rul. 93-16-018 (Jan. 22, 1993) (same); Priv. Ltr. Rul. 93-16-008 (Jan. 14, 1993) (requiring grantor-participant to include all income, deductions and credits of the trust in computing participant’s taxable income); Priv. Ltr. Rul. 92-43-034 (July 24, 1992) (same); Priv. Ltr. Rul. 92-35-044 (Jun. 2, 1992) (same); Priv. Ltr. Rul. 88-43-021 (Jul. 29, 1988); Priv. Ltr. Rul. 88-41-023 (Jul. 9, 1988) (same).

180. The term “Rabbicular Trust” is a servicemark of Michael G. Goldstein, J.D., LL.M., St. Louis, Missouri, 1994. See Michael Goldstein, Michael Swirnoff, & William Drennan, *Taxation and Funding of Nonqualified Deferred Compensation*; M. GOLDSTEIN ET AL., ABA REAL PROPERTY, PROBATE AND TRUST LAW SECTION (ABA) (1998).

control) has occurred, the rabbi trust is designed to terminate and to distribute its assets into individual secular trusts for the various executives (which are then protected from the employer's general creditors).<sup>181</sup> Such distributions from the rabbi trust would be subject to the bankruptcy rules as discussed earlier, but if accomplished before 90 days for non-insiders or one year for insiders, would remain assets of the executive.

If the rabbi trust is not funded at original inception, it may require the "funding" with assets upon the occurrence of a triggering event (e.g., change of control).<sup>182</sup> Such trusts are commonly known as "springing trusts," as the trust becomes "funded" once the triggering event occurs. The Service has explicitly approved of the use of a "change of control" as a triggering event for funding in its model rabbi trust document,<sup>183</sup> but has not issued any private letter rulings affirming their use. Other triggering events that are often used in funding rabbi trusts include the "potential change in control" (i.e., announcement of a take-over bid) or "change of heart" (i.e., employer's refusal to pay benefits under the plan in bad faith or without cause).

If the triggering event is limited to a change in control or a change of heart, it is arguable that there should be no adverse consequence to the executive as the IRS's model rabbi trust document permits such a triggering event to fund the rabbi trust and make such funding irrevocable. In addition, the constructive receipt rules do not tax the executive simply because the executive obtains the right to withdraw monies from the plan upon a change of control. Alternatively, the Service may determine that the rabbi trust was never intended to be subject to the claims of the employer's creditors, despite the document's terms to the contrary, when viewed in conjunction with the secular trusts that are to be maintained for the sole benefit of the executives.<sup>184</sup> Under this argument, if the rabbi trust was never intended to effectively protect the employer's creditors, it would not protect the executives from *current* taxation.

If the triggering event under the rabbi trust is tied to the employer's financial health or its impending bankruptcy/insolvency,<sup>185</sup> the Service would undoubtedly hold the

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181. *Id.*

182. § 10.21 of Rev. Proc. 92-64, 1992-2 C.B. at 424, § 1(b).

183. *Id.* § 5.02, Sec. I, (f).

184. See BNA Tax Mgmt. Portfolio, *Deferred Compensation Arrangements* A-56 (discussing secular trusts).

185. See Michael G. Goldstein and William A. Drennan, *Rabbicular Trust Will Withstand IRS Scrutiny; Creator Counters Criticism*, 4 J. TAX'N EMPLOYEE BEN. 41 (May/June 1996) (noting that an IRS Official reported that the Rabbicular Trust was a "failed attempt to find the Holy Grail"); Michael G. Goldstein, *Current Developments in Executive Benefit Security: The Next Generation - The Rabbicular Trust*, ALI-ABA Uses of Insurance in Estate and

executive in constructive receipt of the deferrals as he/she is no longer subject to substantial risk of loss. In light of the Enron scandal, the use of triggering events to fund the rabbi trust and distribute all benefits into secular trusts may be particularly problematic in the context of a controlling shareholder and/or insider who made have inside knowledge regarding the employer's financial health and/or responsible for the employer's financial problems. Such funding could obviously be to the detriment of the employer clearly at a time when the monies are most needed for the business.

#### *Hybrid Funding Arrangements – Vesting Trust*

Another vehicle, known as the vesting trust, is structured to pay benefits to the executive *only if* certain triggering events occur (e.g., termination of employment, attainment of a specified retirement age, change of control), as opposed to using the triggering events to accelerate the payment of benefits. The vesting trust need not be subject to the claims of the employer's creditors, provided the executive's rights under the trust are nontransferable and are subject to a substantial risk of forfeiture. Proponents of the trust argue that constructive receipt does not apply until the occurrence of the triggering event, as such events impose a substantial limitation on the receipt of benefits. If none of the triggering events occur, the trust monies revert back to the employer, and the executive, if still owed money under an executive deferred compensation arrangement, would be paid directly from the employer's general assets. While the Service has not formally ruled on such an arrangement, it may be regarded as a funded arrangement, and therefore taxable to the executive.<sup>186</sup>

#### *Hybrid Funding Arrangements – Secured Trust*

A vehicle known as the secured trust<sup>187</sup> has been described as a trust that protects executive deferred compensation plans even in the event of an employer's bankruptcy or insolvency—the ultimate in security protection. This trust is structured so as to provide benefits to the executive *only if* the employer goes

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Tax Planning (Oct. 25, 1995) (suggesting the use of the following triggers in a rabbicular trust: "particular financial events (e.g., if the employer's net worth falls below \$X; if the employer's gross sales fall below \$X, etc.); financial ratios (earnings per share falls below X; debt to equity ratio falls below X, etc.); the loss of certain key customers with billings in excess of \$X; catastrophic litigation or environmental liabilities, etc.; or a change in control of the company (signaled by a sale, exchange or other transfer of a certain percentage of the employer's stock to outsiders within a one-year period)").

186. See Priv. Ltr. Rul. 87-39-031, *supra* note 123.

187. This trust is proprietary to Compensation Resource Group, Inc., available at <http://www.clarkbardes.com/crg> (last visited Apr. 13, 2002).

bankrupt or has a change of control, and thus is *not* subject to the claims of the employer's creditors. If the executive terminates employment prior to these triggering events, his/her benefits are forfeited under the trust and the monies revert back to the employer. The employer is regarded as a contingent beneficiary under the secured trust, as it *may* receive the monies in the event of the executive's termination of employment.<sup>188</sup>

Unlike the vesting trust, the secured trust pays the executive *only if* the employer goes bankrupt or insolvent. If the employer goes bankrupt before the executive terminates employment, the secured trust pays the benefits to the executives, as it is not subject to the claims of the creditors. However, if the employer is financially healthy at the time of the executive's termination, it simply pays the executive its deferred compensation out of its general assets and the assets of the secured trust revert back to the employer. The executive is certainly at risk that the employer may have a "change of heart" at the time of termination, as he/she will be then relying on the employer's general assets for payment. Proponents of this arrangement argue that the executive has no constructive receipt in the secured trust because they are subject to a substantial risk of forfeiture (i.e., as benefits are payable *only if* the employer goes bankrupt or has a change of control).<sup>189</sup> The Service has not issued any formal guidance regarding the use of such trusts.

#### *Hybrid Funding Arrangements – The Heavenly Trust*

Another trust arrangement being proposed is known as the heavenly trust<sup>190</sup> (i.e., obviously named as it was too good to be true). Such trust actually refers to the combined use of two trusts — a rabbi trust where assets have actually been set aside for executive deferred benefits but subject to the claims of creditors *and* a secured trust that is established to pay benefits *only* in the event of the employer's insolvency or bankruptcy. Proponents of the device argue that the use of the rabbi trust poses no constructive receipt issues to the executive (as benefits are subject to the claims of creditors), and that the use of the secured trust poses no economic interest or property issues (as benefits are payable *only* in the event of the employer's bankruptcy or insolvency). Clearly viewed as a single unit, the executive is

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188. See transcript of live chat with William MacDonald at [http://www.crgworld.com/transcripts/chat\\_010718.html](http://www.crgworld.com/transcripts/chat_010718.html) (last visited Apr. 13, 2002) (noting that the secured trust is set up as a rabbi trust with no immediate taxation to the executive, but acts like a secular trust in providing protection against bankruptcy and insolvency).

189. *Id.*

190. See HENRY SMITH ET AL., NONQUALIFIED DEFERRED COMPENSATION ANSWER BOOK, 5:6 at 5-4 (3d ed. 1996).



guaranteed payment of the deferred benefits and protected against the claims of the employer's creditors, which defeats the intent of the constructive receipt doctrine.

The Service has yet to rule on the use of a heavenly trust; thus, employers relying on such trusts would certainly be advised to seek an opinion letter from counsel. The secured trust used alone (without a tandem rabbi trust) subjects the executive to the risk that the employer could have a change of heart. However, for a financially healthy employer, this may not be much of a threat as the executives could certainly sue the employer and enforce their rights under the plans. Certainly the use of a secured trust *in tandem with* a rabbi trust containing assets actually set aside (the so-called heavenly trust) eliminates any risk for the executive, and as such would likely be viewed together by the Service. As there is no risk to the executive, he/she has a secured right to the benefits and therefore would be currently taxable.

Given the Service's limitations on its interpretation of the constructive receipt doctrine; the courts' liberal interpretation of various aspects of the constructive receipt doctrine; and its continual focus on *qualified* plans, as opposed to nonqualified plans, it is easy to understand the Service's natural reluctance to aggressively pursue the use of these trusts. However, such lack of formal guidance on a number of key issues has resulted in a potpourri of devices and trusts being used in conjunction with executive deferred compensation plans. Without specific guidance from the Service, an atmosphere of uncertainty has developed prompting certain individuals to "test the waters." Now that the Enron scandal has opened our eyes as to the consequences that these plans have for the employer's creditors (which may also include participants under the employer's *qualified* employee profit sharing plan), the protections afforded to executives, especially insiders, should be reexamined and restricted. ERISA's explicit intent was to protect the assets of qualified pension plans for participants and beneficiaries, affording nonqualified plans with substantially less protective rules.

### *Legislative Proposals*

As the various Senate and House Committees are studying the Enron situation, a variety of different legislative proposals are being considered, both at the qualified plan and executive compensation plan levels. As of the end of July 2002, for example, over 15 legislative proposals have been advanced by Members of Congress.<sup>191</sup> The Bush Administration advanced its own proposal

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191. Profit Sharing/401(k) Council of America, *Legislation Affecting Company Stock*, Apr. 16, 2002, available at <http://www.psc.org/wash/pdf/compstockleg.pdf>.

as well.<sup>192</sup> Despite the number of proposals advanced in Congress or by President Bush, a number of the bills contain identical language, or similar provisions. Thus, three proposals, H.R. 3762,<sup>193</sup> S. 1992,<sup>194</sup> and a substitute to S. 1971 titled The National Employee Savings and Trust Equity Guarantee Act (the "Chairman's Mark"),<sup>195</sup> have emerged as the leading pieces of legislation seeking to remedy corporate fraud and abuses especially in the area of pension plans holding employer stock.

Congressman John Boehner (R-OH) introduced H.R. 3762, which includes two stand-alone bills each introduced in response to the Enron bankruptcy. The House passed H.R. 3762 on April 11, 2002 by a 255 - 163 vote,<sup>196</sup> and subsequently reported to the Senate Health, Education, Labor, and Pension (HELP) Committee on April 15, 2002.<sup>197</sup> Senator Edward Kennedy (D-MA) introduced S. 1992, which was favorably reported out of the Senate HELP Committee and contains similar provisions provided for in H.R. 3762. Finally, the Chairman's Mark, introduced by Senator Max Baucus (D-MT), Chairman of the Senate Finance Committee, contains identical language provided for in S. 1992 and legislative language pertaining to investment education that was previously introduced by Senator Jeff Bingaman (D-NM) as a stand alone bill.<sup>198</sup> The Senate Finance Committee unanimously approved the Chairman's Mark on July 11, 2002.

While all three proposals deal with substantive changes for qualified pension and profit sharing plans with participant directed investments in employer stock, only the Chairman's Mark proposal specifically addresses executive compensation plans. Under this proposal, the 1978 moratorium imposed on the Service's issuance of constructive receipt guidance would be lifted and the Service would be directed to issue new guidance for executive compensation plans, particularly in those areas that Congress considers abusive. These areas include various withdrawal provisions and haircut penalties being used under

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192. *Specifics on the President's Plan to Strengthen Retirement Security*, THE WHITE HOUSE, Feb. 28, 2002, available at <http://www.whitehouse.gov/news/releases/2002/02/20020228-1.html>.

193. Pension Security Act of 2002, H.R. 3762, 107th Cong. (2002) ("H.R. 3762").

194. Protecting America's Pensions Act of 2002, S. 1992, 107th Cong. (2002) ("S. 1992").

195. The National Employee Savings and Trust Equity Guarantee Act, 107th Cong. (2002) (the "Chairman's Mark").

196. H.R. 3762, Bill Summary & Status for the 107th Congress, available at <http://thomas.loc.gov/cgi-bin/bdquery/z?d107:HR03762:@@L&summ2=m&> (last visited Aug. 20, 2002).

197. *Id.*

198. Independent Investment Advice Act of 2001, S. 1677, 107th Cong. (2002).

executive deferred compensation plans. In addition, the proposal instructs the Service to address those situations in which the deferred compensation plan assets are *in form* subject to the claims of the employer's general creditors, but *in substance* are not reachable by the creditors.<sup>199</sup> The proposal also renders amounts deferred under plans that are funded through the use of offshore trusts as taxable income, thereby circumventing the use of offshore trusts.<sup>200</sup> Clearly the proposal is addressing the abuses that have been surfaced in the context of executive deferred compensation plans, as opposed to forging new policy changes for such plans.

Whether any of these proposals will pass a majority of both the House of Representatives and the Senate remains unclear. Moreover, dependent upon the final agreement of the provisions, it remains unclear as to whether President Bush will sign the measure into law. To be sure, in the wake Enron, Worldcom, Xerox, and Merck accounting abuses, the American public is clamoring for both Congress and the President to combat corporate fraud and abuse and strengthen retirement security. With H.R. 3762 already passed in the House, all eyes are on the Senate. Even if the Senate passes either S. 1992 or the Chairman's Mark, both the Senate-passed proposal and H.R. 3762 must go to conference where Members of both Chambers must work to reconcile the differences between the bills. All in all, however, with the November elections quickly approaching, it is likely that some type of retirement security legislation will make it to the President's desk.

### Conclusion

The demise of the Studebaker-Packard company almost thirty years ago left thousands of retirees with insufficiently funded retirement benefits; Congress responded to the public outcry by enacting ERISA.<sup>201</sup> Such legislation was designed to impose substantive regulations on retirement and profit sharing plans, including funding and fiduciary obligations. Other types of employee benefit plans, including welfare benefit and executive compensation plans, were subject to various reporting and disclosure requirements, as well as ERISA's enforcement provisions. At that time, little thought was given to *executive*

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199. See Description of the Chairman's Modifications to the "National Employee Savings and Trust Equity Guarantee Act," THE JOINT COMMITTEE ON TAX'N, July 11, 2002 at 36-38.

200. *Id.* at 39-41.

201. For an extensive background of the history of ERISA, see James A. Wooten, "The Most Glorious Story of Failure in the Business": The Studebaker-Packard Corporation and the Origins of ERISA, 49 BUFFALO L. REV. 683 (2001).

deferred compensation plans that account for the various exemptions afforded by ERISA for such plans.

Today, the dramatic investment loss suffered by Enron participants, whose qualified profit sharing accounts were invested in Enron stock, has prompted Congress to respond. Legislative proposals now under consideration all require varying levels of protection to safeguard participants' investment rights under qualified pension plans holding employer stock. In the meantime, the Enron participants have become unsecured creditors with respect to their ERISA fiduciary breach cases filed after Enron's bankruptcy. As unsecured creditors, their relief will be limited to the small pool of remaining company assets. While media attention that has spotlighted the excessive compensation payments and the withdrawals from deferred compensation plans made to Enron executives a year in advance of the company's bankruptcy, the bankruptcy courts will have to attach such assets, if still available, as voidable conveyances for the benefit of Enron's creditors. Such process could take years to accomplish and thus may not yield much for the Enron participants. The net result of the media attention has been to highlight for the public the various compensation schemes afforded to Enron executives, both in the form of current compensation, as well as deferred compensation. Only one of Congress' legislative proposal addresses executive deferred compensation plans.

In response to the allegations made regarding premature withdrawals made from Enron's executive deferred compensation plans, the Chairman's Mark proposal takes a conservative approach by lifting the moratorium on the Internal Revenue Service regarding constructive receipt rulings. The Service would be able to issue guidance regarding the use of haircut provisions within executive compensation plans and innovative uses of various trust arrangements that attempt to "secure" such plans. Such guidance is certainly needed as the legislative moratorium has resulted in a lack of regulatory guidance and the growth in abuses of the features of executive compensation plans. This proposal also affirms the underlying theme of ERISA and the Code of reserving to the employer the power to decide compensation issues, including how much of a benefit/deferral should be extended to a participant and the timing of paying of such benefits/deferrals.

The author affirms the limiting scope of the Chairman Mark's legislative proposals regarding executive compensation plans. If enacted, the Service could certainly formulate rules to impose more significant limitations on those executives who were controlling shareholders and/or insiders as they can be presumed to have greater control over the exercise of such limitations. As the tax rules were originally formulated on the premise that the

executive is not in control of certain triggering events that could result in payment or acceleration of deferred compensation, certainly revision of those rules should now be formulated, given the realities of the Enron plans.

Any other type of legislative proposal that attempts to use the tax code to make wide sweeping changes relating to employers' corporate compensation decisions would be ill-advised. The fluctuating changes in the maximum dollar limitations imposed on qualified retirement and profit sharing plans have only resulted in less deferrals under those plans and have not curtailed the use of nonqualified excess benefit plans which supplement retirement benefits for executives who are unable to attain the full amount under the qualified plan. Nor has the imposition of excise taxes on excessive compensation payments in the context of golden parachute arrangements deterred their use.

Corporate greed needs to be flushed out at the level of the shareholders and public at large. Greater disclosure requirements under the Securities Exchange Act of 1933 and/or under the corporate governance rules applicable at the various stock exchanges for publicly held businesses would result in a greater immediate impact on the ethical practices of governing boards of directors, than reactive changes under the federal tax code. One suggestion recommends the use of a compensation committee composed of independent directors to approve all executive deferred compensation plans, thereby assuring that a "neutral" set of eyes has reviewed such plans.<sup>202</sup> Such a proposal has a greater likelihood of success in exposing excessive compensation schemes to the public than using the tax code to police such schemes.

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202. See NYSE Comment Letter: Accounting and Listing Standards Committee Proposal from Frederic W. Cook & Co., Inc., to Ms. Janice O'Neill, The New York Stock Exchange (June 27, 2002), plans at [http://www.fwcook.com/pub\\_date.html](http://www.fwcook.com/pub_date.html) (advocating various governance proposals to curb abuses under executive compensation plans). (Last visited July 12, 2002).