Statement for the Senate Finance Committee

Enron: Joint Committee on Taxation Investigation on Compensation-Related Issues

Nonqualified Deferred Compensation

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EXECUTIVE SUMMARY

This statement is intended to respond to issues raised by the Staff of the Joint Committee on Taxation with respect to deferred compensation pursuant to nonqualified deferred compensation plans. The Staff of the Joint Committee on Taxation in the portion of their Report of Investigation of Enron Corporation and Related Entities Regarding Federal Tax and Compensation Issues, and Policy Recommendations regarding the deferral of compensation appears to be primarily concerned with the effects of nonqualified deferred compensation on shareholders, creditors, and the federal treasury. These concerns have been translated into recommendations or suggestions for modification of plan design features that are common practices and are not inherently abusive.

The concerns of the Staff of the Joint Committee on Taxation can be addressed without substantially modifying the Internal Revenue Code or the interpretation and application of the doctrines and theories governing the taxation of deferred compensation and without losing the benefits that employers obtain from being able to provide modestly flexible deferred compensation arrangements.

Section 404(a) of the Internal Revenue Code provides that compensation paid under a plan deferring the receipt of compensation is not deductible under any other section of the Code. However, if it is otherwise deductible under Section 162 of the Code or Section 212 of the Code and satisfies the conditions specified in Section 404, it is deductible under Section 404(a) of the Code. In other words, compensation must be tested under the reasonable compensation rules of Section 162 of the Code. The potential loss of a significant tax deduction, therefore, already provides a significant incentive to employers to provide "reasonable" compensation. In addition, boards of directors of employers already have fiduciary obligations under the business judgment rule, a feature of the corporation laws of every state, that require them to assure that deferred compensation pay levels and those for whom such pay levels are established are not abusive to shareholders, and rules adopted and enforced by the Securities and Exchange Commission regarding corporate management and governance. If there is a concern about the fairness to shareholders of the amounts of deferred compensation provided to company executives, the avenue for which these concerns may be addressed is not the federal tax laws but the laws and rules regarding corporate governance.

Finally, with respect to the revenue effects of nonqualified deferred compensation, such compensation merely involves a delay in the receipt of pay that would otherwise be paid in cash or stock at the time it was earned. The language in Section 404(a)(5) of the Code provides that contributions under a nonqualified deferred compensation plan are deductible in the taxable year in which an amount attributable to the contribution is includable in the gross income of an employee participating in the plan. Simply stated, the deduction is "matched" with the inclusion of income. The tax tension between the deferral desired by the employee and the current deduction desired by the employer is an inherent limitation on the amount and characteristics of deferred compensation that a taxable employer would be willing to provide to the employee.

The revenue concern raised by the Staff with respect to an avoidance of current income taxation may be addressed in a manner other than a manner that significantly impacts the economic or social utility of deferred compensation. An approach that may be more acceptable would be to impose a cap on the deduction at an amount equal to the tax imposed on the individual. So, for example, if the tax rate applicable with respect to the executive was 30%, the deduction for the employer would be determined at no more than that rate. This cap could eliminate any timing issue otherwise applicable and any revenue loss that may otherwise occur at the time that payment is made.

Deferred compensation serves a valuable purpose to an employer, the employer is able to provide benefits to a select group of management level or key employees to attract and retain valuable employees necessary for the operation and development of the company. Deferred compensation also permits an employer to conserve cash currently, offer flexibility in the manner in which compensation can be structured to provide the appropriate incentives to achieve the desired performance, and compete with other employers for the key employees necessary to achieve desired corporate objectives. The corporate interests and objectives served by such incentive arrangements, and the limitations already imposed on such arrangements by the Internal Revenue Code and the Employee Retirement Income Security Act of 1974 cause such arrangements to be inherently limited and selective. Additional restrictions applicable to such deferred compensation arrangements, such as elimination of a reasonable opportunity after compensation is earned to modify the time and manner of payment or the elimination of the right to receive accelerated distributions with a substantial economic penalty, are unnecessary.

The issues raised by the Staff may be better addressed by the careful review of the actions of the board of directors of the employer maintaining the deferred compensation arrangement under the business judgment rule and rules adopted and enforced by the Securities and Exchange Commission, and by modifying Title 11 of the United States Code, the Federal Bankruptcy laws to recapture payments made pursuant to a deferred compensation arrangement when the employer is under financial distress.

Unraveling the established practices of nonqualified deferred compensation plans as a response to the problems of Enron is tantamount to throwing the baby out with the bath water. More targeted measures could be used to address the concerns of the Staff rather than unsettling fundamental deferral principles and losing the economic and social utility that nonqualified compensation offers employers.

INTRODUCTION

It appears that the primary concerns of the Staff of the Joint Committee on Taxation with respect to nonqualified deferred compensation plans are that nonqualified deferred compensation is merely an avoidance of current income taxation, and that control over deferred compensation by an employee for whom the compensation has been deferred by the employer with respect to investment allocation and the distribution of the deferred compensation create undesirable dominion and control over deferred compensation; accordingly, rules should be adopted to prevent inappropriate deferral and access or availability of deferred amounts. For example, it has been suggested that rules that require compensation to be includable in income when earned or, if later, when there is no substantial risk of forfeiture of the rights to such compensation should be adopted. Therefore, it is argued, that this approach would result in a better measure of income than under present-law rules in which an unfunded promise to pay, even if vested, is not currently taxable.

A review of the applicable tax principles may serve the process of addressing the issues raised with respect to nonqualified deferred compensation and the dominion and control exercised by an employee over deferred compensation.

FUNDAMENTAL DOCTRINES AND THEORIES OF TAX

In general, for tax purposes, an "unfunded" nonqualified deferred compensation plan is one where a participant in the plan has only the unfunded and unsecured promise of the employer that amounts will be paid when due under the terms of the plan. The employer may maintain separate bookkeeping accounts to reflect the deferred amounts, establish separate bank accounts, purchase assets such as securities or insurance contracts, and even place those assets in grantor trusts, commonly referred to as "rabbi trusts," to assist the employer in meeting its liabilities under the plan. The plan is nevertheless unfunded so long as those accounts, assets or trusts are not beyond the reach of the creditors of the employer. On the other hand, "funded" nonqualified deferred compensation plans are plans where assets are placed beyond the reach of the creditors of the employer for the exclusive benefit of plan participants. In general, if the obligation of the employer and the rights of an employee are secured in such a manner that assures the employee of payment even in the face of the bankruptcy or insolvency of the employer, the plan is a funded plan.

The tax treatment of a nonqualified deferred compensation plan, in large part, is based on many of the fundamental doctrines and theories of income tax that have existed almost from the infancy of the federal tax system, rather than specific statutory provisions. These theories and doctrines govern the timing of the recognition of income for the employee of the amounts payable under the deferred compensation plan, and determine the timing for the employee's employer to receive a deduction for the amounts that are payable under the deferred compensation plan.

Prior to 1942, accrual basis employers were generally allowed a current deduction for nonforfeitable liabilities to pay deferred compensation even though the compensation was paid and includable in the income of the employee in a later year (*Globe-Gazette Printing Co. v. Commissioner*, 16 B.T.A. 161 (1929), acq. IX-1 C.B. 20 (1930)). This "mismatching" of the employer's deduction and the inclusion in income was eliminated by the Revenue Act of 1942, which added Section 23(p)(1)(D) to the Internal Revenue Code of 1939, the predecessor to Section 404(a)(5) to the Code. That provision tied the deduction to the time of payment, but no deduction was allowable for a transfer when taxation was postponed because the transferee's rights were forfeitable (*see* Section 1.404(a)-12(c) of the Regulations). The Tax Reform Act of 1969 corrected the language in the statute.

Section 404(a) provides that compensation paid under a plan deferring the receipt of that compensation is not deductible under any other section of the Code. However, if it is otherwise deductible under Section 162 of the Code (relating to trade or business expenses) or Section 212 of the Code (relating to expenses for the production of income) and satisfies the conditions specified in Section 404, it is deductible under Section 404(a). In other words, the compensation must be tested under the reasonable compensation rules of Section 162. With respect to unfunded and funded nonqualified deferred compensation plans, Section 404(a)(5) allows the employer a deduction for compensation paid or contributions made in the taxable year in which "an amount attributable to the contribution is includable in the gross income of employees participating in the plan," provided that "separate accounts are maintained for each employee."

A. <u>Reasonable Compensation</u>

A nonqualified deferred compensation plan does not satisfy the requirements contained in Section 401(a) of the Internal Revenue Code (the "Code"), and, as a result, does not receive the favorable tax treatment afforded the plans that do satisfy those requirements. Generally, contributions to an unfunded nonqualified deferred compensation plan are not deductible by an employer and are not includable in an employee's income until some future date when the benefits are distributed or made available to the employee. On the other hand, contributions to a funded plan are generally deductible by the employer and includable in an employee's income in the year the contribution is made. *See* Sections 83, 402(b), 404(a)(5), 404(d) and 451 of the Code; *Revenue Ruling 60-31,* 1960-1 C.B. 174, 1960 WL 12882, as modified by *Revenue Ruling 64-279,* 1964-2 C.B. 121, 1964 WL 12635 and *Revenue Ruling 70-435,* 1970-2 C.B. 100, 1970 WL 20479; *Private Letter Rulings 9206009*, dated November 11, 1991, *9207010*, dated November 12, 1991, *9212019*, dated December 20, 1991, *9212024*, dated December 20, 1991, and *9302017*, dated October 15, 1992.

In *Wellons v. Commissioner*, 31 F.3d 569 (7th Cir.1994) the court disallowed the taxpayer's deductions for the funding of severance obligations on the basis that the payments made by the taxpayer were to a deferred compensation plan and, therefore, were not deductible. The court examined the severance pay plan to determine whether it was a welfare benefit fund or a nonqualified deferred compensation plan. The severance pay plan covered all of the employees who terminated employment for any reason after five years of employment. The court applied Section 1.404(a)-1(a)(3) of the Treasury Regulations, which provides that the entire plan is considered a deferred compensation plan where the plan contains features of both a welfare plan and a deferred compensation plan. Finding that the plan benefits, which were based on salary and length of service, reflected the characteristics of a deferred compensation plan, the court held that the deduction for contributions to the plan's trust was governed by Section 404(a)(5) of the Code. Consequently, the contributions were deductible only when benefits were taxable to plan participants on distribution from the trust under Section 404(a)(5).

Section 404(a)(5) of the Code provides that an employer can deduct the amounts contributed to a nonqualified deferred compensation plan in the taxable year in which an amount attributable to the contribution is includable in the gross income of employees participating in the plan, but, in the case of a plan in which more than one employee participates only if separate accounts are maintained for each employee. Section 404(d) of the Code contains a similar rule for the deduction of payments to a plan for independent contractors. *See* Section 1.404(a)-12(b) of the Regulations. Generally, a deduction is allowed only to the extent of the amount contributed and not the entire amount that is includable in the recipient's income. Section 404(a)(5) of the Code; Section 1.404(a)-12(b) of the Regulations; *Private Letter Ruling 9025018,* dated March 22, 1990.

Section 1.404(a)-12(b)(1) of the Treasury Regulations provides that a deduction is allowable for a contribution under Section 404(a)(5) only in the taxable year of the employer in which or with which ends the taxable year of an employee in which an amount attributable to such contribution is includable in his or her gross income as compensation, and then only to the extent allowable under Section 404(a). For example, if an employer contributes $1,000 to the account of an employee for its taxable (calendar) year 1977, but the amount in the account attributable to that contribution is not includable in the employee's gross income until the employee's taxable (calendar) year 1980 (at which time the includable amount is $1,150), the employer's deduction for that contribution is $1,000 in 1980 (if allowable under Section 404(a)).

In *Private Letter Ruling 9212024,* dated December 20, 1991, which involved a trust created by an employer to fund benefits under a nonqualified plan, the Internal Revenue Service discussed the rules under Section 1.404(a)-12(b)(1) of the Regulations in its analysis of the deduction timing rules. The IRS determined that the employer was entitled to deduct contributions made to the trust that were allocated to the trust accounts of participants in the taxable year in which amounts attributable to those contributions were includable in the gross income of the participants or beneficiaries to the extent such contributions were ordinary and necessary expenses within the meaning of Section 162 of the Code.

In *Private Letter Ruling 9316018,* dated January 22, 1993, which involved a "secular trust" established by an employee, the Internal Revenue Service determined that payments by the employer under the terms of the trust established by the employee were deductible by the employer in the year paid, to the extent the payments were ordinary and necessary expenses within the meaning of Section 162 of the Code. (See *Private Letter Ruling 9417013*, dated April 29, 1994, regarding the tax consequences with respect to a vesting trust.)

Because a vesting or secular trust is considered to be funded for tax purposes, the employer is entitled to deduct contributions to the trust in the year in which the contributions are made or, if later, the year in which participating employees become vested and, therefore, subject to tax on amounts attributable to those contributions to the extent such contributions are considered ordinary and necessary expenses paid or incurred in carrying on a trade or business. Because the employer cannot be the owner of a vesting or secular trust and the income is taxable to the trust, the employer may not deduct trust income (see Section 1.671-1(g)(1) of the Proposed Treasury Regulations). Thus, the amount of the deduction is equal to the amount of the contribution, which, because of trust earnings, could be less than the entire amount includable in the employee's gross income in accordance with Section 1.404(a)-12(b)(1) of the Treasury Regulations.

Section 1.404(a)-12(b)(2) of the Treasury Regulations provides that if unfunded pensions are paid directly to former employees, such payments are includable in their gross income when paid, and accordingly, such amounts are deductible under Section 404(a)(5) when paid. Similarly, if amounts are paid as a death benefit to the beneficiaries of an employee (for example, by continuing the employee's salary for a reasonable period), and if such amounts meet the requirements of Section 162 or 212, such amounts are deductible under Section 404(a)(5) in any case when they are not includable under the other paragraphs of Section 404(a).

In *Private Letter Ruling 9350018,* dated September 17, 1993, which involved a nonqualified plan and a "rabbi trust," the Internal Revenue Service stated that Section 404(a)(5) of the Code provides the general deduction timing rules applicable to any plan or arrangement for the deferral of compensation, regardless of the Code section under which the amounts might otherwise be deductible. Pursuant to Section 404(a)(5) and Section 1.404(a)-12(b)(2) of the Regulations, and provided that they otherwise meet the requirements for deductibility, amounts of contributions or compensation deferred under a nonqualified plan or arrangement are deductible in the taxable year in which they are paid or made available, whichever is earlier. In another ruling involving a rabbi trust, *Private Letter Ruling 9504006*, dated October 19, 1994, the employer was entitled to a deduction pursuant to Section 404(a)(5) for amounts paid or made available under the plan and out of the trust only in the taxable year in which the amounts were includable in the gross income of the participant or his beneficiary, provided such amounts otherwise met the requirements for deductibility under Section 162.

Because the rabbi trust is treated as unfunded for tax purposes, the employer is not entitled to deduct the contributions to the trust in the year in which they are made. The employer is generally entitled to a deduction under Section 404(a)(5) in the year the participating employee is subject to tax. The amount of the deduction is the amount contributed to the trust, plus earnings, that is distributed to the employee. Under Section 671 of the Code, the employer must include all of the income, deductions, and credits of the trust in computing its own taxable income and credits. Thus, the earnings, which are considered an asset of the employer, are treated as contributed or paid by the employer when they are distributed to the employee.

A significant element of Section 404(a)(5) of the Code is that in order to be deductible under Section 404(a)(5) and the regulations thereunder, amounts contributed to a nonqualified plan must also be ordinary and necessary business expenses under Section 162 of the Code. Section 162(a)(1) of the Code allows a deduction with respect to "a reasonable allowance for salaries or other compensation for personal services actually rendered." Section 1.162-9 of the Income Tax Regulations provides that bonuses paid to employees are deductible "when such payments are made in good faith and as additional compensation for the services actually rendered by the employees, provided such payments, when added to the stipulated salaries, do not exceed a reasonable compensation for the services rendered." Whether an expense that is claimed pursuant to Section 162(a)(1) is reasonable compensation for services rendered is a question of fact that must be decided on the basis of the facts and circumstances. Among the elements to be considered in determining this are the personal services actually rendered in prior years as well as the current year and all compensation and contributions paid to or for such employee in prior years as well as in the current year. Thus, a contribution which is in the nature of additional compensation for services performed in prior years may be deductible, even if the total of such contributions and other compensation for the current year would be in excess of reasonable compensation for services performed in the current year, provided that such total plus all compensation and contributions paid to or for such employee in prior years represents a reasonable allowance for all services rendered by the employee by the end of the current year. See Section 1.404(a)-1(b) of the Regulations. (See *Private Letter Ruling 9347012*, dated August 18, 1993.)

In *Dexsil Corporation v. Commissioner*, T.C. Memo. 1995-135, 1995 WL 131525 (1995), the Tax Court's determination of reasonable compensation on the basis of the particular facts and circumstances was vacated, 147 F.3d 96 (2d Cir.1998). The Second Circuit held that the failure to consider the compensation of the Chief Executive Officer from the perspective of an independent investor was legal error. The Tax Court also failed to consider an existing compensation formula.

At issue in this case was whether the amount of salary and bonuses paid by Dexsil during the 1989 and 1990 tax years to Ted Lynn, the president, chief executive officer, treasurer, and chief financial officer of Dexsil, was reasonable compensation for his services and thus deductible by Dexsil as a business expense, or was instead to some extent unreasonable, with the unreasonable amount representing, in effect, a hidden dividend payment. The Tax Court found that Dexsil's deduction for compensation to Lynn for the 1989 and 1990 tax years was unreasonable in amounts of $76,540 and $168,000, respectively, and ordered Dexsil to pay the resulting deficiencies of $33,504 and $95,778. The Second Circuit however vacated the Tax Court's judgment and remanded the case for further proceedings.

The court reviewed the Tax Court's definition and application of the appropriate factors in the determination of reasonable compensation. The court stated that it outlined several factors to be considered in assessing the reasonableness of an employee's compensation in *Rapco, Inc. v. Commissioner*, 85 F.3d 950 (2d Cir.1996). The court summarized the factors and commented that no single factor is dispositive and "the court should assess the entire tableau from the prospective of an independent investor-that is, given the dividends and return on equity enjoyed by a disinterested stockholder, would that stockholder approve the compensation paid to the employee?" Citing *Rapco, Inc.* at 954-55.

Under the hypothetical or independent investor test, courts assess the reasonableness of compensation in terms of "[w]hether an inactive, independent investor would be willing to compensate the employee as he was compensated. The nature and quality of the services should be considered, as well as the effect of those services on the return the investor is seeing on his investment." *Dexsil* at 101. The court noted that the independent investor test is not a separate autonomous factor; rather, it provides a lens through which the entire analysis should be viewed. The court stated that "[a]lthough we accord deference to the Tax Court's special expertise, [the] definition of the appropriate factors is reviewable by this court as a question of law." *Id*. The court then stated that the Tax Court's apparent failure to consider Lynn's compensation from the perspective of an independent investor was legal error. Accordingly, the court stated that it must vacate or remand the case to allow it to afford such consideration.

The court also stated that the Tax Court's opinion was virtually silent with respect to the evidence proffered by Dexsil that, starting in 1982, it had consistently compensated Lynn according to a formula of approximately 11% of sales. Thus, the court was left to wonder whether the judge rejected Dexsil's argument that a formula existed, found the formula to be unreasonable, or simply failed to consider it. The court stated that there was some indication that the Tax Court was suggesting that in order for there to be a valid contingent compensation formula for Lynn, it must have been applied to Dexsil's other employees, and the court found this to be erroneous as a matter of law.

Therefore, the court found that the Tax Court's failure to assess the reasonableness of Lynn's compensation from the perspective of a hypothetical or independent investor was erroneous as a matter of law. Accordingly, the court vacated and remanded the matter for reconsideration consistent with the opinion of the Second Circuit. The court directed the Tax Court to make specific findings regarding the following questions: (1) whether a hypothetical investor would accept the compensation paid to Lynn; (2) whether Lynn was paid according to a long-standing and consistently applied contingent compensation formula, and if so, whether his salary was reasonable in light of this formula; (3) whether Lynn's compensation compared favorably with the compensation paid by similar companies for comparable services, given the many roles Lynn played at Dexsil; and (4) whether, after reconsideration of these factors, the balance of factors has shifted in favor of Dexsil such that it has met its burden of proving that Lynn's compensation was reasonable.

On remand, the Tax Court in *Dexsil Corp. v. Commissioner*, T.C. Memo. 1999-155, 1999 WL 512588 (1999), upheld its determination that compensation paid to Lynn was unreasonable where the taxpayer failed to show that an independent investor would find it reasonable. The Tax Court held that the amount paid to Lynn failed the hypothetical independent investor test for the following reasons:

(1) Dexsil's return on equity varied substantially from year to year and declined for 1989 and 1990. By another calculation, the Tax Court stated that Dexsil's return on equity over the time it was controlled by Lynn averaged an annual rate of 15%, with the increase almost entirely due to retained earnings. On the other hand, Lynn's compensation increased substantially in those years.

(2) The only evidence at trial relating to the rate of return acceptable to a hypothetical investor was data on exchange-listed companies. However, the Tax Court stated that the rate of return acceptable to an investor in a closely held company dominated by family members was not the same as the rate of return paid by a company listed on a major exchange. If that were the law, "any amount of compensation would be regarded as reasonable as long as a minimal average return, computed by adding appreciation as well as actual payments to shareholders, was reflected on the company's balance sheets."

The Tax Court also determined that the testimony that Dexsil had a long-standing, informal agreement to pay Lynn 11% of sales was vague "and had the earmarks of retrospective argument." The court was not persuaded that a "formula existed or was consistently applied."

The Tax Court also stated that it did take into account Lynn's multiple roles when determining the amount of reasonable compensation for him. The court stated that "limits to reasonable compensation exist even for the most valuable employees."

In a 1996 case, *Rapco, Inc. v. Commissioner*, 85 F.3d 950 (2d Cir.1996), the Second Circuit in determining Rapco's president's compensation was unreasonable, found the factors in *Elliotts, Inc. v. Commissioner*, 716 F.2d 1241 (9th Cir.1983), *on remand* T.C. Memo. 1984-516, 1984 WL 15158 (1984), examined from the perspective of an independent investor, were an appropriate standard to evaluate the reasonableness of employee compensation. These factors are: an employee's role in the company, external comparison with other companies, character and condition of the company, potential conflicts of interest, and internal consistency in compensation. The court found that "[t]hese factors adequately balance the company's financial fitness and role in the market, and the employee's responsibility for that role." *Rapco, Inc.* at 955.

The language in Section 404(a)(5) of the Code provides that contributions under a deferred compensation plan are deductible in the taxable year in which an amount attributable to the contribution is includable in the gross income of an employee participating in the plan. The deduction is "matched" with the inclusion of income. As Daniel Halperin noted, "in the case of deferred payment of compensation under nonqualified plans, Congress has imposed 'a matching requirement,' which denies an employer's deduction until the deferred amount is included in the employee's income." Daniel I. Halperin, Interest in Disguise: Taxing the "Time Value of Money," 95 Yale L.J. 506, 520 (1986) (discussing Section 404). To allow an employer "to deduct [deferred amounts] prior to their receipt by their employees would contravene the clear purpose of the taxation scheme governing deferred compensation agreements" (*Albertson's Inc. v. Commissioner*, 42 F.3d 537, 546 (9th Cir. 1994), *aff'g* 95 T.C. 415 (1990)). This tax tension between the deferral desired by an employee and the current deduction desired by the employer is an inherent limitation on the amount of deferred compensation that a taxable employer would be willing to provide to the employee.

And, the timing rules governing the recognition of income by an employee are found in the doctrines and theories of constructive receipt, economic benefit, assignment of income, cash equivalency, the transfer of property, and dominion and control. These doctrines and theories impose a standard and structure to deferred compensation plans implemented by employers and promote fair and equitable tax policy.

B. Constructive Receipt

Generally, contributions pursuant to a nonqualified deferred compensation plan are not includable in a participating employee's income under the constructive receipt doctrine; if the employee's control over the contributions is subject to substantial limitations, then contributions to a nonqualified deferred compensation plan should not be subject to the constructive receipt doctrine. Under Section 451(a) of the Code and Section 1.451-1(a) of the Treasury Regulations, a taxpayer includes the amount of any item of gross income in his or her gross income for the taxable year in which he or she receives it, unless, under the taxpayer's method of accounting, it is properly included in a different period. (See *Private Letter Ruling 9505012*, dated November 4, 1994.)

Section 451(a) of the Code provides that a taxpayer reporting on the cash method of accounting must include an item in income for the taxable year in which such item is actually or constructively received. Section 1.451-2(a) of the Income Tax Regulations defines the term "constructive receipt" as "[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 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."

Thus, under the constructive receipt doctrine, a taxpayer recognizes income when the taxpayer has an unqualified, vested right to receive immediate payment. The doctrine precludes the taxpayer from deliberately turning his back upon income otherwise available. *George C. Martin v. Commissioner*, 96 T.C. 814, 1991 WL 104315 (1991).

The background for understanding the concept of the constructive receipt doctrine and its application to nonqualified deferred compensation plans is found in several early revenue rulings that applied to certain deferred compensation plans. *Revenue Ruling 60-31*, 1960-1 C.B. 174, sets forth the rules of constructive receipt in the area of deferred compensation agreements. This leading ruling in the field of deferred compensation agreements has been sustained by the courts. *See Goldsmith v. United States*, 586 F.2d 810, 815-18, 218 Ct.Cl. 387 (1978). *Revenue Ruling 60-31,* 1960-1 C.B. 174, notes with appropriate authority that "[a] mere promise to pay, not represented by notes or secured in any way, is not regarded as a receipt of income within the intendment of the cash receipts and disbursements method," *Revenue Ruling 60-31*, 1960-1 C.B. 174, and proceeds to review when and under what circumstances certain contractual benefits may be treated as constructively received.

In *Revenue Ruling 71-332*, 1971-2 C.B. 210, a profit sharing plan provided that a participant could withdraw any part of his vested account balance, prior to termination of employment, in the case of financial need but only to the extent approved by the plan's administrative committee. Any participant who desired to make such a withdrawal was required to make a written application to the committee. The committee had the sole discretion to determine whether financial necessity existed and, if so, what portion of the participant's vested account balance could be withdrawn. The plan also provided that, in approving withdrawals, the committee was required to follow a uniform and nondiscriminatory policy.

An employee whose vested account balance was $3,000 made application for a withdrawal of $500 because of a financial need. The committee subsequently approved the application for withdrawal both as to need and as to amount. However, the employee later found that he could relieve his financial need by withdrawing only $400 and only that amount was actually withdrawn.

The IRS found that although the employee could have applied for a withdrawal of the entire vested account balance of $3,000, he was not considered to be in constructive receipt of that amount since the requirement in the plan for substantiating financial need, obtaining approval of the administrative committee, and the acceptance of whatever terms and conditions such committee could impose, constituted substantial restrictions or conditions on the employee's right of withdrawal. However, the $500 amount approved for withdrawal by the committee was actually the maximum amount permitted as a withdrawal in this case and, therefore, was made available to the employee. Accordingly, the employee was required to include $500 in gross income for the year the committee's approval was granted for the withdrawal of such amount rather than the $400 actually withdrawn.

In *Revenue Ruling 77-34*, 1977-1 C.B. 276, a profit sharing plan provided that an employee could withdraw his or her entire interest in the funds contributed to the plan at any time. However, when such a withdrawal was made, the employee incurred a 12-month suspension from participating under the plan, at the expiration of which the employee could reenter the plan. During the period of suspension, no contributions could be made by the company on behalf of the employee. An employee who had been a participant in the plan for 20 years died while still employed having made no request for a withdrawal. The entire amount credited to the decedent's account was payable to the designated beneficiary in several payments over a period of years. The question was whether the decedent's beneficiary received the decedent's share of the plan under the terms of the plan, or from the decedent who constructively received the payments prior to death. The IRS stated that where participants were permitted to withdraw employer contributions subject to the suspension of participation for a specified period during which no contributions were made by the employer on behalf of such employees, such suspension represented a substantial restriction or limitation and the amounts that were permitted to be withdrawn were not made available to the employee. Therefore, the decedent's interest in the employee trust was not constructively received prior to death. (*Revenue Ruling 77-34,* 1977-1 C.B. 276, was made obsolete by *Revenue Ruling 88-85*, 1988-2 C.B. 333, to the extent it referred to Sections 2039(c), (d), (e), (f), or (g).)

Related to the concept of plan suspension established to limit withdrawals is the payment of a financial percentage, or what is commonly referred to as a "haircut" which has been considered to be a limitation or restriction on the availability of compensation. In *Revenue Ruling 55-423*, 1955-1 C.B. 41, which involved a plan suspension, the IRS noted that "[i]n the penalty type of case a participant, who makes a withdrawal, is required to discontinue his participation in the trust or suffer a forfeiture with respect to a portion of his distributable interest. Discontinuance of participation is the surrender of a valuable right and, as long as that remains a condition for withdrawal of his interest, such interest is not made available to the participant." Although the IRS indicated its approval of the "haircut" concept, the IRS did not specifically state the amount of a haircut that would be necessary to preclude constructive receipt. In determining the amount that may be considered to be a substantial limitation or restriction on the availability of deferred compensation, 10% is regarded as a "substantial" penalty amount, primarily based upon the early withdrawal penalty applicable to distributions from qualified plans, individual retirement accounts and Section 403(b) annuities prior to attaining age 59-1/2 as described in Section 72(t) of the Code. Under Section 72(t), such withdrawals are generally subject to a 10% excise tax unless they are rolled over or they meet specific standards for an exception described in that section. Support for the use of the 10/% amount as a sufficient penalty for premature withdrawals is based in part on the legislative history of Section 72(t), which indicates that Congress believed 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" (H.R. Rep. No. 779, 93d Cong., 2d Sess. p. 116, 1974-3 C.B. 359. The IRS has also used the term "substantial deterrent" in General

Counsel Memoranda to be synonymous with "substantial limitations or restrictions" when describing means to avoid the application of constructive receipt (*see, e.g.*, GCM 37562).

In *Revenue Ruling 77-139*, 1977-1 C.B. 278, the participant, at the time of death, was the president and sole shareholder of a corporation and participated in the corporation's noncontributory pension plan and, pursuant to the provisions of the plan, the decedent's spouse was designated beneficiary of a life annuity. The question was whether the decedent's sole ownership of the corporation gave the decedent the unrestricted right to receive the decedent's interest in a qualified pension plan necessary for application of the constructive receipt doctrine or whether the decedent's beneficiary received such interest under the terms of the plan. The IRS stated that if a qualified plan of a corporation with one shareholder was terminated before the retirement or death of the participant shareholder, the corporation was required to establish that abandonment of the plan was due to reasons which justified not having the plan's qualification revoked retroactively. The IRS determined that the power of the decedent to terminate the plan was sufficiently restricted to prevent invocation of the doctrine of constructive receipt. (*Revenue Ruling 77-139,* 1977-1 C.B. 278, 1977 WL 44402 was made obsolete by *Revenue Ruling 88-85,* 1988-2 C.B. 333, 1988 WL 546812, to the extent it referred to Sections 2039(c), (d), (e), (f), or (g).)

In *Revenue Ruling 80-158,* 1980-1 C.B. 196, the decedent was a participant in the employer's noncontributory profit sharing plan that provided for the purchase of ordinary paid up life insurance policies on the lives of all participating employees. On the decedent's retirement date, two policies that had been purchased by the trustee of the plan on the decedent's life were surrendered for two supplemental policies. Under the terms of the supplemental contracts, the decedent as primary payee was to receive monthly annuity payments for life with 10 years of payments guaranteed in any event. In addition, although the supplemental policies were not distributed to the decedent, the decedent had the right to designate a contingent beneficiary as payee of any proceeds payable at death and had the right to surrender the supplemental contracts and receive the commuted value of the guaranteed payments. Upon the decedent's death, the remaining guaranteed installments under the supplemental contracts were paid to the designated contingent beneficiary. In this case, the decedent had the right during the 10-year period of guaranteed payments to surrender the rights under the profit sharing plan for the commuted value of the remaining guaranteed payments. If the decedent had exercised the right to receive the commuted value of the guaranteed payments, the decedent would have suffered a significant economic penalty, because the amount required to purchase a new annuity of comparable value would have been greater than the commuted value of the remainder of the 10-year certain payments. Thus, the decedent's control over the guaranteed payments was subject to a substantial limitation or restriction, and the decedent's interest in the profit sharing trust was not constructively received by the decedent prior to death. (*Revenue Ruling 80-158,* 1980-1 C.B. 196, was made obsolete by *Revenue Ruling 88-85*, 1988-2 C.B. 333, to the extent it referred to Sections 2039(c), (d), (e), (f), or (g).)

In *Revenue Ruling 80-300*, 1980-2 C.B. 165, a corporation adopted a plan under which key employees of the corporation were granted stock appreciation rights. The stock appreciation rights entitled the employee to a cash payment equal to the excess of the fair market value of one share of the common stock of the corporation on the date of the exercise of the stock appreciation right over the fair market value of a share on the date the stock appreciation right was granted to the employee. The IRS stated that the forfeiture of a valuable right is a substantial limitation that precludes constructive receipt of income. The employee's right to benefit from further appreciation of stock, in this case, without risking any capital was a valuable right. However, once the employee exercised the stock appreciation rights, the employee lost all chance of further appreciation with respect to that stock and the amount payable became fixed and available without limitation. Accordingly, the employee would be in receipt of income on the day the stock appreciation rights were exercised.

Generally, as long as the deferred compensation arrangement is unfunded or contains a substantial restriction, such as a period of nonparticipation or an economic penalty, and the participants in the arrangement have no current right to receive a payment under the arrangement, the doctrine of constructive receipt will not apply. Also, pursuant to several court opinions which have addressed this doctrine, if an agreement to defer compensation is entered into prior to the period of service for which the compensation is payable or to the date on which the amount payable is ascertainable, the doctrine is not likely to be applied.

In *Veit v. Commissioner*, 8 T.C. 809 (1947), *acq.* 1947-2 C.B. 4, the taxpayer agreed at the beginning of 1939 to receive 10% of his employer's net profits for 1939 and 1940, to be paid on two dates in 1941. In November 1940, the taxpayer and his employer entered into a new contract and further deferred his share of the 1940 profits to 1942. In holding that the deferred income was not constructively received, it was stated that "there was an agreement to pay at a particular time indefinite amounts, and, prior to the date on which those amounts were due or could be determined, payment was deferred." Thus, there was no constructive receipt of income where an agreement under which the taxpayer would have received deferred payments from his employer was superseded by a bona fide later agreement.

In *Robinson v. Commissioner*, 44 T.C. 20 (1965), *acq. Revenue Ruling 70-435,* 1970-2 C.B. 100, a famous boxer contracted with the promoter of a championship bout for a share of the receipts to be paid to him in four annual installments. Though his share of receipts actually exceeded $500,000 in 1957, the year of the bout, he was paid under the agreement and reported as income only $136,000. The Tax Court rejected the Commissioner's argument that Robinson was in constructive receipt of the entire $500,000 in 1957. The agreement was made before the money was earned and was not a sham; Robinson had no security interest in the deferred amounts. Therefore, he was not in constructive receipt of the deferred amounts.

In *Goldsmith v. United States*, 586 F.2d 810, 218 Ct.Cl. 387 (1978), an anesthesiologist and a hospital entered into a deferred compensation agreement to provide deferred compensation to the anesthesiologist. As part of the deferred compensation arrangement, the parties had agreed that the agreement would be funded by the purchase by the hospital of a life insurance endowment policy. The court determined that there were substantial limitations or restrictions on the anesthesiologist's access to sums withheld from his compensation under the deferred compensation arrangement and, therefore, the sums were not constructively received by the anesthesiologist. The court determined that the funding by insurance was merely a method of investment by the hospital to finance its undertakings. No trust, escrow or other such arrangement affecting the withheld sums was constituted such as would invalidate the deferment by giving the taxpayer a security interest in the sums deferred. Also, the taxpayer had no rights in the withheld sums either against his hospital or the insurance company. The hospital was the sole owner and beneficiary of the policy, and the taxpayer could rely only on the credit of the hospital and the strength of its promise.

In *George C. Martin v. Commissioner*, 96 T.C. 814 (1991), Koch Industries, Inc. decided to improve an old deferred compensation plan for key management employees by adopting a shadow stock plan to resolve certain concerns over the old plan. Under the old plan, a participant's benefits were payable in 10 equal annual installments which did not bear interest. Under the new plan, the benefits were payable in a lump sum unless the participant executed the beneficiary and settlement designation form and elected to receive payment of the shadow stock benefits in 10 equal annual installments. In 1981 two participants elected annual installments and following such elections, one of the participants was involuntarily terminated and the other resigned because he perceived that Koch Industries, Inc. had a lack of confidence in him. The IRS determined that the participants were in constructive receipt of their deferred compensation benefits because they had the unfettered right or choice, in 1981, to receive a lump sum distribution after electing into the new plan. However, the court determined that the facts and circumstances did not justify the application of the constructive receipt doctrine. Initially, the court noted that the shadow stock plan was unfunded and the participants had an unsecured right under, and interest in, the plan. The court also stated that the election to receive either a lump sum contribution or installment payments could only be made before the amounts became due and fully ascertainable. The court also noted that at the time the participants exchanged their old plan units for new plan shadow stock, they could have surrendered the stock for a lump sum or elected installments and surrendered their stock for 10 annual installments. However, the facts of the case reflected that the participants had to give up or forfeit certain rights and future benefits in exchange for current or installment benefits. Thus, the participants' rights to receive income were subject to limitations and restrictions. In summary, the court stated that the participants had the choice or right to receive a lump sum or installment benefits. The choice or right was not sufficiently unfettered to cause constructive receipt.

C. Economic Benefit Doctrine

Contributions made pursuant to a nonqualified deferred compensation plan are generally not includable in the employee's income under the economic benefit doctrine, which identifies when income has actually been received other than by a direct payment of cash. If contributions are made or amounts set aside in accordance with a nonqualified deferred compensation plan are subject to the claims of the employer's general creditors, then such contributions or amounts should not be subject to the economic benefit doctrine. However, if contributions to the plan are protected from the employer's creditors and the rights of the plan participants to the benefits provided under the plan are nonforfeitable, the economic benefit doctrine should apply and the contributions would be includable in the participant's income.

Under the economic benefit doctrine, if any economic or financial benefit is conferred on an individual as compensation in a taxable year, it is taxable to the individual in that year. In *Commissioner v. Smith*, 324 U.S. 177, 65 S.Ct. 591, 89 L.Ed. 830 (1945), *reh. den*. 324 U.S. 695, 65 S.Ct. 891, 89 L.Ed. 1295 (1945), an employer gave an employee, as compensation for his services, an option to purchase from the employer certain shares of stock of another corporation at a price not less than the then value of the stock. In two later years, when the market value of the stock was greater than the option price, the employee exercised the option, purchasing large amounts of the stock in each year. The Tax Court had determined that the excess of the market value of the shares over the option price in the years when the shares were received by the employee was compensation for his services, and taxable as income in those years. The United States Supreme Court agreed and concluded that the employee received an economic benefit at the time he received the shares and, as a result, the employee had taxable income in each year in which stock was acquired.

In *Sproull v. Commissioner*, 16 T.C. 244 (1951), *aff'd per curiam*, 194 F.2d 541 (6th Cir.1952), a corporation created a trust of $10,500 for its president in 1945. The trustee was directed to invest the money and pay one-half of it to the individual in 1946 and pay the remainder to the individual in 1947. The court considered the doctrine of constructive receipt but determined that it did not apply because the individual was not able to reduce any part of the money to actual possession in 1945 because of the time limitation set on payment in the trust instrument.

However, the court determined that the creation of the trust in 1945 had conferred an economic or financial benefit on the individual in 1945 so that the sums paid into the trust were taxable to the individual in 1945. The court explained that in 1945 the employer had completed its part of the transaction by irrevocably paying out the $10,500 for the individual's benefit and the taxpayer had to do nothing further to earn the benefit. The court said that this fact distinguished the case from those in which the exact amount of compensation is subject to a future contingency or subject to the possibility of return to the employer. The court also noted that the trustee's only duties were to hold, invest, accumulate and distribute the funds to the individual; that no one else had any interest in or control over the funds held in the trust; and that the individual could have assigned or otherwise disposed of his beneficial interest in the trust.

In *Minor v. United States*, 772 F.2d 1472 (9th Cir.1985), the court held that a deferred compensation plan adopted by the Snohomish County Physicians Corporation in 1967 for its participating physicians was unsecured from the corporation's creditors and therefore incapable of valuation; thus, a physician's benefits did not constitute property under the statute governing property transferred in exchange for performance of services. Under the arrangement, the physician agreed to continue to provide services to Snohomish Physicians patients until the benefits became payable, to limit his or her practice after retirement, to continue to provide certain emergency and consulting services, and to refrain from providing medical services to competing groups. The Snohomish Physicians established a trust to provide for its obligation under the plan. The Snohomish County Physicians Corporation was both the settlor and beneficiary of the trust and the assets of the trust remained solely those of the corporation and subject to the claims of its general creditors.

The IRS conceded that Minor did not constructively receive the proceeds of Snohomish Physicians' deferred compensation plan, but argued that the trust contributions were taxable under the economic benefit doctrine. "Under that doctrine, an employer's promise to pay deferred compensation in the future may itself constitute a taxable economic benefit if the current value of the employer's promise can be given an appraised value." "The concept of economic benefit is quite different from that of constructive receipt because the taxpayer must actually receive the property or currently receive evidence of a future right to property." The court, in rejecting this argument, concluded that the deferred compensation plan was unsecured from Snohomish Physicians' creditors and thus incapable of valuation. Accordingly, the court concluded that Minor's benefits did not constitute property under Section 83 of the Code. However, the court noted that the plan "severely stretches the limits of a nonqualified deferred compensation plan."

D. Assignment of Income Doctrine

The doctrine of assignment of income is similar to the economic benefit doctrine because, as the United States Supreme Court pointed out in *Helvering v. Horst*, 311 U.S. 112, 61 S.Ct. 144, 85 L.Ed. 75 (1940), the power to dispose of income represents the equivalent of ownership and the exercise of a power to dispose of income represents the equivalent of taxable enjoyment. If a future benefit may be currently assigned to another party, the person assigning the benefit may be subject to current taxation under this doctrine. (See *United States v. Basye*, 410 U.S. 441, 93 S.Ct. 1080, 35 L.Ed.2d 412 (1973), rehearing denied 411 U.S. 940, 93 S.Ct. 1888, 36 L.Ed.2d 402 (1973)).

The doctrine was formalized by the United States Supreme Court in *Lucas v. Earl*, 281 U.S. 111, 50 S.Ct. 241, 74 L.Ed. 731 (1930). The question in that case was whether Earl could be taxed for the whole of the salary and attorneys' fees earned by him in the years 1920 and 1921, or should be taxed for only a half of them in view of a contract with his wife. The contract, made in 1901, provided that the salary and fees earned by Earl became the joint property of Earl and his wife on the very first instant on which they were received. The Court held that "the statute could tax salaries to those who earned them and provide that the tax could not be escaped by anticipatory arrangements and contracts however skillfully devised to prevent the salary when paid from vesting even for a second in the man who earned it." The Court further stated that it believed that "no distinction can be taken according to the motives leading to the arrangement by which the fruits are attributed to a different tree from that on which they grew."

In *Helvering*, the owner of negotiable bonds detached from the bonds negotiable interest coupons shortly before their due date and delivered them as a gift to his son who in the same year collected them at maturity. The question was whether the gift, during the donor's taxable year, of interest coupons detached from the bonds, delivered to the donee and later in the year paid at maturity, is the realization of income taxable to the donor. The United States Supreme Court stated that even though the donor "never receives the money he derives money's worth from the disposition of the coupons which he has used as money or money's worth in the procuring of a satisfaction which is procurable only by the expenditure of money or money's worth. The enjoyment of the economic benefit accruing to him by virtue of his acquisition of the coupons is realized as completely as it would have been if he had collected the interest in dollars and expended them for any of the purposes named." The Court further stated that the "power to dispose of income is the equivalent of ownership of it. The exercise of that power to procure the payment of income to another is the enjoyment and hence the realization of the income by him who exercises it."

In *Commissioner v. P.G. Lake, Inc.*, 356 U.S. 260, 78 S.Ct. 691, 2 L.Ed.2d 743 (1958), *rehearing denied* 356 U.S. 964, 78 S.Ct. 991, 2 L.Ed.2d 1071 (1958), the taxpayers assigned the right to a specified sum of money, payable out of a specified percentage of oil, or the proceeds received from the sale of such oil, if, as and when produced in return for cash. The Court concluded that, while the oil payments were interests in land, the consideration received for the oil payment rights was taxable as ordinary income because the lump sum consideration was essentially a substitute for what would otherwise be received at a future time as ordinary income. The Court stated:

> We have held that if one, entitled to receive at a future date interest on a bond or compensation for services, makes a grant of it by anticipatory assignment, he realizes taxable income as if he had collected the interest or received the salary and then paid it over.... As we stated in *Helvering v. Horst*, supra (311 U.S. 112), "The taxpayer has equally enjoyed the fruits of his labor or investment and obtained the satisfaction of his desires whether he collects and uses the income to procure those satisfactions, or whether he disposes of his right to collect it as the means of procuring them." There the taxpayer detached interest coupons from negotiable bonds and presented them as a gift to his son. The interest when paid was held taxable to the father. Here, even more clearly than there, the taxpayer is converting future income into present income.

Thus, the assignment of income doctrine is likely to be applied when a taxpayer assigns his or her right to receive a benefit to a third party as consideration for some other benefit. However, the assignment of income doctrine is not likely to be applied in the case where a benefit promised under the terms of a deferred compensation plan may not be alienated, sold, transferred, or assigned. (See *Private Letter Ruling 9340032*, dated July 6, 1993, regarding the division of nonqualified deferred compensation in a divorce, and *Private Letter Ruling 9405021*, dated November 8, 1993, for recent discussions of the assignment of income doctrine.)

The assignment of income doctrine, while not examined, at least appeared to have been contemplated in a 2001 case in the Indiana Court of Appeals, *Bizik v. Bizik*, 753 N.E.2d 762 (Ind.App.2001). In that case a former spouse of a participant in an executive supplemental retirement plan was determined not to be entitled to a share of the plan assets where, at the time of the divorce of the parties, the participant was not vested in the plan.

On October 1, 1997, a joint preliminary injunction was issued, precluding Dan and Brenda Bizik, who were married on June 1, 1968, and who filed a petition for separation on September 30, 1997, from incurring any debt or obligation that would create a debt or obligation for the other party. Moreover, the injunction precluded either party from disposing of joint property without the consent of the other party or by permission of the trial court. On July 24, 1998, Brenda filed a petition for dissolution of marriage. Subsequently, a joint mutual restraining order was entered, restraining either party from transferring, encumbering, concealing, or otherwise disposing of joint property, except for the necessities of life, without the written consent of the other party, or without permission of the trial court. The parties thereafter entered into an agreed provisional order on January 16, 1999, which was filed with the trial court on March 3, 1999. On December 14, 1999, a hearing commenced on the petitions of the parties for dissolution of marriage, at the conclusion of which the trial court awarded Brenda a 70% interest in the total marital estate, which was valued at $1,512,920. Dan appealed the award.

The operative question for review was whether the executive supplemental retirement plan in which Dan was a participant was marital property under the relevant Indiana statute, Ind. Code § 31-9-2-98(b). The statute permitted "the inclusion of certain pension-type interests in the marital pot for division;: therefore, the court was required to determine whether the executive supplemental retirement plan in which Dan was a participant was "property" that fell within any of the categories of that statute. Dan argued that the trial court erred by including the executive supplemental retirement plan in the "marital pot" for division. Dan contended that the trial court improperly awarded Brenda an interest in his future income that he had no present right to withdraw and was not vested.

The court, upon review of the issue and the evidence presented, stated that the evidence revealed that the executive supplemental retirement plan was not a pension or retirement plan that Dan had a present vested right from which to withdraw benefits. In fact, the court stated that Dan had testified that if he had died or retired before an acceptable retirement age, he was not entitled to the benefits from the plan. Therefore, because Dan did not qualify for this benefit at any time during the marriage, and the executive supplemental retirement plan was an earning benefit contingent upon Dan's continuation of employment until retirement at an acceptable age, the court concluded that the executive supplemental retirement plan was not an asset as defined by the Indiana statute, Ind. Code § 31-9-2-98. The court concluded that the trial court improperly included the executive supplemental retirement plan as an asset in the marital pot for division, and the appellate court therefore reversed the trial court's determination on the issue and remanded for the trial court to divide the marital assets in accordance with the opinion of the appellate court.

E. Cash Equivalency Doctrine

The cash equivalency doctrine is similar to the economic benefit doctrine and the assignment of income doctrine and provides that if a promise to pay some benefit to an individual is unconditional and can be exchanged for cash, then the promise is equivalent to cash and subject to current taxation.

In *Cowden v. Commissioner*, 289 F.2d 20 (5th Cir.1961), on remand T.C. Memo. 1961-229 (1961), the court considered whether the undertaking of a lessee under a mineral lease arrangement to make future bonus payments was, when made, the equivalent of cash and, as such, taxable as current income. The court described the cash equivalency doctrine as follows:

> A promissory note, negotiable in form, is not necessarily the equivalent of cash. Such an instrument may have been issued by a maker of doubtful solvency or for other reasons such paper might be denied a ready acceptance in the market place. We think the converse of this principle ought to be applicable. We are convinced that if a promise to pay of a solvent obligor is unconditional and assignable, not subject to set-offs, and is of a kind that is frequently transferred to lenders or investors at a

> discount not substantially greater than the generally prevailing premium for the use of money, such promise is the equivalent of cash and taxable in like manner as cash would have been taxable had it been received by the taxpayer rather than the obligation. The principle that negotiability is not the test of taxability in an equivalent of cash case such as is before us, is consistent with the rule that men may, if they can, so order their affairs as to minimize taxes, and points up the doctrine that substance and not form should control in the application of income tax laws. *Id.* at 24.

The court determined that the Tax Court should reconsider the issue as to the willingness of the lessee to pay the entire bonus on execution of the leases and the unwillingness of the taxpayers to receive the full amount and remanded the case to the Tax Court for further consideration.

If a promised benefit may not be transferred or assigned to another party and is subject to certain conditions, this doctrine should not apply.

F. <u>Transfer of Property</u>

The creation of a nonqualified deferred compensation plan generally will not result in a transfer of property to an employee triggering tax under Section 83 of the Code. If contributions or amounts set aside in accordance with a nonqualified deferred compensation plan are subject to the claims of the employer's general creditors, such contributions or amounts should not be considered to be a transfer of property under Section 83 of the Code. In general, Section 83 provides rules for the taxation of property transferred to any person in connection with the performance of services. This property is generally not taxable to the person until it has been transferred to such person or becomes substantially vested in such person. Section 1.83-3(a)(1) of the Treasury Regulations provides that a transfer of property occurs when a person acquires a beneficial ownership interest in the property. (See *TAM 9438001*, dated April 21, 1994, for a discussion regarding the application of Section 83 on a stock option arrangement.)

Section 1.83-3(b) of the Treasury Regulations provides that property is substantially vested for purposes of Section 83 when it is either transferable or not subject to a substantial risk of forfeiture. Section 1.83-3(c) of the Regulations provides that whether a risk of forfeiture is substantial or not depends upon the facts and circumstances. A substantial risk of forfeiture exists where rights in property that are transferred are conditioned upon the future performance (or refraining from performance) of substantial services by any person, or the occurrence of a condition related to a purpose of the transfer, and the possibility of forfeiture is substantial if such condition is not satisfied. Section 1.83-3(d) of the Regulations provides that the rights of a person in property are transferable if such person can transfer any interest in the property to any person other than the transferor of the property, but only if the rights in such property of such transferee are not subject to a substantial risk of forfeiture.

Section 1.83-3(e) of the Regulations provides that for purposes of Section 83, the term "property" includes real and personal property other than either money or an unfunded and unsecured promise to pay money or property in the future. The term also includes a beneficial interest in assets (including money) which are transferred or set aside from the claims of creditors of the transferor.

If employer contributions made pursuant to a nonqualified deferred compensation plan are subject to the claims of the employer's general creditors, then such contributions are not considered property under Section 83. Therefore, at the time the contributions are made, there is no transfer of property under Section 83. However, if the contributions are not available to the employer, are protected from the employer's general creditors in the event of the employer's bankruptcy, and the participating employees are fully vested in the contributions, then a transfer of property would be considered to have occurred under Section 83 and the employee would be subject to tax on the transferred amount.

G. Dominion and Control

A question frequently raised is whether a right of a participant in a nonqualified deferred compensation plan to select among various investment options offered under the terms of the plan should trigger current income. Control over the investment of deferred amounts raises the issue of whether the participant is entitled to the deferred compensation if the participant exercises control over the deferred compensation. Simply stated, the issue is whether some degree of dominion or control over the deferred compensation should lead to earlier taxation.

The regulations under Section 457 of the Code, however, provide a basis for arguing that the ability to direct investments should not result in current taxation to the participant. The IRS has puzzled over participant involvement in the investment process and has issued a number of opinions and rulings that considered participant involvement in the investment process. In early opinions and rulings, the IRS determined that involvement in the investment process by a participant could cause the benefits to be currently taxable. However, subsequent opinions and rulings have indicated that such involvement is acceptable so long as the trustee of a trust or the employer sponsoring the plan is not obligated to obtain the assets requested as an investment.

In the early years, the IRS concluded that amounts withheld from an employee's gross income under a nonqualified deferred compensation plan were currently includable in the employee's gross income if the employee had a right to receive income but voluntarily directed the employer to withhold it and the employee could direct the employer to invest the sums for the employee's benefit. In General Counsel Memorandum 36998 (February 9, 1977), the IRS reviewed two proposed revenue rulings regarding the investment of assets under deferred compensation agreements. In the GCM the IRS stated that it believed that the amounts withheld from the compensation of participating employees in the plans subject to the proposed revenue rulings were includable in the gross income of the employees in the year withheld because the employees had exercised sufficient "dominion and control" over the withheld amounts to warrant the imposition of income tax upon them.

The dominion and control theory has not, however, been advanced in subsequent opinions and rulings regarding the investment of assets in connection with a nonqualified deferred compensation plan. The subsequent opinions and rulings have relied on the analysis of the constructive receipt doctrine and the economic benefit doctrine.

The rulings issued by the IRS subsequent to the publication of GCM 36998 in 1977, pertaining to the investment of assets to be used, directly or indirectly, for the payment of deferred compensation or retirement benefits of highly compensated employees have varied. In some cases, the employer set aside funds and the employee was permitted, by the plan or trust, to suggest the manner of investing the assets, but the employer or trustee was not required to follow the advice. In other rulings, funds were invested by a fiduciary in the type of assets requested or selected by the participant (usually from a specified group of assets). In each of the rulings the IRS concluded that the ability under the applicable trust of the participant to recommend investments in a certain asset, or to benefit from the indexed earnings of a particular investment even though that investment was not required to be made with specified assets, did not generally result in the funds in the trust or allocated under the plan being treated as currently taxable to the employee.

The purpose of deferred compensation generally is to provide benefits to a select group of management or highly compensated employees to permit the employees' employer to attract such employees and to provide "a means to retain valuable employees" (*Demery v. Extebank Deferred Compensation Plan (B)*, 216 F.3d 283 (2d Cir. 2000)). Furthermore, "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 attendant thereto, and, therefore, would not need the substantive rights and protections of Title I [of ERISA]." Department of Labor Advisory Opinion 90-14A, dated May 8, 1990. To cast a wider net and include a significant number of employees in a nonqualified deferred compensation plan could impose a significant tax burden on the employer, which would require the current recognition of the liability but a deferral of the deduction for the deferred amounts.

DEFERRED COMPENSATION

Nonqualified deferred compensation arrangements are an important method for compensating executives and highly compensated employees of both publicly held and private companies, as well as key personnel of tax-exempt organizations. Because of the flexibility of these plans, for taxable employers at least, and the wide variety of plan designs, the reasons for these arrangements are as varied as the plans themselves. While many of the purposes of the plans may be driven by nontax considerations, the tax and accounting consequences are always important elements.

The objective of an employee in participating in these plans is typically to ensure that he or she will be taxed only when payments are actually received under the agreement; to permit deferred amounts to grow on a pretax and tax deferred basis during the deferral period; and to have amounts paid concurrently with some specific purpose, such as retirement. The motive of the employer providing these arrangements is most often the need to attract and retain the people who are essential to the growth and future of the company. After all, most of the competitors of the employer provide similar benefits to their executives or prospective executives. Having agreed to provide deferred compensation, an employer also wants to ensure that it receives a deduction for the deferred amounts when the compensation is paid or payable to the employee.

Retirement income is probably the primary reason for nonqualified deferred compensation arrangements. Before the Employee Retirement Income Security Act of 1974, as amended ("ERISA"), there were no dollar limits on contributions and benefits under qualified plans, and executives generally accrued retirement benefits under those plans just like other salaried employees. With ERISA, however, monetary limitations on qualified plans first appeared. Since then, tax legislation has added further complexity, restrictions and limitations to qualified plans. Although in the past, the qualified plan may have provided the bulk of the retirement income of an executive and a nonqualified plan played only a secondary role, the roles have now been reversed with the limitations on contributions and benefits under qualified plans. In many instances, the nonqualified deferred compensation plan has become the principle source of executive retirement benefits.

A nonqualified deferred compensation plan is narrow in focus and coverage, and not without risk to a participant. The typical form of a nonqualified deferred compensation plan is a plan commonly referred to as a "top-hat" plan.

The term "top-hat" refers to a plan described in Sections 201(2), 301(a)(3), and 401(a)(1) of ERISA, as an employee benefit plan which is unfunded and maintained by an employer "primarily for the purpose of providing deferred compensation for a select group of management or highly compensated employees." A top-hat plan is exempt from the substantive provisions of ERISA, Parts 2, 3 and 4 of Title I of ERISA, pertaining to participation, vesting, funding, and fiduciary responsibilities pursuant to the exemptions in Sections 201(2), 301(a)(3), and 401(a)(1) of ERISA. *See Carr v. First Nationwide Bank*, 816 F.Supp. 1476 (N.D.Cal.1993).

A. <u>ERISA Exemption for Top-Hat Plans</u>

The Department of Labor expressed its view of the reason for, and justification of, the top-hat exemption in Department of Labor Advisory Opinion 90-14A, dated May 8, 1990:

> [i]t is the view of the Department that in providing relief for "top-hat" plans from the broad remedial provisions of ERISA, 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 attendant thereto, and, therefore, would not need the substantive rights and protections of Title I [of ERISA].

Because of this legislative purpose, the phrase "select group of management or highly compensated employees" will be interpreted narrowly by the Department of Labor. *See also* Department of Labor Advisory Opinion 92-13A, dated May 19, 1992.

In *Carrabba v. Randalls Food Markets, Inc.*, 38 F.Supp.2d 468 (N.D.Tex.1999), the district court stated that:

> The definition of a top-hat plan has been described as a narrow one. *See In re New Valley Corp.*, 89 F.3d 143, 148 (3d Cir.1996), *cert. denied*, 519 U.S. 1110, 117 S.Ct. 947, 136 L.Ed.2d 835

> (1997). In applying the statutory language, the court must take into account that "ERISA is a remedial statute to be liberally construed in favor of employee benefit fund participants," and that exemptions from the ERISA coverage should be confined to their narrow purpose. *Kross v. Western Elec. Co., Inc.*, 701 F.2d 1238, 1242 (7th Cir.1983). "[T]op hat plan participants, unlike ordinary pension plan participants, are typically high-ranking management personnel" who "are therefore better equipped than ordinary pension plan participants to effectively protect their interests in the employee benefits bargaining process." *Spacek*, 134 F.3d at 296 n. 12. "This is the very reason that Congress chose not to subject top-hat plans to ERISA's vesting, accrual, participation, and fiduciary requirements." *Id.*

Carrabba at 477.

A conclusion that followed from the court's decision that the plan did not qualify as a top-hat plan is that the members of the class of participants did not receive the financial benefits they should and would have received upon termination of the plan in 1992, if the plan sponsor had recognized that the plan was subject to the accrual and vesting requirements of ERISA and had acted accordingly. In an April 11, 2000 decision, the district court fashioned what it characterized as "appropriate equitable" relief to the participants in the plan who contended that they did not receive the financial benefits they should have received if Randalls Food Markets, Inc. had followed the accrual and vesting rules of ERISA. The court ordered that the class recover $13,625,673 from Randalls Food Markets, Inc.

The Fifth Circuit Court of Appeals subsequently affirmed without comment the district court's ruling ordering Randalls Food Markets, Inc. to pay the $13,625,673 to the participants in the plan following the district court's decision that the plan was not a top-hat plan and did not satisfy the accrual and vesting requirements of ERISA. *Carrabba v. Randalls Food Markets, Inc.*, 252 F.3d 721 (5th Cir.2001).

In *Duggan v. Hobbs*, 99 F.3d 307 (9th Cir.1996), the Ninth Circuit addressed the issue of whether a severance agreement entered into by William Duggan and his employer, Chemworld Corporation, was a top-hat plan under ERISA. The agreement provided that Duggan was to receive retirement benefits for life. Payments were made pursuant to the agreement for a period of time but were terminated by Chemworld when it experienced financial difficulties. Duggan subsequently filed a lawsuit against Chemworld and its president, Danny Hobbs, for breach of contract and violations of ERISA. The court analyzed the facts based upon the guidance issued by the Department of Labor in Advisory Opinion 90-14A. Duggan, a salesman for Chemworld from 1975 to 1983, agreed to retire in return for payments of $1,056.88 per month for life in retirement benefits and up to $300 per month for life in health insurance benefits. Duggan was the only employee ever to receive retirement benefits from Chemworld. During Duggan's last year at Chemworld, he was one of approximately 23 full-time employees. The average employee salary at Chemworld was less than $12,000 per year. However, Duggan was earning between $50,000 and $60,000 a year from his sales commissions and residuals. He was the highest paid non-owner employee at Chemworld. Accordingly, the court considered Duggan to be a "highly compensated employee" for purposes of the phrase, "select group of management or highly compensated employees."

The primary issue in the case was whether the agreement qualified as a "top-hat" plan. If the agreement qualified as a top-hat plan, Hobbs would be exempt from the fiduciary duties ERISA imposes on plan administrators. A top-hat plan is defined as "a plan which is unfunded and is maintained by an employer primarily for the purpose of providing deferred compensation for a select group of management or highly compensated employees." *Id*. at 310. The parties agreed that the plan was unfunded. However, they did not agree on whether the plan provided "deferred compensation" and whether Duggan qualified as a "select group of management or highly compensated employees." *Id*.

The court stated that it could see no reason to treat a select group of highly paid employees, who have the power to influence the design and operation of their deferred compensation plans, differently from Duggan who had the same power to influence, and did influence, the design and operation of his plan. Duggan persuaded Chemworld to provide him with lifelong retirement benefits and he was the only employee ever to receive retirement benefits from Chemworld. The court concluded the policy behind the top-hat exception supported the broader view that "deferred compensation" included the retirement payments derived from Duggan's severance agreement.

The court also concluded that the payments due to Duggan under the agreement were deferred compensation because "they provide compensation for services substantially after the services were rendered." *Id*. at 311. According to the agreement, the benefits were to be paid to Duggan in consideration for Duggan's (1) years of loyal service, (2) waiver of all claims to any commissions and bonuses he was entitled to receive under previous agreements with Chemworld, (3) waiver of all causes of action against Chemworld, and (4) agreement not to compete with Chemworld in certain locations. Therefore, the court determined that Chemworld was providing Duggan deferred compensation for his past services and loyalty. The fact that Duggan and Chemworld entered into the agreement after Duggan had already provided some of the services for which he was being compensated did not change the view of the court that the agreement provided for deferred compensation. "The compensation was deferred because Duggan did not receive it until well after he rendered most of the services for which he was being compensated." *Id*.

The court also considered Duggan's contention that his retirement arrangement under the agreement did not cover a "select group" of highly compensated employees. The court noted that to qualify as a top-hat plan under ERISA, a deferred compensation arrangement must be maintained for a "select group of management or highly compensated employees." Duggan was the only employee covered by the severance agreement. No other Chemworld employee was covered by any retirement plan. During the last week of work, Duggan was one of 23 employees of Chemworld. Therefore, numerically, Duggan qualified as a "select group" of employees. However, the court stated that the "select group" requirement includes more than a mere statistical analysis. The court, after considering Department of Labor Advisory Opinion 90-14A which provides that the top-hat exemption was intended to apply to employees who have the ability to affect or substantially influence the design and operation of their deferred compensation plan, determined that Duggan exerted influence over the design and operation of his severance agreement through his attorney and his negotiations with Hobbs, president of Chemworld. He exerted sufficient influence to become the only employee ever to receive retirement benefits from Chemworld. Accordingly, the court concluded that Duggan's severance agreement was maintained for a "select group."

In sum, the court held that Duggan's severance agreement was maintained primarily for the purpose of providing deferred compensation to a select group of employees, and, therefore, the plan was exempt from the substantive requirements of ERISA.

In *Healy v. Rich Products Corporation*, 981 F.2d 68, 16 EBC 1112 (2d Cir. 1992), *on remand to* 1994 WL 228605 (W.D.N.Y.1994), *aff'd*, 43 F.3d 1458 (2d Cir. 1994), the court considered the issue of whether the word "vested," as used in a reference in a general release to nonqualified plan benefits, has the meaning given that term under ERISA.

Healy was an employee and officer of Rich Products from 1961 until 1987. At the time of Healy's resignation from the company, he was a participant in a Deferred Compensation Agreement and an Incentive Compensation Plan (a phantom stock plan). After his resignation, Healy received the first installments of benefits under the plans. Rich Products subsequently proposed a buy-out of the Rich Products stock and related interests. As part of the purchase of Healy's stock, Healy executed a general release in favor of the company. During the process of negotiating the release, Healy made it clear that he did not want to release his plan benefits. The parties disputed how Healy identified to his attorney which benefits he did not want to release. It was unclear whether the attorneys for either party understood the nature of Healy's request. Nevertheless, the general release ultimately signed included the following exception to the release:

> except, with respect to Mr. Healy, any vested rights under any profit sharing or pension plans of Rich which are subject to the Employee Retirement Income Security Act of 1974, which benefits are not released ...

Healy asserted that among the benefits he was intended to retain were those under the Deferred Compensation Agreement and the Incentive Compensation Plan.

After the closing of the stock sale, Healy sent to the company change in beneficiary forms for the Incentive Compensation Plan and the Deferred Compensation Agreement, but received no reply. He was later advised by the company that those benefits had been released and his pension rights had been extinguished under the terms of the general release. Healy filed suit, asserting that the benefits at issue had been preserved by the release exception. Alternatively, Healy sought reformation of the release to restore his benefits, on the basis either of mutual mistake or fraud.

The district court found that the Deferred Compensation Agreement and the Incentive Compensation Plan were subject to ERISA, but, as top-hat plans, were exempt from the substantive vesting requirements of ERISA. The plans included noncompetition provisions which could result in the forfeiture or suspension of benefits, and the district court found that those provisions were permissible since the plans were top-hat plans. The district court said that because forfeiture clauses are permissible under top-hat plans, "no vesting of rights can occur." Therefore, the court granted the company's motion for summary judgment on the question of whether the release exception for vested rights preserved Healy's benefits under the plans.

The district court dismissed the reformation claim, finding no clear and convincing evidence that there was a mutual mistake as to the exception clause, and, with respect to the fraud claim, concluded that Healy failed to show by clear and convincing evidence that he was justified in relying on the company's counsel's statement that he would provide for a release exception to protect Healy's vested benefits.

The Second Circuit noted that although "top-hat" pension plans are exempt from the vesting requirements of ERISA, the district court looked to the ERISA statute to define the term "vested." The Second Circuit then stated that it found no support for the district court's conclusion that "vested," as used in the terms of the release exception, is defined by ERISA. Instead, the district court was instructed to interpret the language of the release exception without reference to ERISA, but instead by determining the meaning of "vested" as used in the release under customary principles of contract interpretation. The court upheld the district court's conclusion that there was no mutual mistake so as to justify reformation of the release.

B. Whether a Plan Satisfies the Purpose and the Description of a Top-Hat Plan

The courts have generally taken the position that ERISA should be liberally construed in favor of employee benefit fund participants and that exemptions from the ERISA coverage should be confined to their narrow purpose.

Although the Department of Labor has not issued any rulings specifically stating how a top-hat plan is defined for purposes of Sections 201(2), 301(a)(3), and 401(a)(1) of ERISA, the guidance issued by the Department of Labor, the Department of Treasury, and the courts suggests that the eligibility requirements for participation in a nonqualified deferred compensation plan that is intended to satisfy the definition of a top-hat plan should be narrowly applied so that the number of employees who are eligible to participate is limited to a "select group" of high-level employees whose average compensation is significantly greater than the average compensation of all other employees.

In *Modzelewski v. Resolution Trust Corp.*, 14 F.3d 1374 (9th Cir.1994), the Ninth Circuit was asked to determine whether salary continuation agreements were employment contracts or pension plans subject to ERISA. In that case, the Resolution Trust Corporation ("RTC") took over as receiver of MeraBank Savings and Loan, which was declared insolvent in January 1990, and promptly terminated both Gene Rice and Ernest Modzelewski. Adding injury to insult, the RTC refused to pay them anything under their salary continuation agreements which had been established by MeraBank Savings and Loan presumably to attract the most talented managers. The RTC argued that it was entitled to walk away from the salary continuation agreements because they were employment contracts which did not survive receivership, except to the extent payments were vested. Rice and Modzelewski argued that the salary continuation agreements were not employment contracts, but pension plans which arguably survived receivership under the law.

The court stated that it had interpreted the definition of a "pension plan" under ERISA broadly, holding that a pension plan is established if a reasonable person could "ascertain the intended benefits, beneficiaries, source of financing, and procedures for receiving benefits.... That is clearly a sufficient allegation of the establishment of a plan." *Id*. at 1376. The relevant paragraphs of the salary continuation agreement in this case-calculating payments based on age and length of service, identifying the beneficiaries and setting out a schedule for payments-satisfied the court's requirements for a pension plan. "Because ERISA's definition of a pension plan is so broad, virtually any contract that provides for some type of deferred compensation will also establish a de facto pension plan, whether or not the parties intended to do so." *Id*. at 1377.

In this case, the court concluded that Rice was entitled to compensatory damages stemming from the RTC's repudiation of its obligation to make payments under the agreement because Rice had an unconditional right to retire and collect benefits under the salary continuation agreement when he reached age 57, two years before the RTC took over; therefore, his rights had become vested. However, Modzelewski's rights had not become vested at the time RTC took over; therefore, he was not entitled to damages.

In *Flandreau v. Signode Supply Corporation et al.*, 1990 WL 7370 (N.D.Ill.1990), the court determined that a plan was a top-hat plan because the "stated purpose of the Senior Officer SRIP is to provide deferred compensation to the covered retirees" who were "all highly compensated." In *Bass v. Mid-America Co., Inc.*, 1995 WL 622397 (N.D.Ill.1995), the court stated that "[w]hether a plan exists within the meaning of ERISA has been defined by case law and is considered 'a question of fact, to be answered in light of all the surrounding facts and circumstances from the point of view of a reasonable person' " and concluded that a deferred compensation plan was a top-hat plan under ERISA. (See also *Lemanski v. Lenox Savings Bank*, 1996 WL 253315 (D.Mass.1996) in which the court found a deferred compensation plan covering the key executive officers of a bank was a top-hat plan.)

In *Plazzo v. Nationwide Mutual Insurance Company*, 697 F.Supp. 1437 (N.D.Ohio 1988) *rev'd. on other grounds*, 892 F.2d 79 (6th Cir.1989), *cert. denied* 498 U.S. 950, 111 S.Ct. 370, 112 L.Ed.2d 332 (1990), the court was asked to determine whether an Agent's Security Compensation program was an employee pension plan under ERISA. The Agent's Security Compensation program included two benefit programs, deferred compensation incentive credits and extended earnings. Under the deferred compensation incentive credit plan, Nationwide maintained a retirement account for Plazzo and annually credited to that account a sum based upon Plazzo's earnings from original and renewal fees for insurance policies. Under the extended earnings plan, Nationwide agreed to pay Plazzo, upon his retirement, termination, death or disability, a sum equal to his earnings from renewal fees over the prior 12 months. In 1984 Plazzo received information from Nationwide that any payments owing him under the Agent's Security Compensation programs were considered forfeited by Nationwide since Plazzo had allegedly competed with Nationwide in violation of the agreement with Plazzo.

The deferred compensation plan was financed through contributions made by Nationwide on the agent's behalf to a group annuity. The amount of contribution for an agent was calculated based upon a percentage of the sales and renewal fees earned by the agent. Contributions to an agent's account began when the agent had completed five years of service and continued until the agent was terminated for any reason including, but not limited to, retirement, death, or disability as long as the agent had reached age 60. The court concluded that, in view of the benefit accrual and distribution features of the deferred compensation plan, the plan provided retirement income to employees and was an employee pension benefit plan under ERISA.

The extended earnings plan established a benefit whereby an agent with at least five years of service who had terminated upon retirement, death or disability, or qualified cancellation for other reason, was entitled to a sum equal to the renewal services fees paid to the agent by Nationwide for the last 12 calendar months immediately preceding the cancellation of the agreement. The court concluded that this plan too was a pension benefit plan under ERISA.

Nationwide argued that even if the Agent's Security Compensation program was covered by ERISA, the non-forfeiture provision did not apply because the vesting requirements do not apply to a plan which is unfunded and is maintained by an employer primarily for the purpose of providing deferred compensation for a select group of management or highly compensated employees. The court determined that there was no clear standard for determining an exempt class of "highly compensated employees" for purposes of this exemption. The court did, however, note the definition of "highly compensated employee" under Section 414 of the Code. The evidence revealed that there were approximately 5,000 to 6,000 Nationwide agents. The agents were not considered upper management and they did not represent a small number of officers. The evidence also revealed that the compensation earned by agents was dependent upon their own initiative, judgment and skill and sometimes the receipt of orphan policies. Therefore, highly motivated agents were often well compensated while less motivated agents were less well compensated. The court concluded that these factors were not indicia of a consistently highly compensated select group of individuals. Accordingly, the court held that the Agent's Security Compensation program was subject to the non-forfeiture provisions of ERISA.

RECOMMENDATIONS

In reviewing the tax theories and principles and considering the structure of nonqualified deferred compensation plan and those for whom the plans are intended to benefit, it would seem that tax policies would be better served by not overhauling the policies, but correcting the manner in which the policies are intended to be applied.

The Staff of the Joint Committee on Taxation appears to be concerned with the effects of nonqualified deferred compensation on shareholders, creditors and the federal treasury. The concerns of the Staff can be addressed without substantially modifying the Internal Revenue Code or the interpretation and application of the doctrines and theories governing the taxation of deferred compensation and without losing the social and economic benefits that employers obtain from being able to provide modestly flexible deferred compensation arrangements for the benefit of a select group of individuals. As discussed earlier, Section 404(a) of the Internal Revenue Code provides that compensation paid under a plan deferring the receipt of compensation will be deductible only if the compensation otherwise satisfies the requirements for reasonable compensation pursuant to Section 162 of the Internal Revenue Code. The potential loss of a significant tax deduction provides, therefore, a significant incentive to employers to provide only "reasonable" compensation. In addition, the boards of directors of employers have fiduciary obligations under the business judgment rule, a feature of the corporation laws of every state, that require them to assure that deferred compensation pay levels and those for whom such pay levels are established are not abusive to shareholders. If there is a concern about the fairness to shareholders of the amounts of deferred compensation provided to company executives, the avenue for which the concerns may be addressed is not the federal tax laws but the rules and laws governing the obligations and responsibilities of the boards of directors under the business judgment rule and rules adopted and enforced by the Securities and Exchange Commission.

Under the business judgment rule, the structure and administration of nonqualified deferred compensation plans should be governed by the conduct of the board of directors of the employer and the fiduciary duties of care and loyalty owed by the directors to the employer and its shareholders. This conduct may be governed under federal law and state law. In *Buckhorn, Inc. v. Ropak Corporation*, 656 F.Supp. 209 (S.D. Ohio 1987), *aff'd without opinion* 815 F.2d 76 (6th Cir. 1987), Ropak Corporation and Ropak Holdings Corporation sought a preliminary injunction of certain actions taken by Buckhorn, Inc. and its board of directors in response to Ropak's tender offer for any and all shares of Buckhorn stock. Specifically, Ropak sought to enjoin various measures adopted by the board of directors including severance and stock option agreements with six key managers of Buckhorn, Inc. In considering the merits of Ropak's motion, the court noted that Buckhorn, Inc. was a Delaware corporation and, accordingly, the conduct of its directors was governed by Delaware law.

Under Delaware law, the directors of a corporation owe unyielding fiduciary duties of care and loyalty to the corporation and its shareholders. The fiduciary duty of care requires a director to exercise an informed business judgment and to consider all material information reasonably available before making a business judgment.

The court stated that, generally, when reviewing the action of directors, Delaware courts have applied the business judgment rule which presumes that "the directors of a corporation acted on an informed basis, in good faith and in the honest belief that the action taken was in the best interests of the company." Therefore, whether the actions of a corporation's board of directors with respect to issues related to nonqualified deferred compensation plans are taken in the best interests of the corporation may depend upon the standard of conduct required under the business judgment rule and the fiduciary duties of care and loyalty to the corporation and the shareholders of the corporation owed by the directors.

Furthermore, if a court concludes that the terms of a deferred compensation arrangement are so unfavorable to a corporation that no director of ordinary sound business judgment would have voted in favor of it, the arrangement can be invalidated. The term used to describe such a result is "waste" or "gift" of corporate assets. If, in contrast, reasonable persons could disagree whether a compensation arrangement is favorable to the corporation, it could be upheld under the business judgment rule (*Saxe v. Brady*, 184 A.2 602, 610 (Del. Ch. 1962)).

Therefore, the governing body of an employer should determine for the key employees the compensation reasonable for the performance of services, the compensation necessary to attract and retain the key employees and the structure of deferred compensation plans that would serve the best interests of the employer and its shareholders and satisfy the fundamental theories and principles of tax and the requirements of ERISA.

The Securities and Exchange Commission could be part of the corporate governance solution. Corporate governance rules regarding the independence of the members of the board of directors, the responsibilities of the board, and the audit of the actions of the board could be adopted and enforced.

Similarly, the issues raised by the Staff regarding the effects of deferred compensation on creditors may be better addressed under the bankruptcy laws and not by changing the deferral rules of nonqualified deferred compensation plans. Title 11 of the United States Code, The Federal Bankruptcy Laws (the "Bankruptcy Code"), envisions the ratable distribution of assets of a bankrupt or reorganizing entity to creditors in accordance with priorities established by the Bankruptcy Code. There are sections of the Bankruptcy Code that permit avoidance of transactions that enable creditors to recover more than they would be entitled to if transfers by or on account of the reorganizing/bankrupt entity enables an entity to recover more than it would get in a straight liquidation. Section 546 of the Bankruptcy Code also permits a debtor in possession or trustee the right to use any available state law that would be available for avoidance of transfers, e.g., Uniform Fraudulent Transfer Act. Section 547 of the Bankruptcy Code, Preferences, enables the trustee to recover transfers made within the 90 days prior to the bankruptcy or in the case that a transfer is made to an insider of the debtor, one year, that enables that creditor to receive more than it would receive in a liquidation. Likewise, Section 548 of the Bankruptcy Code, Fraudulent Transfers, also provides that a trustee can avoid any transfer made within one year from the date of filing of a case to the extent the debtor receives less than a reasonably equivalent value in exchange for the transfer or obligation, was insolvent on the date that the obligation was incurred or rendered insolvent as a result of the transfer.

Each of those statutes might be modified or amended to include that transfers of deferred compensation to insiders within a year of the bankruptcy are presumptively avoidable thereby placing the burden of proof on the recipient of the transfer to establish that there was equivalent value and entitlement, non preferential, or other possible defenses to the transfer.

Finally, with respect to the revenue effects of nonqualified deferred compensation, it is clear that such deferred compensation merely involves a delay in the receipt of pay that would otherwise be paid in cash or stock at the time it was earned. As previously stated, Section 404(a)(5) of the Internal Revenue Code provides that contributions under a nonqualified deferred compensation plan are deductible in the taxable year in which an amount attributable to the contribution is includible in the gross income of an employee participating in the plan. Simply stated, the deduction is "matched" with the inclusion of income. Therefore, the tax tension between the deferral desired by the employee and the current deduction desired by the employer is an inherent limitation on the amount and characteristics of deferred compensation that a taxable employer is willing to provide to an employee. And, if, at the time the deduction is "matched" with the inclusion of income, the corporate tax rates are less than the tax rates applicable with respect to the individual for whom the deferred compensation is includable in income, the effects of nonqualified deferred compensation on the federal treasury should be favorable.

Any other revenue concern of the Staff with respect to an avoidance of current income taxation could be addressed in a manner other than a manner that significantly impacts the economic or social utility of deferred compensation. An approach that may be more acceptable would be to impose a cap on the deduction at an amount equal to the tax imposed on the individual. So, for example, if the tax rate applicable with respect to the executive was 30%, the deduction for the employer would be determined at no more than that rate. This cap could eliminate any timing issue otherwise applicable and any revenue loss that may otherwise occur at the time that payment is made.

Unraveling the established practices of nonqualified deferred compensation plans as a response to the problems of Enron is tantamount to throwing the baby out with the bath water. More targeted measures could be used to address the concerns of the Staff rather than unsettling fundamental deferral principles and losing the economic or social utility that deferred compensation offers employers.