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Nonqualified Deferred Compensation Plans: A Review and Critique

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NONQUALIFIED DEFERRED COMPENSATION PLANS: A REVIEW AND CRITIQUE

CARTER G. BISHOP†
MARIAN McMATHON DURKIN††

We live in the great world as well as in the little. We belong to groups that extend beyond particular places and we speak a language . . . that aspires to universality. If it is to perform its expressive function, our theory must help us grasp this transcendent aspect of our experience.¹

The tax treatment of nonqualified deferred compensation plans (NQDCPs) encourages the deferral of the payment of personal service income beyond the economic performance of the services, the natural market date for payment. The current use of such plans is premised upon an exemption from a complex series of Department of Labor unfunded plan rules (ERISA² funding, anti-discrimination and reporting standards) and avoidance of the common law income tax doctrines of constructive receipt and economic benefit. Even where the employee receives a currently taxable economic benefit from the compensation, taxation may be further postponed through the imposition of a substantial risk of forfeiture under IRC § 83.³ The breadth, complexity and interrelationship of the labor and tax regulatory regimes confine the understanding of the conditions of the deferral to sophisticated tax planners. This article reviews both sets of rules to enable nonspecialist compensation planners to

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³. I.R.C. § 83 (1990) (dealing with property transferred in connection with services). Reference to sections of the Internal Revenue Code in the text will hereinafter be designated by "IRC."
understand and implement nonqualified deferred compensation arrangements. In addition, the article critiques both the tax and nontax advantages that such arrangements enjoy under current law and recommends an alternative regulatory and tax structure. The article explores the economic rationality of such arrangements compared to qualified plans and discusses the economic and social policy costs to our tax system of the current method of taxing and regulating nonqualified plans. The article concludes that nonqualified deferred compensation plans receive unwarranted regulatory and tax subsidies compared to qualified plans and that these subsidies should be reduced, in part, by expanded ERISA regulatory control, by requiring such plans to be “funded” and/or by modification of the constructive receipt doctrine to require taxation of the compensation to the employee at the time of the economic performance of the services. If ERISA coverage is expanded to require the funding of such arrangements, the employee may nevertheless defer taxation of compensation beyond the economic performance of the services under IRC § 83 if the employee is willing to accept a risk of forfeiture of the compensation. However, the “risk” of the employee not receiving the funds in the future is within the employee’s control and is not related to the employer’s financial stability. At a minimum, the article concludes that ERISA coverage should not discourage current funding of such plans by over-regulating “funded” plans to require satisfaction with the other ERISA standards, such as the anti-discrimination rules.

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INTRODUCTION

A. Article Paradigm

Complex but necessary solutions to difficult problems in law and society are often best expressed at the intersection of related practice areas because the intersections are traditionally high tension points. Since income taxation shadows the economic effects of commercial transactions, the practice of tax law is affected by other areas of law claiming contextual relevance to the same commercial transaction. This symbiotic relationship is particularly noticeable with regard to nonqualified deferred compensation plans (NQDCPs)\(^4\) where Treasury and

\(^4\) An NQDCP may include one or more of the following types of plans: (1)
Department of Labor (DOL) regulations serve important independent as well as related functions.

This article explores the mutual dependence of these two regulatory schemes. This exploration is both a satisfying and frustrating experience. Understanding mutual dependence demands a separate analysis of each area—adding length and bulk to the writing process. The intended benefit of this approach is to provide the reader with an exposure to the subtleties of practice at a variety of levels. The risk is that the multilevel analysis will at some points appear unrelated.

The responsibility for this failure belongs with the regulatory agencies responsible for promulgation of unrelated rules. The solution requires agencies with overlapping jurisdiction over NQDCPs to cooperate and develop a proactive and related set of rules satisfying the concerns of each. This article presents some insights that we hope will inform that process in a new and meaningful way.

Many opportunities are seized to criticize the tax and DOL regulation of NQDCPs. In fact, the sheer weight of the criticism could create the false impression that NQDCPs are simply not a good idea and that they should be discouraged rather than encouraged as they are under our current system. This is not intended. NQDCPs are a good idea. They are a creative vehicle for the provision of tax-favored retirement savings beyond that provided under the heavily regulated qualified benefit plan system.

Increased retirement savings is an important social policy goal, yet arguably not a utilitarian idea. There are, however, several flaws in the regulatory maintenance of NQDCPs. In order to isolate these flaws we have considered the two principal regulatory regimes which have the primary impact over such excess benefits plans (exclusive use of an NQDCP to avoid IRC § 415 qualified plan contribution and benefit limitations); (2) "top hat" plans (use of an NQDCP to provide benefits for a select group of management or highly compensated employees); (3) salary continuation plans (use of an NQDCP to pay a portion of a key employee's salary for a fixed period of time in the event of separation from service for any reason); (4) salary reduction plans (use of an NQDCP to allow a key executive to elect to defer a portion of their current salary until after retirement); (5) stock appreciation rights (use of an NQDCP to pay excess value of stock on date of exercise over value at date of grant, either in stock or in cash) and (6) stock option plans (use of an NQDCP to transfer stock to key executives at a set price during a stated period of time with the economic value based on the potential of the option stock to appreciate in value).
plans: income tax deferral and exemption from ERISA anti-discrimination rules. All characterization and structuring issues regarding NQDCPs essentially seek these advantages at a minimum. At the same time, additional advantages may be sought, but they are traditionally not the central core of the NQDCP structuring need.

The discussion below turns to a separate but brief overview of these two ideas with a critical perspective informing the discussion: income tax deferral creates an advantage that the ERISA exemptions permit and encourage the employee to enjoy. Without a tax advantage, NQDCPs would still exist because they serve the important economic goal of increasing retirement savings. ERISA has many levels of coverage including funding, reporting, and anti-discrimination standards. At present, exemption from one standard constitutes an exemption from all. The ERISA exemption process need not be this inflexible. Exemption from the ERISA anti-discrimination rules need not create a concomitant funding exemption. We argue that the broad exemptions have been linked by history rather than necessity. Understanding this relationship enables the reader to think clearly about what tax advantages should exist for NQDCPs and why. In addition, the reader is permitted to rethink the ERISA exemption and whether an anti-discrimination exemption should be tied to a funding exemption and, if not, why not.

**Tax Deferral.** In order to understand this NQDCP minimum need, the tax treatment of NQDCPs is contrasted with qualified plans, which are subject to full ERISA regulation, including its discrimination and funding standards. Employer contributions to qualified plans are deductible at the time they are made to a tax-exempt trust while the employee is not taxed until the receipt of a retirement distribution from the trust, which is usually at retirement. The effect of this treatment is to exempt the amount of compensation income deferred and its attendant investment earnings from income tax during the entire period of deferral. This allows the employee to accumulate a larger pre-tax retirement base. In addition,

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5. I.R.C. § 404(a)(1) (1990) (providing for deductions for contributions made by an employer to an employee's trust or annuity plan and compensation under a deferred compensation plan).
6. Id. § 402(a)(1) (providing that the amount taxed shall be the amount distributed in any year).
the employee's tax rate at retirement may be less than the tax rate during accumulation, although this factor assumes a greater measure of progressiveness in the income tax rates than currently exists.

How do the tax benefits available to NQDCPs measure against those for qualified plans? The answer depends upon the comparative tax rate of the employee and employer. As the employer's tax rate approaches zero, the tax benefits available to NQDCPs approach that of a qualified plan. Where the employer's tax rate is zero, the tax benefits are equal. This is because the employer is not initially taxed on the plan's income or the economic accretion which generates the funds to pay the compensation because its tax rate is zero. Thus, an employer with a zero tax rate who is not entitled to a current compensation deduction is in an economic equivalent position with a taxable employer entitled to take a current deduction for the compensation. In either event, the amount of the compensation is effectively shifted from the employer's tax base. Where the employee is not required to include the compensation in income at the moment of employer shift, a deferral exists to allow pre-tax accumulation during the deferral period. 7

7. This idea simply capitalizes on the lowest tax rate between the employer and the employee. Where the employer's tax rate is less than the employee's, it is an economic advantage to leave the compensation income taxed to the employer through a postponed compensation deduction. This is accomplished in most cases by simple nonpayment since the employer's compensation deduction may be governed by when the cash method employee receives the compensation and is therefore taxed on the amount. The rules governing employer deduction are discussed in detail in the text of this article; however, these rules may be summarized as follows, using three models:

1) Nonqualified Deferred Compensation Plans (Model I). Under IRC § 404, all cash and accrual method employers are entitled to a deduction for compensation paid under a plan of deferred compensation when the cash method employee must include the compensation in income (generally upon receipt). See id. § 404 (providing the time for deduction).

2) IRC § 83 Compensation (Model II). Where compensation is not paid under a plan of deferred compensation and is IRC § 83 property, the cash and accrual method employer may be entitled to a deduction when the employee includes the compensation in income under IRC § 83(h). The employee may elect to be taxed upon distribution or upon transfer. See id. § 83(b). For this purpose, property does not include money transfers unless the compensation is already taxed to the employee under the economic benefit doctrine because of a funded set aside.

3) IRC § 461 Compensation (Model III). Where the compensation is an unfunded money transfer (i.e. not part of a plan of deferred compensation), the accrual method employer may be entitled to a normal accrual deduction but not before economic performance occurs. Economic performance is the rendition of the services
In addition, where the employer's tax rate is zero, the employer's earnings on the deferred compensation will not be taxed.

Where the employer's tax rate is greater than zero but less than the employee's, the NQDCP is still tax subsidized, albeit not as significantly as with qualified plans. It is not until the employer's tax rate equals or exceeds the employee's tax rate that this tax subsidy is completely eliminated.

In 1978, Congress responded to this abuse in a limited way. It enacted IRC § 457, which requires government employees to lose many of these benefits by regulating the amount and degree of compensation that may be deferred. In 1986, Congress expanded IRC § 457 to embrace all tax-exempt organization employees (except church employees). These two statutory efforts have scaled back the benefits of NQDCPs to a limited group of employees whose employers are not subject to tax. However, there obviously are many other categories of corporate employers with effective tax rates approaching, if not equalling, zero. The mania of leveraged buyouts over the past decade left many employers with heavy debt levels, ef-
effectively converting the preleverage tax payment stream into debt service payments through an interest expense deduction. In addition, other employers with net operating loss carryovers, those engaged in heavy equipment and capital asset deployment, and many insurance companies and banks, traditionally have very low taxable incomes. In short, the abuse perceived by IRC § 457 has not been eradicated.

There are a variety of methods to scale back tax benefits of NQDCPs not currently governed by IRC § 457. One would be to amend IRC § 457 to tax the employer on the compensation at the moment of deferral beyond economic performance of the service at the employee's income tax rate. Another would be to tax the employee at the moment of deferral beyond economic performance on the basis of an expanded view of the common law constructive receipt doctrine. This is the approach adopted by this article since it was the Treasury Department's response in a 1978 proposed regulation which, although subsequently withdrawn, was the genesis of IRC § 457. In addition, it has the advantage of correcting an overly generous limitation on the constructive receipt doctrine in noncompensation areas.

In any event, the idea is that an NQDCP should not enjoy a tax benefit approaching or equaling the tax benefits available to qualified plans unless they suffer from the same regulatory environment, including the ERISA anti-discrimination rules. Eliminating the subsidy, i.e. tax benefit, will make such NQDCPs less attractive. However, to the extent that qualified plans do not satisfy employees' retirement funding needs, the use of NQCDPs will continue. In addition, if the ERISA pro-

With a SERP, a company promises to pay employees out of general operating profits when they retire. But you have no guarantee that this firm will be around when you retire . . . . [The company] may be taken over, and the new management may not want to pay it. And if it goes into bankruptcy, executives in the SERP get in line with other creditors . . . .

Id.

11. Briefly, the doctrine of constructive receipt provides that one may be taxed on income not yet actually received, but rather constructively received. See infra notes 170-217 and accompanying text.

12. We must confess some displeasure with this outcome. Given the opportunity to choose between a tax system that encourages unlimited savings (consumption model) and one that does not (accretion model), we would choose a consumption unlimited savings driven system. However, our current income tax system is largely based on an accretion model, taxing rights to income as they mature, whether consumed or saved. A significant accretion exception is limited savings encouragement
posal discussed in this article is adopted, NQDCPs would become “funded” plans and the compensation would be taxed to the employee at the time of funding, presumably at or near the time of economic performance. In this case, the funding would bring the NQDCP under IRC § 83 since the plan’s cash assets would now constitute IRC § 83 property. As a consequence, the employee wishing to defer taxation of the “funded” compensation amount could do so if willing to accept an IRC § 83 substantial risk of forfeiture.13

Thus, the point is that even if the constructive receipt doctrine is expanded to reach NQDCPs and the ERISA funding rules are also expanded as discussed below, the effect will be that the employee will still be able to defer the compensation under IRC § 83. This, of course, implies that if an NQDCP were “funded” under current ERISA rules, deferral could nevertheless be achieved by IRC § 83. Since the IRC § 83 risk of forfeiture is less than the employer risk of financial failure and non-payment, it is suggested that this is a superior economic risk posture for most clients, even if the law does not change.

**ERISA Exemption.** Under DOL regulations, an NQDCP is generally unregulated and exempt from almost all ERISA requirements only if it is considered “unfunded.” Where the tax benefit is not significant because of a narrow employer-employee tax rate differential, this feature becomes paramount, particularly for employers not simultaneously maintaining qualified plans. If the NQDCP were ERISA governed, the plan would have to be offered on a nondiscriminatory basis, in addition to meeting other ERISA requirements—including funding and reporting. These ERISA requirements greatly increase the employer’s cost of offering an NQDCP to executive groups and would largely eliminate these types of plans if they were not ERISA-exempt.

Unfortunately, ERISA exemption for unfunded plans de-
pends almost entirely on a single characteristic. The employee must accept full economic risk of the employer not being able to pay the deferred compensation when due because of financial failure. Only in such cases will the NQDCP obtain ERISA exemption as an "unfunded" plan. Since this characteristic is also the foundation of postponing current taxation to the employee under the economic benefit doctrine, an NQDCP failing this funding test would be subject to not only ERISA regulation, but also current inclusion in employee income. However, if the employee is subject to an IRC § 83 substantial risk of forfeiture, in the case of non-money compensation transactions, then the employee may be able to avoid current taxation.

Legal formalism aside, the nontax economic considerations driving ERISA exemption for most NQDCPs are not the employer's economic burden associated with actually funding the plan. Indeed, in an effort to obtain more security for future payment of the deferred compensation, employers are generally willing to isolate the deferred compensation funds from operating funds by placing the compensation in a "rabbi trust"14 or in a similar employee security-enhancing device. Even though the employer is the beneficiary of these devices, since the deferred compensation funds are subject to attack by the employer's general creditors, the funds escape working capital absorption risk. Thus, absent employer financial failure, the employer will be able to pay the deferred compensation at retirement.

The point of avoiding ERISA funding is principally twofold: (1) to avoid current taxation to the employee at the moment of deferral; and (2) to avoid the other more rigorous requirements of ERISA coverage, most notably the minimum coverage and participation rules—otherwise referred to as the anti-discrimination rules. In cases where the employer's tax rate is close to the employee's tax rate, these enumerated taxation concerns diminish in comparison to the ERISA coverage issue. Accordingly, if the tax rules are modified to eliminate entirely the deferral tax advantage, there should be no obstacle to expanding the ERISA coverage to require that NQDCPs be "funded."

The effect of such an ERISA proposal is modest from the employer's perspective, but the employee security gained is

14. See infra text accompanying notes 300-16 (discussing "rabbi trusts").
enormous. Retirement benefits are simply an unsuitable wager on employer future financial stability. However, in order to continue to encourage additional retirement savings programs through the use of NQDCPs, this article suggests that such plans should not be subject to ERISA anti-discrimination rules, since the application of these rules would effectively eliminate the future existence of NQDCPs. Rather, only the ERISA funding requirements should be applied to NQDCPs.

**Article Organization.** With this in mind, the rationale behind the organization of this article may become more apparent. The first section addresses the ERISA issues by discussing existing rules in the context of qualified plans. This sets up the context and ability to explain and contrast the ERISA exemption for "unfunded" NQDCPs and follows it with a critique section.

The next section treats the income tax issues associated with the taxation of deferred compensation. The focus is on the rules governing the inclusion of the compensation to an employee. The reason for this focus is that IRC § 404 permits an employer deduction for such compensation only when the employee actually includes the compensation in income. As discussed, this IRC § 404 matching requirement for deduction and income effectively eliminates the tax advantages of NQDCPs except in cases where the employer's tax rate is less than the employee's tax rate. IRC § 457 has further restricted the tax advantage to non-government and tax-exempt organization employees. Nevertheless, for these employees to continue to enjoy this tax advantage, the benefit is available only where the employee is able to achieve deferral beyond the moment of economic performance. For most cash method employees, this timing result is driven by common law notions of constructive receipt and economic benefit, unless the compensation transaction is governed by IRC § 83 which was enacted

15. Viewed from another perspective, when the tax law encourages a particular result, such as the case with NQDCPs, the tax system encourages pre-tax economic risk shifting and any serious evaluation of the merits of the tax result must consider the desirability of the risk shift. In the case of NQDCPs, the tax subsidy enjoyed depends upon the employee accepting the risk of financial failure of the employer and the concomitant inability to receive the deferred compensation at retirement. We contend throughout this article that the tax system should not encourage such shifting. The slight tax advantage to the parties does not justify the quantum of additional risk accepted by the employee.
in 1969. Accordingly, the income taxation section divides itself into a discussion on common law doctrines and IRC § 83.

The benefits of this approach are that it brings together disparate but relevant material to a complete understanding of the range of problems associated with NQDCPs. The disadvantage is that it lengthens the article and often makes individual sections or levels difficult to relate back to the primary point. We believe the advantages outweigh the disadvantages.

B. Importance of Nonqualified Plans

The first formal pension plan was established by American Express in 1875. Through the post-World War II and Korean War period, the assets employed in such plans experienced explosive growth. This was partially attributable to increasing income tax rates and war wage stabilization programs which encouraged both employers and unions to offer

16. W. Greenough & F. King, Pension Plans and Public Policy 27 (1976). Retirement planning is a relatively recent social phenomenon which has developed in the past 100 years. In the early and mid-19th century, life expectancies were so low that most workers died while still gainfully employed. This fact was gradually modified by improved medical care and advanced control of infectious disease. From this perspective, the evolution of retirement planning is a critical part of massive change in the social fabric of industrialization and should be considered by other developing countries. See generally W. Graebner, A History of Retirement: The Meaning and Function of an American Institution, 1885-1978 (1980); L. Hannah, Inventing Retirement: The Development of Occupational Pension in Britain (1986).

17. In 1935, 4.1% of wage earners paid income taxes with the median taxpayer reflecting a 4% marginal income tax rate, but by 1945 these percentages increased to 65.3% and 23%, respectively. At the same time, the marginal corporate tax income tax rate increased from 13.7% to 40% (and finally 52% by 1955). See generally R. Ippolito, Pensions, Economics and Public Policy 25 (Tables 2-4) (1986). Currently, a significant explanation for the proliferation of all fringe benefits, including deferred compensation, may be favorable tax treatment. See J. Langbein & B. Wolk, Pension and Employee Benefit Law 28 (1990) (citing D. Hamermesh & A. Rees, The Economics of Work and Pay 341 (4th ed. 1988)).

The following chart chronicles a comparison of the ordinary and capital gain tax rates over the past 130 years:
and accept nonwage fringe benefit concessions. During this period, qualified pension plans captured most of the attention of the regulatory and tax specialists.

Based upon the magnitude of assets employed in the industry, the attention to qualified plans is predictable. By the end of 1987, the combined assets of private and public pension funds (excluding federal funds) were approximately $2.1 trillion, and in 1984, pension funds held 22.8% of all corporate equity and 49.9% of all corporate bonds.

Even though qualified deferred compensation plans have captivated center stage, NQDCP's secondary compensatory role is expanding for key employees as a supplement or substitute for their qualified plans and other equity capital accumulation programs. The increase in use of NQDCPs directly
results from the fact that properly structured "unfunded" NQDCPs are not subject to the cumbersome, complex, and expensive qualified plan anti-discrimination rules found in ERISA and the innumerable other income tax restrictions.23

Prior to 1978 and 1986, the tax benefits associated with NQDCPs for employees of governments and other tax-exempt organizations equaled the tax benefits available to employees participating in a qualified plan.24 In addition, the effect of post-1982 legislation has been to reduce benefits payable from qualified plans while, at the same time, increasing the costs associated with achieving these dwindling benefits.25

Although the tax benefits of qualified plans were no longer
available after 1986 to employees of governmental agencies and other tax-exempt organizations, the aggregate employer and employee tax benefits will still be significant where the employer's income tax rate during the compensation deferral period is lower than the employee's income tax rate. With expected continued legislative assaults on qualified plans compelled by restrictive congressional budgetary demands, the importance of NQDCPs can be expected to expand. In addition, the practice with regard to qualified plans has become needlessly complex, spawning a sub-specialty for armies of lawyers, accountants, and actuaries. In contrast, the practice with regard to NQDCPs has remained more manageable, and therefore more appealing, to a broader base of non-tax specialists. These practitioners look for evolving interpretations to the basic economic benefit and constructive receipt income tax paradigms to mold their advice.

As the volume of corporate assets employed and designated as NQDCP assets increases, practitioners will no doubt stretch the limits of current rules regarding acceptable tax methods of securing the availability of the assets necessary to pay the intended liability. With this expansion and search for new payment security methods comes a renewed need to question the appropriateness of exempting NQDCPs from the strict regulatory scheme applicable to qualified plans.

The centerpiece of this article is to question whether it is appropriate for NQDCPs to continue to enjoy a tax subsidy (where the employer's tax rate is lower than the employee's tax rate) while, at the same time, tax restrictions relative to quali-
fied plans expand. In addition, while nontax regulatory demands with regard to qualified plans expand, regulation of "unfunded" NQDCPs is virtually non-existent. This paradox must be questioned and, failing justification, must be addressed and modified.

C. General Rules and Areas of Concern

The tax and regulatory rules governing NQDCPs literally propel legal formalism over legal realism. Provided such compensatory arrangements are properly structured, an employee may defer taxation until the year of actual receipt of the compensation notwithstanding the economic performance of the compensatory services in an earlier year. Although an accrual method employer is not entitled to a current deduction for the future employee compensatory obligation,27 the arrangement need not satisfy costly qualified plan restrictions, including employee coverage and contribution limitations as well as funding and reporting requirements. Moreover, where the employer's tax rate is reduced to zero (or at least less than the employee's tax rate) from substantial net operating losses, sheltering, or other factors, the NQDCP has many, if not all, of the tax attributes of a qualified plan. The employee's ability to defer taxation on unlimited amounts of current compensation,28 without accepting a significant risk of employer nonpayment, coupled with the employer's ability to provide such arrangements on a discriminatory basis to highly-compensated executives without the compliance costs29 and requirements associated with qualified plans, is an attractive alternative to qualified plans as a method for executive compensation.

Below the executive compensation level, the availability of Individual Retirement Accounts (IRAs) for low and moderate income employees provides a sufficient deferral mechanism.

27. *See infra* notes 331-39 and accompanying text (discussing standards governing employer deductions).

28. Although not the focus of this article, it is important to note that the total amount of deductible compensation (deferred and undeferred) may not exceed a reasonable amount. *See* I.R.C. § 162(a)(1)(x) (1990).

29. Compliance costs associated with the establishment and maintenance of a qualified plan may include legal, accounting, actuarial and trustee fees. Some of these fees, such as accounting and trustee fees for defined benefit plans, are incurred on an annual basis; others are incurred on an irregular basis. Employers must also take into consideration overhead costs dedicated to a qualified plan if the plan is administered in-house.
such that employer-maintained qualified plans are not necessary. Consequently, except as part of a broader benefits package negotiated by labor unions, smaller employers do not ordinarily find employee pressure to institute employer maintained qualified plans. Indeed, many employees at this compensation level are consuming at or above their current earnings and disposable income level and, as a result, may not demand a qualified plan and may well oppose it in favor of current cash compensation.

Viewed from this perspective, the driving force behind employer-maintained qualified plans, particularly smaller non-union shop employers, may be executive compensation level employees. Unfortunately, the cost-benefit analysis will encourage such compensation privileged employees to seek NQDCPs to avoid the contribution limitations of qualified plans. When possible, employers are likely to be persuaded by a similar cost-benefit analysis to avoid the coverage requirements and maintenance costs associated with qualified plans. Finally, in many cases the economic interests of highly-compensated employees and employers are closely linked in other ways. Such employees may be a part of the ownership or other decision making control group of the employer.

History suggests that in such cases people most often act in their own economic self-interest; such is the nature of a capitalistic based economy. But what about the fundamental social policy question relating to retirement benefits of employees not empowered as members of the influential highly-compensated employee group? Is not part of the goal and guarantee of ERISA to provide, as well as to protect, retirement income to less economically privileged employees through anti-discrimination provisions? Is it not a fundamental perspective of ERISA that once an employer decides to provide retirement benefits to any employee, it must do so fairly to all employees?

Assuming this to be true, NQDCPs may be seriously undermining the intent and effectiveness of qualified deferred compensation arrangements in all but large union shop employment situations, where lower income employees may band together to collectively exert their influence. Even in

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In these cases, some of the restrictive contribution limitations may be avoided by highly compensated employees who may participate in both qualified and nonqualified deferred compensation arrangements.

Tax law should possess and reflect a social conscience. As Duncan Kennedy appropriately reminds us, we live in the great world as well as in the small.\textsuperscript{31} In the context of tax law, this may simply be another way of asking whether the tax treatment of NQDCPs is fair. The answer to the fairness question necessarily embraces an assessment of the social costs of this treatment.\textsuperscript{32} Our intent is to initiate dialogue on this important

\textsuperscript{31} D. Kennedy, \textit{quoted in} T. Shaffer, \textit{supra} note 1, at 229.

\textsuperscript{32} A brief heuristic response to why we ask this question may be found in the writings of Studs Terkel:

\begin{quote}
[Grace Elements, felter in a luggage factory,] is a sparrow of a woman in her mid-forties. She has eighteen grandchildren. "I got my family the easy way. I married my family." She has worked in factories for the past twenty-five years: "A punch press operator, oven unloader, sander, did riveting, stapling, light assembly . . . ." She has been with one company for twenty-one years, ARMCO Corporation.

During the last four years, she has worked in the luggage division of one of the corporation's subsidiaries . . . .

"We're about twelve women that work in our area, one for each tank. We're about one-third Puerto Rican and Mexican, maybe a quarter black, and the rest of us are white. We have women of all ages, from eighteen to sixty-six, married, single, with families, without families.

\ldots .

The tank I work at is six-foot deep, eight-foot square. In it is pulp, made of ground wood, ground glass, fiberglass, a mixture of chemicals and water. . . .

In forty seconds you have to take the wet felt out of the felter, put the blanket on—a rubber sheeting—to draw out the excess moisture, wait two, three seconds, take the blanket off, pick the wet felt up, balance it on your shoulder—there is no way of holding it without it tearing all to pieces, it is wet and will collapse—reach over, get the hose, spray the inside of this copper screen to keep it from plugging, turn around, walk to the hot dry die behind you, take the hot piece off with your opposite hand, set it on the floor—this wet thing is still balanced on my shoulder—put the wet piece on the dry die, push this button that lets the dry press down, inspect the piece we just took off, the hot piece, stack it, and count it—when you get a stack of ten, you push it over and start another stack of ten—then go back and put our blanket on the wet piece coming up from the tank . . . and start all over. Forty seconds. We also have to weigh every third piece in that time. It has to be within so many grams. We are constantly standing and moving. If you talk during working, you get a reprimand, because it is easy to make a reject if you're talking.

A thirty-inch luggage weighs up to fifteen pounds wet. The hot piece weighs between three to four pounds. The big luggage you'll maybe process only four hundred. On the smaller luggage, you'll run maybe 800, sometimes 850 a day. All day long is the same thing over and over. That's about ten steps every forty seconds about 800 times a day.

We work eight straight hours, with two ten-minute breaks and one twenty-minute break for lunch. If you want to use the washroom, you have
question. What rationale exists to permit NQDCPs to be virtually DOL unregulated with a limited tax advantage, while qualified plans are heavily regulated while failing to enjoy a significantly greater tax advantage?

The analysis that follows has two principle components. The first examines the regulatory environment of both qualified and nonqualified deferred compensation plans. The second component examines the income tax analysis of NQDCPs. The reason for this dichotomy is that both are of equal importance. It is meaningless to understand the income tax advantages of NQDCPs if the plan is not properly structured to avoid the regulatory scheme of qualified plans. Indeed, since the tax benefits for employees of tax-exempt employers has been reduced since 1986 with the enactment and amendment of IRC § 457, the avoidance of the DOL nontax ERISA regulatory framework may well be the paramount consideration. Unfortunately, most literature in this area examines these two concepts in an unrelated context. Successfully drafted NQDCPs

to do that in that time. By the time you leave your tank, you go to the washroom, freshen up a bit, go into the recreation room, it makes it very difficult to finish a small lunch and be back in the tank in twenty minutes.

The job I'm doing is easier than the punch presses I used to run. . . . I guess my scars are pretty well healed by now, because I've been off on medical leave for two, three months. Ordinarily I usually have two, three burn spots. It's real hot, and if it touches you for a second, it'll burn your arm. Most of the girls carry scars all the time.

We had two or three serious accidents in the last year and a half. . . .

I have arthritis in the joints of some of my fingers. Your hands handling hot pieces perspire and you end up with rheumatism or arthritis in your fingers. Naturally in your shoulder, balancing that wet piece. You've got that heat, you've got the moisture because there's steam coming out. You have the possibility of being burnt with steam when the hot die hits that wet felt. You're just engulfed in a cloud of steam every forty seconds.

It's very noisy. . . . I've lost a certain percentage of my hearing already. I can't hear the phone in the yard. The family can.

In the summertime, the temperature ranges anywhere from 100 to 150 degrees at our work station. . . . We really suffer.

I attended a conference of the Governor's Commission on the Status of Women. Another lady went with me. We were both union officers. Most of the women there were either teachers or nurses or in a professional field. When they found out we were from labor, their attitude was cold. You felt like a little piece of scum. . . .

I hope I don't work many more years. I'm tired. I'd like to stay home and keep house. We're in hopes my husband would get himself a small hamburger place and a place near the lake where I can have a little garden and raise my flowers that I love to raise. . . ."

S. TEREKEL, WORKING 384-89 (1972).
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require a mutually dependent analysis and the features of analysis in the regulatory and tax regimes are by no means identical.

To avoid the regulatory regime, an NQDCP must generally be structured as an “unfunded” plan, a term of art under ERISA. The income tax treatment of NQDCPs relating to future transfers of cash compensation depend upon whether the arrangement is governed by common law concepts of constructive receipt or economic benefit, or the statutory pattern of IRC § 83.\textsuperscript{33} This latter question is governed by whether the employer maintains the cash or other assets that will fund the current obligation to pay compensation in the future as part of its assets, or whether the employer sets the funding assets aside from its assets for the exclusive current benefit but future payment to the employee.

Wading through the mass of thoughts, laws, regulations, and interpretations collected below is an exhausting experience. That is the point. In the past, only those clients with sophisticated counsel could afford to pay for (or even discover) and implement the benefits of NQDCPs. If this is the aim of current tax law, it needs to be redirected.

I. ERISA COMPLIANCE STANDARDS

A. Introduction and Historical Context

A complete appreciation of the use and expansion of NQDCPs fundamentally depends on an understanding of the limitations and costs of qualified plans. The analysis which follows describes the major start-up and administrative “costs” associated with a deferred compensation plan governed by ERISA and IRC § 401.

As this article will show, the primary factor determining whether an NQDCP will be governed by the qualified plan regulatory scheme turns upon whether the plan is “funded.” Whether a deferred compensation plan is “funded” is a complicated matter. The focus of the question is subject to constant regulatory interpretation and change. Nevertheless,

\textsuperscript{33} This is because IRC §§ 404(a)(5) and 404(b) allow employer deductions when the employee includes the compensation in income. The timing of the employee income inclusion is governed by general income tax principles of constructive receipt and economic benefit as modified by IRC § 83 when the transfer is subject to a substantial risk of forfeiture.
The regulatory scheme governing qualified plans has become increasingly complex. The succession of legislation, regulations, and rulings have imposed a greater cost on employers maintaining qualified plans. The cost encompasses a number of factors, including: (1) the legal and accounting fees to establish the plan; (2) the increased employer contributions because of the expanded participation and coverage requirements; (3) the Pension Benefit Guaranty Corporation (PBGC) insurance premiums relating to defined benefit plans; and (4) the administrative costs incurred in satisfying ERISA's funding, reporting, and disclosure requirements.

This complex regulatory scheme has developed since 1942. Early legislation, which introduced a comprehensive design and operational scheme for private pension and welfare plans, included the Revenue Act of 1942 (1942 Act) and the Welfare and Pension Plan Disclosure Act of 1958 (WPPDA). The 1942 Act and subsequent amendments were designed to prevent qualified plans from discriminating or disproportionately benefiting one group of employees over another and to prevent qualified plans from taking excessive or unjustified tax deductions. The WPPDA was designed to protect plan assets against fraudulent plan administrator behavior.

The growth in the size, scope, and number of employee benefit plans, and the effect these plans had on the well-being and security of millions of employees, sparked and intensified debate over a perceived inadequate regulation of the plans. Two significant events occurred in 1962 which led to the eventual enactment of ERISA in 1974. The WPPDA was amended to authorize the Department of Justice to bring appropriate legal action to protect plan participants' interests and authorized the DOL to interpret and enforce the WPPDA. In addition, President Kennedy established a Committee on Corporate Pension Funds and Other Retirement and Welfare Programs. That...
committee issued a report in 1965, which served as the framework for the 1974 ERISA legislation.

The purpose of ERISA is to provide comprehensive protection to employee benefit plan participants and beneficiaries.37 Title I contains a comprehensive five-part scheme which: (1) regulates the funding and operation of plans (Parts 2 and 3); (2) requires reporting and disclosure to participants and federal regulatory agencies (Part 1); (3) creates causes of action for participants to enforce their rights under employee benefit plans (Part 5); and (4) provides fiduciary standards to regulate those who control plan assets (Part 4).

Initially, ERISA granted responsibility for its enforcement to three federal agencies: the DOL, the IRS, and the PBGC. In an attempt to make ERISA compliance less burdensome and to improve administration by eliminating jurisdictional overlap, President Carter adopted the Reorganization Plan No. 4 of 1978.38 Under this plan, the IRS was assigned primary responsibility for prescribing minimum standards for pension plans with respect to participation, vesting, and funding. However, the DOL retained primary jurisdiction over fiduciary standards and the reporting and disclosure requirements.

B. IRC § 401 Qualified Plan Limitations

In order for an employer to secure a tax exemption for a qualified retirement plan, the plan must satisfy the qualification requirements set forth in IRC § 401(a). If the plan satisfies these requirements, the employer’s contribution to the plan is currently deductible; however, the employee is not taxed until the compensation is actually received.39 Further, earnings on plan assets are not taxed until distributed to the participant. This combination provides the fundamental employee tax benefit of a qualified plan: income tax deferral through current tax exemption on the employee compensation, coupled with a tax exemption on the investment income attributable to the deferred compensation.40

40. The combination of a current employer deduction for the future compensation, coupled with exclusion from the income of the employee at the moment of the employer deduction, effectively exempts the compensation from income until the employee includes it in income upon retirement. This allows a tax-free accumulation
Every qualified plan must be established and maintained by an employer according to a written plan and, except in limited instances, all assets of the plan must be held by trustees in a trust created and organized in the United States.\textsuperscript{41} Communication of the existence and basic terms of qualified plans is required within the year of adoption.\textsuperscript{42} The salient features of the plan must be communicated to employees in summary form which "shall be written in a manner calculated to be understood by the average plan participant, and shall be sufficiently accurate and comprehensive to reasonably apprise such participants and beneficiaries of their rights and obligations under the plan."\textsuperscript{43}

In addition, IRC § 401(a) requires that: (1) the plan be permanent;\textsuperscript{44} (2) the plan provide that trust assets may not be "used for, or diverted to, purposes other than for the exclusive benefit of [the] employees or their beneficiaries";\textsuperscript{45} (3) both pension and profit sharing plans meet a standard of definiteness in establishing the economic benefits to be provided under the plan;\textsuperscript{46} (4) the plan reflect a procedure for establishing and carrying out a funding policy and funding method consistent with the objective of the plan;\textsuperscript{47} (5) the plan meet all minimum participation and coverage standards;\textsuperscript{48} (6) contributions or benefits not discriminate in favor of highly compensated employees;\textsuperscript{49} (7) the plan meet vesting standards;\textsuperscript{50} (8) the plan provide for 100% vesting upon termination of the

\textsuperscript{41}I.R.C. § 401(a) (1990) (specific requirements for qualified pension, profit-sharing, and stock bonus plans); ERISA §§ 402, 403, 29 U.S.C. §§ 1102, 1103 (1988) (specific requirements for the establishment of plans and trusts).

\textsuperscript{42}Treas. Reg. § 1.401-1(a)(2) (as amended in 1976); see also Rev. Rul. 72-509, 1972-2 C.B. 221.


\textsuperscript{44}Treas. Reg. § 1.401-1(b)(2) (as amended in 1976) (permanency tested by reference to the employer's intent at the time the plan is established).


\textsuperscript{46}Treas. Reg. § 1.401-1(b)(1)(ii) (as amended in 1976).

\textsuperscript{47}I.R.C. § 412(b) (1990); ERISA § 402(b), 29 U.S.C. § 1102(b) (1988).


\textsuperscript{49}Id. § 401(a)(4) (noting that highly compensated employees are defined in IRC § 414(q)).

\textsuperscript{50}Id. § 411.
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plan; the plan reflect provisions with respect to any merger or consolidation with or transfer of liabilities to any other plan; (10) the plan provide that the participant's benefits under the plan may not be assigned or alienated except by a qualified domestic relations order; (11) the plan reflect distribution consent requirements; and (12) the plan reflect a claims procedure for participants and beneficiaries whose claims for benefits under the plan have been denied.

1. Annual Benefit and Contribution Limitations

The benefits an employee can acquire under a defined benefit plan are limited as are the annual additions that may be made to an employee's account under a defined contribution plan. Generally, these limitations affect only highly compensated employees.

a. Defined Benefit Plans

The maximum benefit which may be accrued or paid under a defined benefit plan is limited in two ways. First, a defined benefit plan must provide that the participant's benefits under the plan may not be assigned or alienated except by a qualified domestic relations order.

51. Id. § 411(d)(3).
52. Id. § 401(a)(12).
53. Id. §§ 401(a)(13), 414(p). A qualified domestic relations order is a domestic relations order—
   (i) which creates or recognizes the existence of an alternate payee's right to . . . receive . . . a portion of the benefits payable with respect to a participant under a plan, and (ii) with respect to which the requirements of paragraphs (2) [IRC § 414(p)(2)] and (3) [IRC § 414(p)(3)] are met.
54. Id. § 414(p)(1)(A).
55. Id. § 417(e)(2).

A defined plan in which the benefit is expressed as a definitely ascertainable amount to be paid at an employee's retirement. The defined benefit plan must be funded to meet the promised benefits. The amount of the funding necessary to provide such promises are actuarially determined. id. §§ 414(j), 415(a) (b), 411(a)(7)(A)(i).

A defined contribution plan does not promise a specific dollar retirement benefit; rather, the employee's benefit is determined by the amount in the employee's account in the plan, which is, in turn, determined by the amount of employer contributions to the plan and investment earnings. Id. §§ 414(i), 411(a)(7)(A)(ii).

Defined benefit and defined contribution plans serve different employee needs and purposes. Generally, the defined benefit plan provides secure and predictable retirement income for long-term employees of a single employer. On the other hand, defined contribution plans, historically, have played a secondary and supplementary role, benefiting younger, mobile employees who have sufficient incomes to take advantage of employee elective contributions and employer matching provisions.
benefit plan may not provide an annual benefit greater than the lesser of (1) 100% of the average of the employee's average compensation in her three highest compensation years or (2) $90,000 (indexed for inflation).\textsuperscript{57} If a participant has completed less than ten years of service with the employer, the compensation limitation is proportionately reduced.\textsuperscript{58} Second, the IRC § 401(a)(4) regulations restrict the maximum benefits payable to the twenty-five highest paid employees if a pension plan is terminated or if benefits become payable to a member of the restricted highly compensated class within ten years of the plan's establishment and before certain funding requirements have been satisfied.\textsuperscript{59}

\textbf{b. Defined Contribution Plans}

The most common form of a defined contribution plan is a profit-sharing plan. A profit-sharing plan may contain a definite contribution formula or the contribution amount may be determined in the discretion of the board of directors.\textsuperscript{60} Although it is not necessary to make annual contributions to a profit-sharing plan, regulations under IRC § 401(a) specifically provide that "merely making a single or occasional contribution out of profits for employees does not establish a plan of profit-sharing. To be a profit sharing plan, there must be recurring and substantial contributions."\textsuperscript{61}

The maximum deductible contribution to a defined contribution plan is limited to an amount equal to 15% of the compensation of all participants.\textsuperscript{62} The maximum annual addition to any employee's account is limited to the lesser of 25% of the employee's compensation or $30,000 (indexed for inflation).\textsuperscript{63} Amounts deferred by an employee under an IRC § 401(k) plan must also be included in the calculation of the annual additions limitations.\textsuperscript{64}

\textsuperscript{57} Id. § 415(d)(1).
\textsuperscript{58} Id. § 415(b)(5).
\textsuperscript{59} Treas. Reg. § 1.401-6 (as amended in 1976).
\textsuperscript{60} I.R.C. § 401(a)(27)(A) (1990). This provision was passed as part of the Tax Reform Act of 1986, which eliminated the requirement that contributions be made from either current or accumulated profits.
\textsuperscript{61} Treas. Reg. § 1.401-1(b)(2) (as amended in 1976).
\textsuperscript{63} Id. § 415(c)(1). Annual additions include all employer and employee contributions. Id. § 415(c)(2).
\textsuperscript{64} Id. § 415(c)(2)(B).
c. Combined Plan Limitations

When an employer maintains both a defined benefit plan and a defined contribution plan covering the same participants, a special combined plan limit applies.\(^65\) The limit is imposed by the "combined plan fraction," a number which is composed of the sum of the defined benefit fraction and the defined contribution fraction.\(^66\)

The defined benefit plan fraction for any year is a fraction, the numerator of which is a participant’s projected annual benefit under the plan determined at the close of the plan year.\(^67\) The denominator is the lesser of (1) 1.25 multiplied by the IRC § 415(c)(1)(A) defined benefit dollar limit in effect for the year, or (2) 1.4 multiplied by the IRC § 415(b)(1)(B) percentage of compensation limit for the year.\(^68\)

The numerator of the defined contribution plan fraction is the sum of the participant’s annual additions for all prior years of service with the employer.\(^69\) The denominator is the lesser of (1) 1.25 multiplied by IRC § 415(c)(1)(A) dollar limit in effect for the year and each prior year of service with the employer, or (2) 1.4 multiplied by the IRC § 415(c)(1)(B) defined contribution plan percentage of compensation limit in effect for such years.\(^70\)

The sum of these two fractions cannot exceed 1.0 for any participant for any year.\(^71\) The equation mathematically produces a combined plan limit that is equal to 100% of 1.25 times the applicable dollar limit or 1.4 times the applicable percentage of compensation limit, whichever is less.

2. Participation and Coverage Requirements

In return for the favorable tax consequences accorded qualified plans, an employer must cover a minimum number of employees and must offer plan participation to a broad group of employees.\(^72\) Qualified plans may not discriminate in favor of employees who are officers, shareholders, or highly compen-
sated. In order to establish compliance with these two requirements, an employer must satisfy the minimum coverage rules (consisting of two parts) and the minimum participation rules.

a. Minimum Coverage Rules

The first part of the minimum coverage requirement is relatively easy to determine. The plan must contain specified age and service requirements for employees to be eligible to participate. The minimum age requirement is age 21. The maximum period of service a qualified plan may require an employee to work before becoming eligible to participate is one year of service. A plan may require an employee to complete two years of service as a condition of eligibility if the employer is willing to vest an employee’s accrued benefit derived from employer contributions upon entry into the plan.

The second part of the minimum coverage requirement is more difficult to determine. The plan must satisfy at least one of three alternative coverage tests. Under these tests, a qualified plan must cover a significant portion of an employer’s nonhighly compensated employees. A “significant portion” is determined by making a comparison between excluded and covered employees. IRC § 410 provides three alternative coverage tests.

The first test requires the plan to benefit 70% or more of all of the employer’s nonhighly compensated employees. The second test requires that the percentage of nonhighly compensated employees benefiting under the plan be at least 70% of the percentage of highly compensated employees benefiting under the plan. The third test contains two parts which require an employer to satisfactorily demonstrate that the plan covers a classification of employees that does not discriminate in favor of highly compensated employees and that the average

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73. Id. § 410(b)(1).
74. Id. §§ 410(a), 410(b).
75. Id. § 410(a)(1)(A)(i).
76. Id. § 410(a)(1)(A)(ii).
77. Id. § 410(a)(1)(B)(i).
78. Id. § 410(b)(1)(B).
79. Id. § 410(b)(1)(A).
80. Id. § 410(b)(1)(A), (B).
benefit percentage\textsuperscript{81} for nonhighly compensated employees is at least 70\% of the average benefit percentage for highly compensated employees (expressed as a percentage of compensation).\textsuperscript{82}

Certain employees may be excluded for purposes of these coverage tests. These include employees covered by a collective bargaining agreement, airline pilots, nonresident aliens, and (for purposes of the first two tests only) employees who have not satisfied the minimum age and service requirements of the plan.\textsuperscript{83} An employee is considered "benefiting" under a plan only if she accrues a benefit in a defined benefit plan\textsuperscript{84} or, where there is no defined benefit plan, the contributions or forfeitures are allocated to her account.\textsuperscript{85}

\textit{b. Minimum Participation Rules}

Prior to 1986, an employer could maintain a number of different plans covering different groups of employees and still satisfy minimum coverage rules if the employer could demonstrate that the benefits under the plans were comparable. An employer was permitted to take social security contributions into account when testing the comparability. However, because Congress believed the comparability rule led to abuses and inequities in the pension system, it enacted IRC § 401(a)(26) in 1986 to address these concerns.\textsuperscript{86} IRC § 401(a)(26) prescribes a minimum participation standard.\textsuperscript{87} In order to meet this standard, a qualified plan must benefit the lesser of fifty employees, or 40\% or more of all employees of the employer.\textsuperscript{88}

Where the employer's objective is to benefit a select group of employees, the costs of complying with the qualified plan requirements must be considered. In addition to the increased contribution amount due because of the broad coverage rules,

\textsuperscript{81} The term "average benefit percentage" means that, with respect to any employee group, the average of the benefit percentage is calculated separately with respect to each employee in the group, irrespective of participation in the plan. \textit{Id.} § 410(b)(2)(B).
\textsuperscript{82} \textit{Id.} § 410(b)(2)(A).
\textsuperscript{83} \textit{Id.} § 410(b)(3).
\textsuperscript{84} \textit{Id.} § 411(a)(7)(A)(i).
\textsuperscript{85} \textit{Id.} § 411(a)(7)(A)(ii).
\textsuperscript{86} \textit{Id.} § 401(a)(26)(A).
\textsuperscript{87} \textit{Id.}
\textsuperscript{88} \textit{Id.}
employers must examine the costs associated with establishing a plan and maintaining the plan on an annual basis.

C. General Applicability of ERISA

Title I of ERISA is generally applicable to "employee pension benefit plans" and "employee welfare benefit plans." Unless otherwise exempt, plans covered by Title I are subject to stringent requirements involving reporting and disclosure (Part 1); participation and vesting (Part 2); funding (Part 3); and fiduciary responsibility (Part 4). Additionally, such plans are subject to enforcement provisions (Part 5), which grant federal courts jurisdiction to hear claims of plan participants and beneficiaries.

An employee pension benefit plan is defined to include "any plan, fund or program . . . established or maintained by an employer or by an employee organization [which either] (i) provides retirement income to employees, or (ii) results in a deferral of income by employees for periods extending to the termination of covered employment or beyond." 89

1. ERISA Exemptions

Although ERISA's reach is broad, certain types of plans are exempt from all or part of its coverage. These plans include: (1) individually negotiated unfunded deferred compensation arrangements either standing alone or within employment agreements; (2) individual retirement arrangements; governmental plans; (4) church plans; (5) unfunded excess

The term "governmental plan" means a plan established or maintained for its employees by the Government of the United States, by the government of any State or political subdivision thereof, or by any agency or instrumen-
benefit plans;\textsuperscript{95} (6) funded excess benefits plans;\textsuperscript{96} (7) plans maintained solely for compliance with applicable worker's compensation, unemployment compensation, or disability insurance laws;\textsuperscript{97} (8) plans maintained outside of the United States primarily for the benefit of non-resident aliens;\textsuperscript{98} and (9) unfunded NQDCPs maintained by an employer primarily for the purpose of providing deferred compensation for a select group of management or highly compensated employees (hereinafter Top-Hat Plans).\textsuperscript{99}

2. Funding Requirements

Since the status of a plan as "funded" or "unfunded" is critical to the determination of whether it is subject to ERISA, an examination of the funding requirements is necessary.

\textsuperscript{94} ERISA § 4(b)(2), 29 U.S.C. § 1003(b)(2) (1988); see also ERISA § 3(33), 29 U.S.C. § 1002(33) (1988) (For purposes of ERISA, "church plan" generally means a plan established and maintained by a church.).


\textsuperscript{96} Funded excess benefit plans are not exempt for all ERISA coverage but are exempt from the participation and vesting rules of Part 2 and the funding rules of Part 3 of Title I of ERISA. See ERISA § 201(7), 29 U.S.C. § 1051(7) (1988); ERISA § 301(9), 29 U.S.C. § 1081(9) (1988).


a. Qualified Plans

The minimum funding requirements appear twice in ERISA in duplicate language in Title I and Title II. Under Title II (which contains amendments to the Internal Revenue Code), the minimum funding requirements apply to almost all qualified pension plans (excluding profit-sharing plans and stock bonus plans) except governmental plans, church plans, and insurance contract plans. Under Title I, the minimum funding requirements apply to NQDCPs as well as qualified plans. Plans exempt from the funding requirements include Top-Hat Plans and excess benefit plans in addition to those plans exempt from Title II's funding requirements.

The type of plan and its provision have an effect on the amount of employer contribution that will be made to the plan on an annual basis. Most profit-sharing plans provide the employer with complete discretion in determining what to contribute, if anything. Employers maintaining plans subject to ERISA's funding rules are required to contribute an amount equal to the normal cost of the plan plus amounts calculated to amortize any unfunded liabilities over a calculated period of years. Once the employer determines the appropriate minimum funding amount for the plan, the threat of excise taxes enforces compliance.

b. Nonqualified Plans

1) DOL View of "Funded Plans"

The DOL last addressed the issue of what constitutes a "funded" plan versus an "unfunded" plan in a December 13, 1985, letter to the IRS. The IRS had requested the DOL to state its position with respect to whether the creation of a "rabbi trust" created pursuant to the terms of an NQDCP

102. Id. § 412(h).
104. But see supra text accompanying notes 57-61.
108. For a more complete explanation of "rabbi trusts," see infra text accompanying notes 300-16.
constituted a "funded" plan for purposes of Title I of ERISA. The DOL stated as follows:

Under Title I of ERISA, whether a plan is "funded" is significant only with respect to two types of plans, "Top-Hat" plans and excess benefit plans . . . . The Department is generally of the view that any determination of the "funded" or "unfunded" status of a plan of deferred compensation requires an examination of the surrounding facts and circumstances, including the status of the plan under non-ERISA law. With particular regard to the development of regulations concerning "Top-Hat" plans, the Department recognizes, and must ensure, that employers design and maintain these plans only for a select group of management or highly compensated employees, that is, employees who may not need the substantive protections of Title I of ERISA. It is apparent that the various "rabbit trust" vehicles upon which the Service has opined were devised and predicated on consideration of tax code provisions, regulations and doctrines concerning the deferral of income. In the absence of pertinent legislative history defining "unfunded" for purpose of Title I of ERISA, the Department believes that in the case of "Top-Hat" plans (as well as excess benefit plans) the positions adopted by the Service regarding the tax consequences to trust beneficiaries of the creation of, or contributions to, a "rabbit trust" should be accorded significant weight under Title I. Thus, it has been the working premise of the Department that a "Top-Hat" Plan or excess benefit plan would not fail to be "unfunded" solely because there is maintained in connection with such plan a "rabbit trust" . . . .

2) Judicial View of "Funded" Plans

The courts have considered the definitional issue of "unfunded" plans with little guidance from the DOL or ERISA legislative history. The first case to consider whether an NQDCP was a "funded" plan pieced together ERISA and DOL regulatory "legislative history." In Dependahl v. Falstaff Brew-

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109. 13 Pens. Rep. (BNA) 702 (1986). The language of the DOL statement raises the question of whether the DOL would share the same view of what constitutes a "funded" plan if the plan did not relate solely to executive compensation groups. This may be more of a concern than a problem since NQDCPs are generally utilized with respect to highly compensated executives.

the employer used general corporate assets to purchase whole life insurance policies on key executives. The policies were owned by the corporation which was the beneficiary under the policies. The corporation purchased these policies to support its payment obligation to the executives' beneficiaries under a separate death benefit plan. Falstaff Brewing was acquired and the successor attempted to terminate the plan along with the underlying policies when it discharged many of the executives.

The Court held the plan was "funded" and thus subject to ERISA and its complete retirement vesting rule:

This regulation [29 C.F.R. § 2540.104-24], along with others, also seems to equate "unfunded" with payments of benefits from the employer's general assets. . . . This correlation is entirely reasonable. In the case of the [Falstaff] Plan, for example, the benefits will eventually be paid through the insurance contracts purchased and maintained by payments by Falstaff. Through these payments Falstaff has allowed the insurance companies to accumulate a fund for the eventual payment of benefits. This Court must conclude, therefore, that the [Falstaff] Plan is not an unfunded excess benefit plan exempt from ERISA.

The Eighth Circuit affirmed, noting the following:

We agree with the district court's conclusion that the plan was funded. Funding implies the existence of a res separate from the ordinary assets of the corporation. All whole-life insurance policies which have a cash value with premiums paid in part by corporate contributions to an insurance firm are funded plans. The employee may look to a res separate from the corporation in the event the contingency occurs which triggers the liability of the plan.

The ruling of Dependahl may be limited to the type of NQDCP at issue in that case. Following the Eighth Circuit affirmation, the DOL issued Advisory Opinion 81-11A to provide guidelines a company may follow to avoid a classification of its

111. Id.
112. Id. at 1190-91; cf. United States v. Drescher, 179 F.2d 863, 864 (2d Cir.) (corporation purchased and retained employee-owned policies), cert. denied, 340 U.S. 821 (1950).
113. See Dependahl, 491 F. Supp. at 1192.
114. See id.
insured death benefit plan as "funded."\textsuperscript{116} Under that opinion, a plan that uses life insurance policies will not be considered funded provided that (1) the insurance proceeds are payable only to the employer who is named the beneficiary on the policy; (2) the employer has all ownership rights under the policy; (3) neither the participant nor the beneficiary has any preferred claim against the policies or any beneficial ownership interest in them; (4) participants and beneficiaries are not told that policies will be used to provide benefits; (5) plan benefits are not limited or otherwise restricted by life insurance; and (6) the plan does not require or allow employee contributions.\textsuperscript{117}

Subsequent cases considering the "funded" issue have attempted to distinguish \textit{Dependahl} based on the unique provisions of the NQDCP challenged. In \textit{Belka v. Rowe Furniture Corporation},\textsuperscript{118} the court agreed with the Eight Circuit's \textit{Dependahl} decision that the distinction between "funded" and "unfunded" plans is whether there is a separate \textit{res} set apart from the sponsoring employer's general funds.\textsuperscript{119} However, the court noted that unlike the NQDCP in \textit{Dependahl}, the death benefit in \textit{Belka} was not the only benefit payable. If the participant terminated employment for reasons other than death, she would have been entitled to benefits under the \textit{Belka} NQDCP which would have been paid from the general assets of the employer.\textsuperscript{120} The court noted that the plan specifically provided that the participant had "no rights with respect to, or claim against, such policy, except as provided in the insurance policy itself."\textsuperscript{121}

The Eighth Circuit revisited the NQDCP ERISA funding issue in \textit{Belsky v. First National Life Insurance Company}.\textsuperscript{122} The court adopted the \textit{Belka} reasoning and distinguished an NQDCP in the nature of a salary continuation agreement (which provided a key executive with death, disability, and retirement benefits) from the exclusive death benefit agreement

\textsuperscript{116} DOL Adv. Op. Ltr. 81-11A (Jan. 15, 1981) (In place of "funded," this letter uses the description "assets" of the plan.)
\textsuperscript{117} \textit{Id}.
\textsuperscript{118} 571 F. Supp. 1249 (D. Md. 1983).
\textsuperscript{119} \textit{Id}. at 1251-52.
\textsuperscript{120} \textit{Id}. at 1252.
\textsuperscript{121} \textit{Id}.
\textsuperscript{122} 818 F.2d 661 (8th Cir. 1987).
in *Dependahl*.[123] The court reasoned that in *Dependahl*, there was near certainty that the insurance benefits would be ultimately paid, since the triggering event for the Company's obligation to pay its employee and the insurance company to pay the proceeds under the policy was the same.[124] Thus, the benefits amount could only be determined with reference to the face amount of the policy.

c. Highly Compensated Employees

In order for a Top-Hat Plan to be exempt from ERISA coverage it must be unfunded and must benefit primarily a "select group of management or highly compensated employees."[125] The theory is that such employees are in less need of regulatory protection. The phrase "select group of management or highly compensated employees" is not defined in Title I of ERISA. However, the DOL has issued a series of advisory opinions containing illustrations of what constitutes "a select group of management or highly compensated employees."

The DOL found a Top-Hat Plan covering only select key employees, who were administrative, supervisory or professional employees earning in excess of $18,200 a year, to be exempt from ERISA coverage.[126] In another example, a Top-Hat Plan covering less than 4% of the active work force limited to 115 employees annually and whose average annual salary was $28,000 (compared to $19,000 for managerial employees) was exempt.[127] However, a pension plan covering the executive payroll, which included a cost-accountant, a comptroller, three foremen, a scheduler and a time study position, did not constitute a Top-Hat Plan in view of the broad range of salaries and positions of the employees represented.[128] In a recent Advisory Opinion, the DOL provided some clarification of its position regarding those who may be covered by Top Hat Plans.[129]

It . . . is the Department's position that the term "primar-

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123. *Id.* at 663.
124. *Id.* (i.e., the death of the employee).
DEFERRED COMPENSATION PLANS

ily,” as used in the phrase “primarily for the purpose of providing deferred compensation for a select group of management or highly compensated employees” in [ERISA] sections 201(2), 301(a)(3) and 401(a)(1), refers to the purpose of the plan (i.e., the benefits provided) and not to participant composition of the plan. Therefore, a plan which extends coverage beyond “a select group of management or highly compensated employees” would not constitute a “top hat” plan for purposes of Parts 2, 3, and 4 of Title I of ERISA.130

This interpretation would severely restrict the group of employees a plan could cover and still come under the Top-Hat exemption. In addition, it appears from the opinion that in DOL’s view the employees covered by the Top-Hat Plan must have been able to exercise some degree of control or influence over their deferred compensation plan in order to bring it within the classification of a “select group of management or highly compensated employees.”

3. Reporting Standards

Unfunded Top-Hat Plans are not required to conform to the ERISA standards provided for participation, vesting, funding, and fiduciary responsibility, but are subject to both the reporting and disclosure and the administration and enforcement provisions of ERISA. Reporting and disclosure requirements for Top-Hat Plans are not onerous under DOL regulation 29 C.F.R. § 2520.104-23.131 The regulation provides that the reporting and disclosure requirements will be satisfied if the plan administrator provides plan documents to the DOL when requested,132 and files a statement which includes the name and address of the employer, the employer’s federal identification number, a declaration that the employer maintains a plan or plans primarily for the purpose of providing deferred compensation to a select group of management or highly compensated employees, and a statement of the number of such plans and the number of employees in each plan.133

If an NQDCP is found to be “funded” and therefore covered by ERISA, the plan is subject to the full reporting and disclo-

130. Id.
132. Id. § 2520.104-23(b)(2).
133. Id. § 2520.104-23(b)(1).
sure requirements of Part I of Title I of ERISA. The plan administrator subject to these reporting and disclosure requirements must provide detailed reports concerning the plan and its operations to participants, the IRS, and the DOL. The reports that must be provided to participants include a summary plan description, an annual statement of receipts and disbursements, a statement of benefits accrued and vested benefits (on request of a participant), and a statement setting forth information required in the annual registration statement under IRC § 6057.134

The reports filed with the DOL include a summary plan description, a Form 5500-Annual Return, and a summary annual report.135 Finally, the reports required to be filed with the IRS include the Form 5500-Annual Return and Form 1041 (tax return for trusts).136

**D. Roadmap To Create An “Unfunded” Plan**

Employers structuring an NQDCP must take care to avoid the federal income tax doctrinal pitfalls: constructive receipt and economic benefit.137 IRS guidelines provide that deferred compensation is not taxable until actually received if (a) the deferral is agreed to before the compensation is earned; (b) the deferred amount is not unconditionally placed in trust or escrow for the benefit of the executive; and (c) the promise to pay the deferred compensation is merely a contractual obligation not evidenced by notes or secured from the employer’s creditors in any way.138 If these conditions are satisfied the deferred compensation is not taxable before actual receipt regardless of whether the compensation is forfeitable or nonforfeitable.139

These guidelines contemplate that the NQDCP is “unfunded.”140 The status of an NQDCP as “unfunded” is mandated if the employer wants to avoid ERISA compliance.141

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136. Id.
137. For a more complete discussion of these doctrines, see infra notes 170-329 and accompanying text.
139. Id. at 179.
140. Id. at 180.
141. See supra text accompanying note 125.
However, employees often desire more security for ultimate payment of their retirement benefits. In most cases, increased security for the employee will cause the plan to be considered "funded" under the Dependahl standard. Placing an employee's deferred compensation into escrow or trust may cause the NQDCP to lose its "unfunded" status if the employer is not the owner and beneficiary of the trust. 142

The IRS guidelines require that if deferred compensation is placed in escrow for the benefit of the employee, the amount of the escrow account will be taxable to the employee immediately if the rights of the employee are nonforfeitable. 143 Thus, where an employee's NQDCP compensation was placed in a trust, but the employee's rights to the account were only those of an unsecured general creditor of the employer, no income to the employee resulted. 144 The critical distinction between the two examples is that in the latter case the employee had not gained any greater rights to the employer's assets than an unsecured promise to pay. As the previous section explained, this fact was determinative to the court in the Dependahl and Belka cases. 145

The IRS has issued a number of rulings considering the question of the funded nature of a plan where the employer has placed money in a trust or account for the benefit of the employee. 146 The conclusions reached in those rulings provide employer guidance in establishing an NQDCP with enhanced security for the employee. The IRS ruled that the NQDCP participants would not be in constructive receipt of amounts paid into the trust or account where the assets would at all times be subject to the claims of the employer's general creditors. 147 Since the trust deposits or accounts were subject to the claims of the employer's general creditors, the trust or

143. Id.
145. See supra text accompanying notes 110-21.
146. See Priv. Ltr. Rul. 88-18-023 (Feb. 5, 1988) (Where trustee must hold assets and income for the benefit of the employer's general creditors, and where employees had no preferred claim on these assets, no constructive receipt or economic benefit has occurred.); Priv. Ltr. Rul. 88-170-176 (Feb. 3, 1988); Priv. Ltr. Rul. 86-34-031 (May 21, 1986).
147. Id.
accounts would not be deemed “funded” and the economic benefit doctrine would also not be applicable.

Employers must exercise care in structuring NQDCPs to maintain the unsecured, and therefore “unfunded,” status of the plan in order to achieve a deferred tax result for the employee and to avoid the application of ERISA. The closer the employer approaches securing the promise, and thereby eliminating employer credit and business risks to the employee, the closer the arrangement approaches a current taxable event to the employee. 148

E. Critique and Proposal

The ERISA coverage exemption for “unfunded” NQDCPs is premised partly on the idea that the typically covered employee is a member of the highly compensated group. Consequently, such an employee is deemed to be sufficiently sophisticated and powerful to represent her own interests adequately without the paternalistic intervention of ERISA.

It 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]. 149

In addition, such an employee is thought to be less dependent on pension or deferred compensation programs as a source of retirement income than a rank and file employee. 150

The focus of the various groups and committees examining the private pension system in the 1960s and 1970s was

148. Amounts subject to an NQDCP (defined for this purpose under IRC § 3121(v)(2)(C)) are those included within the definition of “wages” subject to FICA withholding, FUTA withholding, and payment at the later of the year: (1) when the services are performed, or (2) when the amounts are no longer subject to a substantial risk of forfeiture. I.R.C. §§ 3121(v), 3306(r) (1990). Since NQDCPs are used principally by highly-compensated executives, employment tax withholding will not increase because the non-deferred compensation of the executives will, in almost all, cases already exceed the maximum wage base.


predominantly the rank and file employees who were losing their benefits due to the lack of employer funding of their plan, inadequate disclosure to participants regarding the operation of the plan, and the lack of standards regulating the conduct of those individuals managing plan assets. This focus was shaped largely by the passage of the WPPDA which

unleashed a nonstop torrent of mail from employees all over the country complaining over their failure to qualify for private pension benefits and mistakenly assuming the WPPDA provided some remedy in this respect. This was a phenomenon which did not cease until ERISA was enacted and was the basis for the enduring grass roots constituency in support of broad pension reforms.\(^{151}\)

The vision of ERISA was summarized by Senator Jacob Javits:

The problem, as perceived by those who were with me on this issue in Congress, was how to maintain the voluntary growth of private plans, while at the same time making needed structural reforms in such areas as vesting, funding, termination, etc., so as to safeguard workers against loss of their earned or anticipated benefits—which was their principal course of complaint and which—over the years—had led to widespread frustration and bitterness. [The] new law represents an overall effort to strike a balance between the clearly-demonstrated needs of workers for greater protection and the desirability of avoiding the homogenization of pension plans into a federally-dictated structure that would discourage voluntary initiatives for future expansion and improvement.\(^{152}\)

Congress did not intend to bring that group of employees covered by “unfunded” NQDCPs within ERISA’s purview. These employees, it was assumed, knew the risks they were taking when they accepted their employer’s unsecured and unfunded promise to pay benefits in the future and they were willing to take those risks because of the incentive of a greater than ERISA benefit payoff. For a long time executives felt reasonably secure that their NQDCP would be honored when pay-


\(^{152}\) See J. Langbein & B. Wolk, supra note 17, at 69.
ments came due. However, given the recent takeover activity of the 1980s, this premise has been challenged.

Since the 1980s, many corporations have ceased to exist. Some have succumbed to unwanted takeovers, others have been rescued by "white knights," and others have been forced into bankruptcy under Chapter 11 in order to survive. The security of the corporate promise has been seriously eroded. Given this corporate activity, the greatest concern to executives has come in the change of control situation. These changes inevitably cause fallout in the executive ranks.\(^{153}\)

Consequently, executives have demanded more security for the corporate promise behind their NQDCPs. Moreover, the demand for more security will increase as more and more companies respond to the gradual but persistent restriction on the level of benefits that may be provided through tax-qualified retirement plans by instituting NQDCPs for a significant portion of an executive's retirement benefits. Tax and pension planners continue to struggle with the tension created between the demand for more security and the notion of a "funded" plan for purposes of ERISA and the tax laws.

The responses by companies to the demand for additional security\(^{154}\) has in some respects diminished the concern regarding the company's refusal to pay benefits when they come due; however, since any funds set aside to enable the company to satisfy its promise remain subject to the claims of the general creditors of the company, the executive cannot guard against the company's financial inability to pay.

An executive who has seen a larger and larger portion of her retirement benefits shifted to NQDCPs may find herself in a worse position than the employee who depends on her benefits from a qualified plan. The executive may have put in many years with the company, yet, due to market factors over which the executive has no control and which may severely impact the financial viability of the company, the executive may lose a significant portion of her retirement benefits as a result of the company's financial inability to pay.

One of the primary driving forces behind ERISA's passage was the protection of a worker's reliance on an employer's promise to pay benefits at a certain date if certain requirements

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153. See supra note 10.
154. See infra text accompanying notes 300-16 (explaining "rabbi trusts").
were met. The legislation is complex and contains many provisions to enable employees to be informed about the operation of their retirement programs and to enforce their rights to the promised benefits. Given today’s financial conditions and the magnitude of corporate activity, which did not exist at the time of the passage of ERISA, executives should be given this same protection with respect to their retirement benefits.

Congress has legislated limitations on the amount of benefits that can be provided to employees through a tax qualified plan. These benefits replace a lower and lower percentage of an executive’s income each time Congress tampers with the limits. The result of this activity has caused the proliferation of NQDCPs which are intended to supplement the executive’s qualified plan benefits and position the executive with a post-retirement income level, which equates to the post-retirement income level of the rank-and-file employees. Under the current regulatory scheme of ERISA, the supplemental benefits promised to the executive are not protected. These retirement benefits may be lost entirely to the executive by events which the executive had no knowledge of or control over when she agreed to the NQDCP benefits.

If one accepts the premise that retirement benefits should not be gambled on the financial security of the employer, it is unacceptable that NQDCPs should continue to fall outside of ERISA’s regulatory protection. The loss of retirement security cannot be justified on any grounds: the loss cannot be remedied. It is a final outcome which time will not correct. Justifying the lack of DOL and ERISA intervention on the grounds that executives can take care of themselves simply misses the point.

At another level, the fundamental assumption is questionable. Is it true that such employees can take care of themselves? Do these employees have superior knowledge and information which adequately protect their retirement savings from loss? We would argue that they do not. In most cases, losses under an NQDCP will occur because of changes in the financial condition of the employer. It is impossible to anticipate such events as unknown future competition, technology changes, or litigation. Position and power have little to do with forecasting unknown events.

Finally, there seems little reason why all funded plans must
be subject to ERISA’s other requirements, such as its anti-discrimination provisions. If this feature of ERISA regulation were eliminated, no doubt most, if not all, NQDCPs would be employer-funded to provide the employee with greater protection of her retirement savings. In such an event, the employee would be immediately taxable under the common law economic benefit doctrine unless the receipt of the funds where subject to an IRC § 83 risk of forfeiture. The employee may not have the liquidity to pay the tax without the compensation. In such cases, the employers will have to work out a liquidity arrangement with the employee such as an interest free loan under § 7872 of the tax liability. This will not affect the employer’s liquidity since its tax liability will be reduced commensurately by its immediate tax deduction, provided its tax rate equals or exceeds the employee’s tax rate. In addition, since employers will be forced to continue to offer qualified plans to attract rank and file employees and to provide a benefits floor for executives, funding NQDCPs should not significantly discourage the use of qualified plans.

II. INCOME TAX ANALYSIS OF “UNFUNDED” PLANS

A. Introduction

It is pedagogically useful but somewhat misleading to divide the income tax analysis of unfunded plans into two models according to IRC § 83. It implies that the 1969 enactment of IRC § 83 substantially modified the common law timing and character treatment of deferred compensation transactions. The differences are more subtle than implied by the dichotomy. In any event, since IRC § 404(a)(5) and IRC § 404(b) provide that the employer’s deduction is tied to the employees’ income inclusion, the timing of the deduction and inclusion is keyed to the employees’ income tax position.

Life before and after IRC § 83 may be viewed as the past and the present, with IRC § 83 operating as a bridge between. In fact, IRC § 83 has had an impact on deferred compensation structuring, but not by intended design. The specific target of IRC § 83 was the conversion of ordinary compensation income into capital gains while at the same time postponing the timing
of income recognition.\textsuperscript{155} This opportunity existed under pre-1969 common law with respect to transfers of "property" subject to various employee use and ownership restrictions implemented by the employer. The concern was with transfers of property other than money which reflected the possibility of significant post-transfer appreciation, specifically stock options.

Since money transfers do not inherently reflect an appreciation potential, they were excluded from the application of IRC § 83 unless the transfer conferred an immediate common law economic benefit to the employee. Under these circumstances, immediate taxation follows the common law doctrine unless the transfer contains substantial restrictions to the employee. Thus, the impact of IRC § 83 on money transfers can be seen as one of essentially eliminating common law taxation under constructive receipt and economic benefit analysis provided appropriate IRC § 83 restrictions are present. The analysis below discusses the extent to which such restrictions imposed under common law would have prevented current taxation, much the same as IRC § 83.

Viewed from this perspective, the statutory language of IRC § 83, as borrowed from the old IRC § 421 regulations governing the transfer of restricted property, created its own set of specific applications while excluding others. Thus, some of the IRC § 83 coverage issues overlap with prior common law notions expressed under the constructive receipt and economic benefit doctrines, and some do not. Because of the specific nature of the statutory and regulatory language of IRC § 83, the tax results governing deferred compensation transactions will not always be consistent between common law and IRC § 83.

This section of the article will examine the alternative interpretations under IRC § 83 and the common law. Inevitably, there will be differences which become most important when the statutory coverage requirements of IRC § 83 do not apply. In these unique circumstances, common law lurks to fill the gap left or created by the IRC § 83 language.

Because of the broad definition of covered IRC § 83 property transactions, the difference is most evident in NQDCP transactions involving money as opposed to other forms of

\textsuperscript{155} For a detailed discussion of the legislative history of IRC § 83, see infra text accompanying notes 391-95.
property transfers. In these cases, the dreaded fear of the failure of IRC § 83 coverage and its attendant lack of an IRC § 83(b) election alternative may be considered a benefit, depending upon the employee's perspective and the precise nature of the transaction. Since most NQDCP arrangements in the past have been governed by the IRC § 404 tax regime, IRC § 83 has not played a large role. If the thrust of this article is successful, all NQDCPs would become "funded" and therefore taxable immediately, unless subject to an IRC § 83 substantial risk of forfeiture. Even if the points of this article are not addressed, it may well be in the employer's best risk aversion interest to fund the NQDCP and defer taxation through the less risky IRC § 83 forfeiture provisions. These provisions are more in the control of the employee than is the risk of employer nonpayment.

In order to discuss these circumstances, an independent examination of both common law and IRC § 83 is necessary. The analysis first considers the development of the common law and its constructive receipt and economic doctrine (Model I). Then, the major aspects of IRC § 83 (Model II) will be examined.

B. Model I (Non- § 83)

1. General Analysis

A primary assumption of our analysis is that employees contemplating a deferred compensation arrangement are cash method taxpayers and that their employers are accrual method taxpayers. This juxtaposition of accrual and cash method taxpayers has historically produced the opportunity for mismatch in the timing of the employer's compensation deduction and the employee's inclusion of the compensation income.\(^{156}\) For transactions covered by IRC § 83, this result was modified in 1969 by the addition of IRC § 83(h) requiring the employer to

\(^{156}\) See I.R.C. §§ 402(b)(1), 404(a)(5) (1990). Where the deferred compensation arrangement utilizes a nonexempt employees' trust as opposed to a "rabbi trust" (employer beneficiary trust), the tax results to the employee are governed by IRC § 402(b)(1). The compensation becomes income to the employee when the amounts are credited to the trust unless receipt of the amounts are subject to a substantial risk of forfeiture under IRC § 83. The tax results to the employer are governed by IRC § 404(a)(5). The compensation becomes a deduction for the employer when the amounts in the trust are includable as income to the employee under IRC § 402(b)(1).
postpone her deduction for transfers of "property," regardless of her method of accounting, until the employee included the covered compensation in income under either IRC § 83(a) or IRC § 83(b).\textsuperscript{157}

With regard to deferred compensation arrangements falling outside of IRC § 83,\textsuperscript{158} 1984 statutory modifications to the accrual method of accounting under IRC § 461(h) now require that the employer deduction be postponed until economic performance occurs. In the case of compensation transactions, this would be the earlier of the employer's actual payment or the employee's performance of the services subject to the deferred compensation agreement.\textsuperscript{159}

A cash method employee generally includes compensation for services rendered as income in the year of actual receipt of the cash or when the employee, directly or indirectly, receives the economic benefit of the employer's payment of the compensation.\textsuperscript{160} A cash method employee may also be required to include compensation in income prior to its actual receipt in the form of cash or a noncash economic benefit where the employee constructively receives such items.\textsuperscript{161}

The actual receipt of cash by the employee in return for services presents few problems in our current tax system. The employee is required to include in current income the amount of money received under a claim of right.\textsuperscript{162} If the employee is required to repay part of the consideration at a subsequent time, IRC § 1341 offers a restoration of the tax result to the employee in the form of a deduction or recomputed tax credit.

\textsuperscript{157} The IRC § 83 result only covers areas not governed by IRC § 402(b)(1) or § 404(a)(5), even though there are areas of substantial overlap. In addition, the IRC § 83 rules only apply to transfers of "property" as defined under Treasury Regulation § 1.83-3(e). Where such a transfer does not occur, the common law rules of taxation would be governed by IRC § 461(h), limiting premature employer accruals based upon the lack of immediate economic performance.

\textsuperscript{158} These would include, primarily, transfers of money to a "rabbi trust" or other situations in which the employer does not secure the obligation to the employee. Such transfers or employer promises are not IRC § 83 property under Treasury Regulation § 1.83-3(e). In addition, where IRC § 404(a)(5) applies because of the presence of a plan of deferred compensation, IRC § 83 does not.


\textsuperscript{160} See id. § 451(a) (general rule for taxable year of inclusion); Treas. Reg. § 1.451-1(a) (as amended in 1978) (in-depth treatment of the general rule).

\textsuperscript{161} Treas. Reg. § 1.451-2(a) (general rule for constructive receipt of income).

\textsuperscript{162} See North Am. Oil Consol. v. Burnet, 286 U.S. 417 (1932) (discussing the claim of right doctrine).
in the year of repayment. 163

This fundamental paradigm becomes more clouded when the employee's actual receipt takes the form of a noncash benefit. Such receipts are taxable to the extent of their fair market value 164 at the time of actual receipt. Nevertheless, noncash benefits may pose enormous problems of valuation, particularly where the valuation issue is complicated by employer-attached restrictions to the employee's use and enjoyment of the property such as continued service requirements or covenants not to compete, both enforced through forfeiture restrictions. Should such property be valued at the time of the receipt or at the time restrictions lapse? Prior to 1969, under a regulation then in force, the tax event was postponed until the restrictions lapsed, but was valued at the earlier receipt date. 165 In part, IRC § 83 was enacted in 1969 to counter this result. 166 Under IRC § 83, unless the employee elects otherwise, the valuation occurs at the time the restrictions lapse at the property's then fair market value. 167

Notwithstanding the 1969 enactment of IRC § 83, there are a substantial number of deferred compensation arrangements not covered by IRC § 83. This is primarily because of the limited definition of IRC § 83 property. 168 In these circumstances, what rules apply to govern inclusion of the compensation in the employee's income? Presumably common law will govern.

The following analysis focuses on common law. Important

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166. For a discussion of the legislative history of IRC § 83, see infra text accompanying notes 391-95.
167. See I.R.C. § 83 (1990). The employee also can elect under IRC § 83(b) to have the property taxed in the year of transfer. To avoid the valuation problems just discussed, the valuation is made at fair market value assuming the restrictions were not imposed. See id. § 83(b).
168. Treas. Reg. § 1.83-3(e) (as amended in 1985). Under IRC § 83 and the corresponding regulations, 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 . . . . In the case of a transfer of a life insurance contract, retirement income contract, endowment contract, or other contract providing life insurance protection, only the cash surrender value of the contract is considered to be property.

Id.
common law concepts include constructive receipt, and actual receipt classified under the major area of concern—the receipt of noncash benefits. The latter concept will be referred to as the common law doctrine of economic benefit. Finally, economic benefit can be further thought of as consisting of two major branches of receipt problems: (1) those involving the actual receipt of noncash benefits subject to valuation created by employee use restrictions, and (2) the receipt of a noncash benefit in the form of an obligation to transfer property to the employee in the future.

These latter forms of specialized economic benefits in the form of a "promise to pay"—whether from the employer or from someone other than the employer—present obvious difficulties as well as opportunities. The issue is whether to value the promise to pay now or value the actual property received pursuant to the promise when it is actually received.

These issues are addressed below. Understanding a fundamental distinction between constructive receipt and economic benefit before embarking on this journey is important. Economic benefit requires and presumes actual receipt; the question is when and how much to tax. In contrast, constructive receipt reaches to tax that which the employee has not yet received whatever its form.169

2. Constructive Receipt Doctrine

a. Historical Development

The notion of constructive receipt originated170 in 1919

169. Because of judicial limitations on the constructive receipt doctrine for mere promises to pay or transfer of property in the future, a presumption exists that the promisee has not received a taxable economic benefit. See Minor v. United States, 772 F.2d 1472 (9th Cir. 1985); Loose v. United States, 74 F.2d 147 (8th Cir. 1934); Amend v. Commissioner, 13 T.C. 178 (1949), acq., 1950-1 C.B. 1. This convention reconciles the economic benefit and constructive receipt doctrines in the promise-to-pay overlap area and preserves an important distinction between cash and accrual methods of accounting. Absent such an interpretation, cash method taxpayers would essentially be treated as accrual method taxpayers.

However, the failure to tax the receipt of promises to pay or transfer property in the future under the economic benefit doctrine on other grounds is usually justified because of the risk of nonpayment. If this is the true problem in taxing the receipt of such promises, case interpretation should focus on determining the risk of nonpayment rather than on whether the promise is legally secured. Such a focus is a rough and unreliable risk analysis tool. We refer to this problem as the "receipt paradox."

170. Regulations issued under the Revenue Act of 1913 described gross income but did not discuss receipt as the time of inclusion. See Reg. § 33, art. 4 (1914).
when the Treasury Department promulgated a regulation interpreting IRC § 213 of the Revenue Act of 1918 which defined gross income. The concept has never been embodied in a statute and has been perpetuated as part of the regulatory process. The pertinent 1919 regulation read as follows:

Income which is credited to the account of or set apart for a taxpayer and which may be drawn upon by him at any time is subject to tax for the year during which so credited or set apart, although not then actually reduced to possession. To constitute receipt in such a case the income must be credited to the taxpayer without any substantial limitation or restriction as to the time or manner of payment or condition upon which payment is to be made. A book entry, if made, should indicate an absolute transfer from one account to another. If the income is not credited, but is set apart, such income must be unqualifiedly subject to the demand of the taxpayer. Where a corporation contingently credits its employees with bonus stock, but the stock is not available to such employee until the termination of five years of employment, the mere crediting on the books of the corporation does not constitute receipt. The distinction between receipt and accrual must be kept in mind. Income may accrue to the taxpayer and yet not be subject to his demand or capa-
Constructive receipt is currently described under IRC § 451 and Treasury Regulation § 1.451-2(a) as follows:

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

Thus, it is clear that the notion of constructive receipt, as developed under these regulations, is to tax cash method taxpayers on cash or property income items even though the cash...
or property is not yet received or reduced to actual possession. The idea is to expressly recognize the concept that, although a taxpayer may arrange her affairs to produce the minimum possible tax liability,\(^{175}\) she may not deliberately ignore income rightly belonging to her simply to postpone the tax thereon.

The doctrine is sensible in its simplest form. Without the doctrine of constructive receipt, cash method taxpayers (as opposed to accrual method taxpayers) would have complete control over when they would report income simply by refusing to accept physical possession of their property until the year they decided to report the income.

As applied to deferred compensation arrangements and other property disposition transactions, the doctrine has adopted legal formalism as the bright line to distinguish circumstances in which constructive receipt will apply. Thus, constructive receipt will apply when the taxpayer has a legal right to demand payment. This formalistic reliance on a formal contract right, as opposed to economic reality, has developed an unnecessary and restrictive limitation on the doctrine. A presumption should be inferred that the payment is to be made immediately following economic performance (the time of the provision of the services or the property delivery). This distinction is both unnecessary and unwarranted. To the extent that cash method taxpayers have the option and opportunity to take current cash or vested economic benefits, they should be taxed as if they exercised the option. In effect, this would place the cash method taxpayer on the accrual method for this purpose, but allow the cash method taxpayer a factual opportunity to demonstrate that the payor either could not or would not currently pay the sum due immediately following economic performance under the contract.

Past services and future services will be discussed separately below, since both case law and the IRS recognize a distinction between the two with regard to the constructive receipt doctrine. With past services, economic performance of the serv-

\(^{175}\) See Gregory v. Helvering, 293 U.S. 465, 469 (1935). In the Second Circuit opinion affirmed by the Supreme Court, Judge Learned Hand wrote these now immortal words: “Any one may so arrange his affairs that his taxes shall be as low as possible; he is not bound to choose that pattern which will best pay the Treasury; there is not even a patriotic duty to increase one’s taxes.” Helvering v. Gregory, 69 F.2d 809, 810 (2d Cir. 1934), aff’d, 293 U.S. 465 (1935).
ices has occurred. In this situation, as expected, the IRS applies the doctrine more stringently.

b. Past Services

How does the constructive receipt doctrine apply, specifically in the employment context, with respect to deferring the taxation of income for services rendered? For past services, under the constructive receipt doctrine, it is clear that a cash method employee will be currently taxed on compensation that is currently set aside on the books of the employer for services rendered, provided: (1) there are no restrictions on payment; (2) the employee can demand immediate payment; (3) the employer has sufficient funds to pay the compensation; and (4) the employee is aware of these facts.176

The open and remaining question is, under what conditions, if any, may the taxpayer arrange her affairs to avoid the application of the constructive receipt doctrine with regard to future services, provided tax deferral is desirable? The IRS's position on this matter differs slightly, but importantly, from case law in this regard.

c. Future Services

1) IRS Position

Treasury Regulation § 1.451-2(a) contemplates that a taxpayer with the option to take cash in a deferred compensation arrangement will be taxed as if the cash was actually received, even if the cash payment precedes the taxpayer's economic performance under the contract.177 In such cases, the taxpayer is treated as if she actually received the economic benefit of the cash payment, or as if she constructively received the cash payment, even though actual receipt of the cash is postponed. The narrow question is, when will the taxpayer have the option to currently take cash in circumstances where a deferral was actually chosen?

In the early case of Amend v. Commissioner,178 a cash method farmer sold and delivered his wheat to a grain elevator in Au-


gust 1944, under a contract to receive payment in January 1945. Testimony clearly indicated that the grain elevator was ready, willing, and able to make payment for the wheat sale in 1944, the year of the taxpayer's economic performance through delivery of the wheat.\textsuperscript{179} In fact, the manager for the grain elevator was required to obtain special permission not to make immediate payment at the time of the delivery in 1944 as was its general practice.\textsuperscript{180} The taxpayer testified that he was comfortable with the credit worthiness of the grain elevator and had no concern that the elevator would be unable to pay him as scheduled in January 1945.\textsuperscript{181}

The government contended that, under the constructive receipt doctrine, the taxpayer was taxable in 1944\textsuperscript{182} because the wheat was sold and delivered in 1944, and the taxpayer had a clear opportunity to take cash payment at that time. He, however, voluntarily elected not to do so.\textsuperscript{183} The tax court held that the taxpayer was not taxable in 1944 under the constructive receipt doctrine, since he had no legal right to demand

\begin{footnotes}
\footnotetext{179} Id. at 183.
\footnotetext{180} Id. The case did not discuss the economic benefit doctrine but it is clear that the taxpayer considered himself better off with receipt of the grain elevator's promise to pay in 1945 than he did with possession of the wheat in 1944. Otherwise, he would not have dictated this contract term. The question of constructive receipt may be phrased in terms of whether the taxpayer was in a position to be taxed as if he currently received a taxable economic benefit (the ability to take cash). The expansion of the economic benefit doctrine to reach cases such as Amendment would effectively eradicate any distinction between cash and accrual methods of accounting creating a "receipt paradox," unless the taxpayer had the ability to take a cash equivalent economic benefit. This assumes that the taxpayer received a mere promise to pay from the grain elevator. However, it is this critical promise to pay intersection of constructive receipt and economic benefit which is the most troubling. The constructive receipt doctrine assumes that it is not appropriate to tax the taxpayer as if the economic benefit were currently received. Viewed from this perspective, the economic benefit doctrine becomes essentially a "time value of money" concept taxing the present value of property to be received in the future, except where the receipt is confined to a mere promise to pay.

The assumption of this article is that there is no difference in the application of the "mere promise to pay" not generating a current and taxable economic benefit in service and property transactions; however, since most property sale transactions are secured (as opposed to service transactions), the principle has less impact. In effect, secured property transactions under IRC § 453 installment reporting overrides the current taxable economic benefit received, which would otherwise be taxable under IRC § 1001. Absent a provision, such as IRC § 453, that applies to service transactions, the secured versus unsecured paradigm will continue.

\footnotetext{181} Amendment, 13 T.C. at 184.
\footnotetext{182} Id.
\footnotetext{183} Id. at 183.
\end{footnotes}
payment under the contract the parties negotiated. 184

As a result, the case established that the parties to a contract are free to strike their bargain without fear of the application of the constructive receipt doctrine taxing the contract that they could have made. Limiting the constructive receipt doctrine to the contract terms actually negotiated places an enormous limitation on the doctrine. Surprisingly, the IRS acquiesced and thereby blessed the limitation. 185

Citing Amend, the IRS issued Revenue Ruling 60-31186 which extended the judicial concept from a sale of property to deferred compensation arrangements. The ruling involved the application of the constructive receipt doctrine to five specific factual deferred compensation circumstances and reflected that section 1.451-2(a) of the Income Tax Regulations cannot be administered by speculating whether the payor would have been willing to agree to an earlier payment . . . . Consequently, it seems clear that in each case involving a deferral of compensation a determination of whether the doctrine of constructive receipt is applicable must be made upon the basis of the specific factual situation involved. 187

In 1978, apparently dissatisfied with the application of the doctrine to state and local governments and tax-exempt employers, 188 the IRS issued Proposed Regulation § 1.61-16189 which provided that the constructive receipt doctrine would be modified by currently taxing deferred compensation where it was clear that the compensation had been withheld at the discretion of the employee or when there was a specific employer set-aside. 190 As a practical matter, however, most of the IRS's

184. Id. at 185.
186. Rev. Rul. 60-31, 1960-1 C.B. 174. Although this ruling is thirty years old and has been slightly modified, it remains essentially intact as the IRS's primary position regarding the application of the constructive receipt doctrine to deferred compensation arrangements.
187. Id. at 178.
188. The dissatisfaction stems from the fact that the tax results are equivalent for employers offering qualified plans and for employers offering NQDCPs, despite the fact that NQDCPs are without the regulatory procedural safeguards and coverage requirements. These concerns have largely been addressed with the passage and modification of IRC § 457. See I.R.C. § 457 (1990).
189. For the text of this proposed treasury regulation, see infra note 216.
concerns regarding employees of state and local governments were addressed with the passage of IRC § 457 in 1978.\textsuperscript{191} Congress provided that the regulation should not apply to a taxable employer.\textsuperscript{192} The 1986 amendment of IRC § 457 extended its coverage to tax-exempt employers.\textsuperscript{193}

As a result of these limitations and the IRS's current satisfaction with the application of the constructive receipt doctrine to the contract actually negotiated, the primary contemporary issue surrounding the application of the doctrine to future property transfers relates to the "substantial limitations or restrictions" language of section 1.451-2(a).\textsuperscript{194}

2) Case Law

An exhaustive distillation of case law reveals that a cash basis taxpayer will be taxed under the doctrine of constructive receipt when the following elements are present: (1) an amount is immediately due and owing; (2) the obligor is ready, willing and able to pay; (3) the amount due and owing is credited to the taxpayer on the books of the obligor or in a separate bank account; (4) the taxpayer can withdraw the amount without restrictions or limitations, or has an unconditional vested right to receive the amount; and (5) the taxpayer is aware of the previous four elements.\textsuperscript{195}

An employee will not be in constructive receipt of compensation payable at a subsequent time if it is to be paid pursuant to an agreement to defer compensation. When must the agreement be executed? Clearly before payment, but case law and the IRS differ on whether the agreement must be executed before the services are rendered. The case law suggests not.\textsuperscript{196}

\textsuperscript{194} Treas. Reg. § 1.451-2(a) (as amended in 1979). Section 1.451-2(a) does not provide that income is constructively received merely because its eventual payment is not subject to conditions or restrictions. The central consideration is whether the taxpayer's control over the time of the payment is subject to restrictions or substantial limitations. \textit{Id.}

A good example of current constructive receipt analysis is Revenue Ruling 82-121. Rev. Rul. 82-121, 1982-1 C.B. 79 (discussing the taxation of stock appreciation rights); see infra notes 406-08 and accompanying text.
\textsuperscript{195} See Metzer, \textit{Constructive Receipt, supra} note 176, at 531.
\textsuperscript{196} \textit{Id.} at 541-42 (comparing judicial treatment of agreements to defer unearned
However, the IRS requires the agreement to be executed prior to the time the employee renders the services.\textsuperscript{197} The IRS has announced that, with respect to "unfunded" NQDCPs where the employee's right to payment is nonforfeitable, it will only issue advance rulings if the election to defer is entered into prior to the beginning of the period for which the compensation is payable or earned.\textsuperscript{198} Thus, for advance ruling purposes, the IRS's position is that the deferral agreement must be executed prior to the rendition of the services generating the payment, unless the amount to be deferred is subject to a substantial risk of forfeiture.\textsuperscript{199}

The case law is somewhat more generous with regard to the compensation before services are rendered as well as after services are rendered but before the payment date).

\textsuperscript{197} See id. at 542. The IRS generally finds constructive receipt where an employee has an irrevocable right to elect deferral or nondeferral, unless the right to receive the deferred amounts is subject to forfeiture. \textit{Id.}


\textsuperscript{199} \textit{Id.} Revenue Procedure 71-19 essentially requires the deferral election to precede the period during which the employee's services are actually performed. See \textit{id.} This is generally defined as the employee's calendar taxable year. Thus, the deferral election for income for services to be rendered in 1990 must be made on or before December 31, 1989. See Priv. Ltr. Rul. 88-04-057 (Nov. 4, 1987); Priv. Ltr. Rul. 83-21-051 (Feb. 18, 1983).

The IRS has released several private rulings somewhat relaxing this rigid time parameter in the following circumstances:


(2) New NQDCP Participants—A newly eligible employee may elect to participate in a pre-existing NQDCP and defer compensation, provided the employee's election to participate (deferral equivalent) is made within thirty days of eligibility and the NQDCP arrangement only covers compensation earned after the participation election. See Priv. Ltr. Rul. 86-37-085 (June 16, 1986). However, the IRS declined to express an opinion regarding the taxation of deferred amounts attributable, in part, to services performed in the same calendar year, but prior to the election. \textit{Id.}

(3) Undetermined Bonus—The employee may be able to elect to defer a bonus in the year in which the services generating the discretionary bonus are rendered where the amount of the bonus is not determinable prior to the end of the plan year. See Priv. Ltr. Rul. 82-34-135 (May 28, 1982). But see Priv. Ltr. Rul. 84-09-022 (Nov. 28, 1983) (Employees who elected to defer receipt of a portion of a contingent award, prior to the beginning of the plan year, were permitted to defer its recognition.); Priv. Ltr. Rul. 83-07-088 (Nov. 19, 1982) (Employees who elected to defer receipt of an incentive bonus by December 22 of the year prior to the plan year were permitted to defer its recognition.).
timing of the deferral agreement provided it was executed before the payments were due, even if execution was after the services were performed. In *Veit v. Commissioner*, the taxpayer executed an agreement with his employer to defer his yet-undetermined bonus for 1940 until 1942. The agreement was executed after some services were performed, but prior to the determination of the bonus amount. The court held that, since the deferral agreement was bona fide and entered into at arm's length, the taxpayer was not in constructive receipt of his 1940 bonus during the 1940 taxable year. The IRS acquiesced in that decision but would not issue an advance ruling to the same effect today, unless the bonus also was subject to a substantial risk of forfeiture during the deferral period.

In *Oates v. Commissioner*, an insurance salesman entered into an agreement with his employer to alter the payment method of anticipated renewal commissions. The agreement was executed after the sale of the insurance policy which would generate the potential renewal commissions. However, it was executed before the specific amount of future renewal commissions was determinable through the policyholder’s payment of renewal premiums on the policies. The agreement essentially altered the payment method of the anticipated renewal commissions by equalizing the monthly payout. Hoping to achieve greater retirement stability, the taxpayer agreed to receive $1,000 a month for fifteen years. This method differed from a normal payout which would have been greater in the early years and would have decreased in the later years as fewer policy holders renewed their policies. The issue was whether

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201. Id. at 815.
202. Id. The bonus was to be determined as a percentage of the corporation’s profits for the year 1940. Id. at 811.
203. Id. at 818.
205. 18 T.C. 570 (1952), acq., 1960-1 C.B. 5, aff’d, 207 F.2d 711 (7th Cir. 1953).
206. Id. at 579-82.
this "exchange" of contract rights was taxable in the year of exchange because the taxpayer was in constructive receipt of the present value of payment under the original agreement, or later, as the payments actually were received under the modified agreement.207 The tax court held that, since the exchange was merely a contract substitution or novation, it was not taxable in the year of the exchange.208

The Oates decision suggests that the exchange was for the employer's "mere promise to pay." The form of the promise should not alter the taxation of the transaction, provided that each promise exchanged is separately considered not to be a currently taxable economic benefit.

The Oates analysis was extended in Commissioner v. Olmstead Incorporated Life Agency.209 In Olmstead, the taxpayer exchanged a right to receive future renewal commissions for an annuity contract from the employer/insurance company.210 Following the novation idea in Oates, the court held the exchange was not taxable.211 The receipt of the annuity was treated as an Oates amendment to the employer-employee contract. The Olmstead court also distinguished the taxpayer's receipt of an annuity contract from the situation in Drescher.212 Since the Drescher annuity was purchased from an outside insurance company, the court relied on the fact that the Olmstead annuity contract was issued by the employer/insurance company.213

This analysis is somewhat troubling. If the taxpayer in Olmstead had received cash and used that cash to buy an annuity from his employer, the transaction clearly would have been taxed. There was no indication in Olmstead, as in Drescher, that the taxpayer had the option to take cash. Therefore, constructive receipt of the cash was not present. However, Drescher may stand for the broader proposition that the receipt of any annu-

207. See id. at 470.
208. Id. at 585. Similarly, the IRS ruled in Revenue Ruling 60-31 (situation 3) that an author could enter an agreement with a publisher to defer royalty payments, even after the completion of the writing services, provided that the agreement preceded the time when the royalties were earned through actual book sales. See Rev. Rul. 60-31, 1960-1 C.B. 174.
209. 304 F.2d 16 (8th Cir. 1962).
210. Id. at 18.
211. Id. at 22.
212. Id. (distinguishing United States v. Drescher, 179 F.2d 863 (2d Cir.), cert. denied, 340 U.S. 821 (1950)).
213. Id. at 22.
ity is the receipt of a cash equivalent because of the annuity’s market characteristics. If such were the case, Olmstead improperly distinguished Drescher. The Olmstead court treated the annuity more like a mere promise to pay than a market annuity property right. To avoid this issue, simple contract amendments, as in Oates, may be a safer idea.\(^\text{214}\)

3) Policy Analysis

The constructive receipt doctrine has become overly formalistic and rule-oriented in an attempt to properly limit the scope of the unreasonable opportunity offered by Amend.\(^\text{215}\) A better approach would be to modify the constructive receipt doctrine to read something like Proposed Regulation § 1.61-16,\(^\text{216}\) a regulation that was later withdrawn and was not reissued. The regulation would have taxed the employee under the constructive receipt doctrine when the facts demonstrated that the

\(^{214}\) Although beyond the scope of this article, it may well be that when the taxpayer in Olmstead received the annuity contract, his rights to payment under the annuity contract were superior to the rights to payment as a mere general creditor of the insurance company. Under state law, as modified and interpreted through the insurance regulations, such policyholders may indeed have a superior claim to the insurance company’s required capital reserves over the insurance company’s other general creditors. Of course, if this is true, it is an argument for current taxation of the taxpayer in Olmstead, just as it was in Drescher.

\(^{215}\) Amend v. Commissioner, 13 T.C. 178 (1949), acq., 1950-1 C.B. 1; see supra notes 177-94 and accompanying text.

\(^{216}\) Prop. Treas. Reg. § 1.61-16, 43 Fed. Reg. 4638 (1978). The proposed regulation read as follows:

Except as otherwise provided in paragraph (b) of this section, if under a plan or arrangement (other than a plan or arrangement described in sections 401(a), 403(a), or (b), or 405(a)) payment of an amount of a taxpayer’s basic or regular compensation fixed by contract, statute, or otherwise (or supplements to such compensation, such as bonuses, or increases in such compensation) is, at the taxpayer’s individual option, deferred to a taxable year later than that in which such amount would have been payable but for his exercise of such option, the amount shall be treated as received by the taxpayer in such earlier taxable year. For purposes of this paragraph, it is immaterial that the taxpayer’s rights in the amount payment of which is so deferred become forfeitable by reason of his exercise of the option to defer payment.

(b) Exception. Paragraph (a) of this section shall not apply to an amount payment of which is deferred as described in paragraph (a) under a plan or arrangement in existence on February 3, 1978 if such amount would have been payable, but for the taxpayer’s exercise of the option, at any time prior to March 6, 1978. For purposes of this paragraph, a plan or arrangement in existence on February 3, 1978 which is significantly amended after such date will be treated as a new plan as of the date of such amendment. Examples of significant amendments would be extension of coverage to an additional class of taxpayers or an increase in the maximum percentage of compensation subject to the taxpayer’s option.

\(Id.\) (emphasis added).
compensation was withheld at the control and direction of the employee, or that the employee had significant control over the investment of the funds.\textsuperscript{217} Such a modification effectively would prevent control-oriented employees from avoiding current taxation by deferring their income. However, it also would utilize the constructive receipt doctrine to bar deferral where the employee retained control of the deferral.

3. Economic Benefit Doctrine
   a. Historical Developments

   Early in the development of the income tax, it was clear that cash method taxpayers would not be able to postpone income through the receipt of valuable property rights, simply because the receipt was not in the form of cash. In \textit{Commissioner v. Smith},\textsuperscript{218} the court determined that the receipt of nearly any type of economic benefit would trigger the imposition of the income tax.\textsuperscript{219} On the one hand, if the receipt of the mere right to receive an economic benefit in the future was sufficient to trigger the imposition of a tax to a cash method taxpayer, the distinction between cash and accrual method taxpayers would dissolve.\textsuperscript{220} Doctrines, such as the cash equivalency doctrine, were designed to confine the economic benefit doctrine. On the other hand, where the mere promise to pay adopts characteristics similar to an outright transfer of property to the recipient, the doctrine should apply. Accordingly, the major and evolving area of law concerning an exception to the application of the economic benefit doctrine traditionally has been the identification of the contours and characteristics of a mere promise to pay.

\textsuperscript{217} See id.

\textsuperscript{218} 324 U.S. 177 (1945).

\textsuperscript{219} \textit{Id.} at 181. The Court explained that the income tax provisions are "broad enough to include in taxable income any economic or financial benefit conferred on [an] employee as compensation, whatever the form or mode by which it is effected."

\textit{Id.}

\textsuperscript{220} The economic benefit doctrine essentially is an accrual-oriented "time value of money" concept. From this perspective, current receipts of cash and noncash property rights are taxed under the cash method. The cash method, however, essentially ignores the value of the current receipt of an obligation to receive property in the future and taxes the actual receipt of the property delivered under the obligation in the future.
1) Cash Equivalency Doctrine

a) Property Transactions

Early interpretations of the income tax system required the taxation of a broad range of noncash receipts. The Revenue Act of 1918 provided, with respect to property transfers, that "[w]hen property is exchanged for other property, the property received in exchange shall for the purpose of determining gain or loss be treated as the equivalent of cash to the amount of its fair market value, if any."221

In 1921, Congress modified this language by substituting the following: "[O]n an exchange of property, real, personal or mixed, for any other such property, no gain or loss shall be recognized unless the property received in exchange has a readily realizable market value."222

The idea was to relax the rules regarding the taxation of amounts received by taxpayers in sales or exchanges.223 The regulation interpreting the 1921 statute provided that "property has a readily realizable market value if it can be readily converted into an amount of cash or its equivalent substantially equal to the fair value of the property."224

In 1924,225 Congress once again modified this language by replacing it with the version which currently appears in IRC § 1001(b): "The amount realized from the sale or other disposition of property shall be the sum of any money received plus the fair market value of the property (other than money) received."226

The statutory language was changed from readily realizable market value to fair market value in 1924 because, as the Senate Committee Report reveals that "[t]he question whether, in a given case, the property received in exchange has a readily realizable market value is a most difficult one, and the rulings on this question in given cases have been far from satisfactory. . . . The provision can not be applied with accuracy or

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with consistency.”

b) Service Transactions

In the six years from 1918 to 1924, the tax measuring rod for property received in the disposition of other property was transformed from “equivalent of cash” to “readily realizable market value” to “fair market value.” Regarding payment for services, regulations promulgated under the Revenue Act of 1918 provided that compensation paid other than in cash was taxable to the extent of the “fair market value” of the property received. After 1924, the standard measuring rod for both property and service transactions was the “fair market value” of the item received.

The idea conveyed by these earliest income tax notions is that receipts do not have to be in the form of cash or money in order for cash method taxpayers to be currently taxable. In such cases, the simple fair market value of the property received will be taxable when the beneficial interest in the prop-

228. Reg. § 45, art. 33 (1919) provided as follows:

ART. 33. Compensation paid other than in cash.—Where services are paid for with something other than money, the fair market value of the thing taken in payment is the amount to be included as income. If the services were rendered at a stipulated price, in the absence of evidence to the contrary such price will be presumed to be the fair value of the compensation received. Compensation paid an employee of a corporation in its stock is to be treated as if the corporation sold the stock for its market value and paid the employee in cash. When living quarters such as camps are furnished to employees for the convenience of the employer, the ratable value need not be added to the cash compensation of the employee, but where a person receives as compensation for services rendered a salary and in addition thereto living quarters, the value to such person of the quarters furnished constitutes income subject to tax. Premiums paid by an employer on policies of group life insurance covering the lives of his employees, the beneficiaries of which are designated by the employees, are not income to the employees.

Reg. § 45, art. 34 (1919) provided as follows:

ART. 34. Compensation paid in notes.—Promissory notes received in payment for services, and not merely as security for such payment, constitute income to the amount of their fair market value. A taxpayer receiving as compensation a note regarded as good for its face value at maturity, but not bearing interest, may properly treat as income as of the time of receipt the fair discounted value of the note at such time. Thus, if it appears that such a note is or could be discounted on a six or seven per cent basis, the recipient may include such note in his gross income to the amount of its face value less discount computed at the prevailing rate for such transactions. If the payments due on the note so accounted for are met as they become due, there should be included as income in respect of each such payment so much thereof as represents recovery for the discount originally deducted.
erty is received. As explained in *Commissioner v. Smith*, the income tax provisions are "broad enough to include in taxable income any economic or financial benefit conferred on [an] employee as compensation, whatever the form or mode by which it is effected." *Smith* may be considered the genesis of the economic benefit doctrine, a doctrine which arose in the context of compensation. Nevertheless, except for a partial statutory complement in IRC § 402(b) providing for current taxation of compensation funded through a nonqualified trust, the doctrine has remained primarily a common law doctrine.

Serious systemic questions arise, however, where the nature of the property received suggests that true receipts are likely. It is obvious that, if a cash method employee receives $10,000, she will be taxed in the year of receipt. It is equally obvious that, if the same taxpayer receives marketable securities with an established value of $10,000, the same result should occur.

Treasury Regulation § 1.61-1(a) provides in relevant part: "Gross income includes income realized in any form, whether in money, property, or services." Treasury Regulation § 1.61-2(d)(1) governing pre-1969 transfers, provides in relevant part: "If services are paid for in property, the fair market value of the property taken in payment must be included in income as compensation." Treasury Regulation § 1.61-2(d)(6), generally applicable to post-1969 transfers (the year IRC § 83 was enacted), provides that Treasury Regulation § 1.61-2(d)(1) is not applicable to transfers of property subject to a substantial risk of forfeiture as defined in IRC § 83. However, where IRC § 83 applies to "a transfer of property, and the property is not subject to a restriction that has significant

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229. 324 U.S. 177 (1945).
230. Id. at 181.
232. See I.R.C. § 403(b) (1990). On the deduction side, IRC § 404(a)(5) provides that deferred compensation under a nonqualified deferred compensation plan is deductible to the employer only in the year the account is includable in the gross income of the employee participating in the plan. See id. § 404(a)(5). Thus, the 1942 addition of IRC § 404(a)(5) ended the ability of accrual method employers to take a current deduction for such nonqualified deferred compensation when the cash method employee postponed inclusion of the amount in income. This advantage is now reserved for qualified plans.
effect on the fair market value of such property, then the rules contained in paragraph (d)(1) . . . shall also apply to such transfer . . . .”

But, what about a transfer of “property” which is in the nature of a promise to pay other property in the future? Such promises of future property transfers contain special problems for cash method employees which must be addressed by the economic benefit doctrine. The employee has a current receipt of the promise to pay, whether it be cash or other property, and the economic benefit doctrine must then be used to determine whether to tax the receipt of the promise or the subsequent delivery of the property subject to the promise. Finally, one must grapple with the doctrine to determine the distinctions between the receipt of an employer’s promise to pay and the employer’s transfer to the employee of another party’s promise to pay. Is the receipt of the non-employer’s promise to pay the equivalent of a current property receipt—notwithstanding the future receipt of property under that promise—to be valued at fair market value and currently taxable?

Although Smith may be considered the substantive genesis of the economic benefit doctrine, it does little to place the proper intellectual limits on the concept. Is the current receipt of any beneficial ownership interest currently taxable to the extent of its fair market value? Would such a rule not place enormous stress on current valuation systems, particularly for small property interests? Moreover, does not the cash method of accounting suggest that it is the amount of cash or, as suggested by the Revenue Act of 1918, the cash equivalent of property receipts, that properly distinguishes between the cash and accrual methods of accounting? Without such notions in the compensation area, would not the accrual method taxpayer be taxed on compensation as the services are rendered, regardless of when the compensation is received, and would not the cash method taxpayer be taxed at exactly the same time? After

235. Id. § 1.61-2(d)(6).
236. As will be discussed, the non-employer promise to pay will be treated as any other property receipt and taxed to the extent of its fair market value. See United States v. Drescher, 179 F.2d 863 (2d Cir.), cert. denied, 340 U.S. 821 (1950).
237. Commissioner v. Smith, 324 U.S. 177 (1945); see supra notes 218-20 and accompanying text.
238. See supra note 221 and accompanying text.
all, the cash method taxpayer receives the employer's promise to pay as the economic performance of the services occurs. Assuming the employer is solvent and the promise is short-lived, will the employee not have current income from the mere receipt of the promise and would not that receipt be taxable upon its fair market value? In such cases, do factors such as the assignability and market negotiability affect whether the property interest received (here, the employer's mere promise to pay) is currently taxable? Is merely the fair market value of the amount currently included in income by the employee currently taxable? Finally, if the latter is true, restrictions will cause severe valuation discounts and then, how does the system account for the subsequent actual property receipt at its undiscounted value?

These questions are not intended to be merely rhetorical. They are also illustrative of the relationship and operation of the economic benefit doctrine in deferred compensation cases where the cash method employee currently receives the employer's promise to transfer property to the employee in the future. The choices of taxation would include the following options: (1) current taxation of the fair market value of the employer's promise with a subsequent taxation of the fair market value of the property received in excess of the amount included in income in the earlier year; (2) current taxation of the fair market value not of the promise but of the property to be transferred under the promise; or (3) postponement of taxation until actual receipt of the property under the promise. These are essentially questions of timing and basis.

Option one assumes that the valuation differences in income in year one and the subsequent year are properly attributable to interest. This would be true if the promise were to pay money in a subsequent year, if the promise carried no interest or carried a below market interest rate, if no change in interest rates occurred between the years, and if the employer's solvency were not at issue. In such cases, limited as they may be, the discount rate applied to future receipt should reflect only below market interest rates paid on the promise, if any. In any other case, the difference in the amount included in the income of the employee in year one and that included in the subsequent year will not be solely attributable to the failure of the earlier promise to bear a market interest rate.

Option two is an improvement since it ignores the promise...
valuation and proceeds to the valuation issues attendant to the property to be delivered under the promise. Assuming that this promised property were cash and that it was valued without any restrictions upon its future receipt, the amount included in income in year one would exactly equal the value of the future receipt, unless the promise to pay did not reflect a market interest rate. Any additional amount to be received would be reported as interest. Where the property to be received is not money but other property, fluctuations in its value between the receipt of the promise and the receipt of the property would create a problem. Theoretically, this should be treated as unrealized gain or loss emanating from pre-disposition fluctuations in the value of the property. Unfortunately, it will be enormously difficult to distinguish between value fluctuations (capital in nature) and interest rate modifications (ordinary in nature) and hence these fluctuations may distort the proper reporting of ordinary and capital transactions.

b. "Mere Promise To Pay" Paradigm

Fortunately, the current system avoids many of these potential problems, at least where the promise to pay emanates from the employer. The special or unique features of a "mere promise to pay" must be identified in order to properly define the outer boundaries of the economic benefit doctrine. In Minor v. United States, the principles were judicially expressed and reinforced.

The facts in Minor are complex but important. Dr. Minor was a physician practicing in Snohomish County, Washington. In 1959, he entered into an agreement with Snohomish County Physicians Corporation (SCPC) to render medical services to patients subscribing to the SCPC prepaid medical plan. In return, Dr. Minor agreed, as is customary, to accept the SCPC fee schedule as compensation guidelines for his services.

In 1967, SCPC adopted a voluntary nonqualified deferred compensation plan (Plan) under which participants could elect to defer any percentage of their compensation from ten per-

239. 772 F.2d 1472 (9th Cir. 1985).
240. Id. at 1473.
241. Id.
cent to ninety percent.\textsuperscript{242} Dr. Minor elected to defer receipt of ninety percent\textsuperscript{243} of his SCPC compensation under the terms of the plan.

In order to satisfy its obligations under the Plan, SCPC created a trust in which SCPC was the settlor, transferring to the trust the participating physician's deferred fees.\textsuperscript{244} SCPC was also the trust beneficiary and three physicians, including Dr. Minor, were the trustees.

SCPC, as the trust beneficiary, directed the trustees to invest the trust corpus in insurance retirement annuity contracts\textsuperscript{245} to provide for the payment of benefits under the Plan. The annuity benefits were for the individual accounts of the participating physicians and were designed to fund payments to the physician upon retirement, death, disability, or pre-retirement termination of the physician providing the physician did not breach a covenant not to compete by practicing in the SCPC patient service area. Each participating physician agreed to "continue to provide services to [SCPC] patients until the benefits become payable, to limit his or her practice after retirement, to continue to provide certain emergency and consulting services at [SCPC's] request, and to refrain from providing medical services to competing groups."\textsuperscript{246}

In 1970, 1971, and 1973, Dr. Minor included in income only

\textsuperscript{242} Id.

\textsuperscript{243} From 1967 through 1971, Dr. Minor elected to defer only 50\% of his SCPC compensation. \textit{Id.}

\textsuperscript{244} \textit{Id.}

\textsuperscript{245} Prior to 1986, annuities were a favored deferred compensation investment vehicle because the investment build-up (interest income) was not taxable until actual receipt by the annuitant. However, with respect to the investment returns on contributions to annuity contracts made after February 28, 1986, IRC § 72(u) provides that if the annuity is (1) not held by a "natural person" (the term does not include a trust or other entity holding the annuity as agent for a natural person); and (2) the annuity is not considered an "immediate annuity" (payments must begin within one year of the date of purchase under § 72(u)(4)); then (3) the "income on the contract," as defined in § 72(u)(2), will be currently taxable to the owner under the formula prescribed in § 72(u)(2)(A). \textit{See I.R.C. § 72(u) (1990).} Thus, taxation of deferred annuities was radically altered.

Accordingly, it is anticipated that annuity contracts will be considerably less popular as a means of investing NQDCP obligations. The employer is not only taxed on a potentially inferior investment return but the employer does not have the liquid assets from the investment to pay the tax. However, because of the tax-exempt nature of qualified plan trusts, the annuity will continue to be a popular funding vehicle for qualified plans.

\textsuperscript{246} \textit{Minor}, 772 F.2d at 1473.
the fees he actually received from SCPC. He did not include any portion of the SCPC fees paid to the trust on his account relative to the services he rendered during those years. The IRS contended that Dr. Minor should be taxed on the amounts paid into the trust by SCPC for his account even though he did not actually receive these amounts. The IRS contended that "the economic benefit doctrine applies here because an economic benefit was presently conferred on [Dr.] Minor, although he did not receive and had no right to receive the deferred compensation benefits during the tax year." 248

The court distinguished the constructive receipt doctrine and the economic benefit doctrine based upon the notion that the economic benefit doctrine presumes actual receipt of a non-cash benefit and the issue is simply whether to currently tax the receipt, an issue complicated when the current receipt is of an obligation to receive a future tangible property transfer. 249 Citing Goldsmith v. United States, 250 the Minor court reasoned that in order for the receipt of the noncash economic benefit to be currently taxable, it must be capable of valuation. 251 In cases of deferred compensation, this means that the employer’s promise to pay the compensation to the employee in the future must be capable of valuation. In this regard, the court reasoned that "[a] current economic benefit is capable of valuation where the employer makes a contribution to an employee’s deferred compensation plan which is nonforfeitable, fully vested in the employee and secured against the employer’s creditors by a trust arrangement." 252

The court noted that in all cases where an economic benefit has been found, one of two elements has been present: (1) the employer’s contribution is secured against the employer’s creditors, or (2) the employee’s interest is nonforfeitable. 253

247. Id. The IRS conceded that the constructive receipt doctrine did not apply. Id. at 1474. Presumably, the IRS did not apply the constructive receipt doctrine because (1) Dr. Minor’s deferred compensation agreement with SCPC was made before he performed the services; and (2) the amounts credited to his account were subject to substantial restrictions on his ability to draw upon the funds, that is, he had no current right to the funds.

248. Id. at 1473.

249. Id. at 1474.

250. 586 F.2d 810 (Ct. Cl. 1978).

251. Minor, 772 F.2d at 1474.


The court then analyzed the SCPC trust to determine whether transfers to it created a current economic benefit to Dr. Minor. Since the court found that the beneficiary of the trust was SCPC and not Dr. Minor, the trust assets were still subject to the claims of SCPC's general and unsecured creditors. In its finding, the court carefully analyzed and distinguished the IRS's reliance on *Sproull v. Commissioner.*

This same finding precluded not only the common law economic benefit doctrine, but also the application of IRC § 83 under Treasury Regulation § 1.83-3(e) since the employer's promise would not constitute "property" under § 83. The court reasoned that the question of whether the SCPC trust restrictions upon Dr. Minor's ultimate receipt of the trust funds constituted a "substantial risk of forfeiture" within the meaning of IRC § 83 was irrelevant since IRC § 83 did not apply. The mere financial risk that the employer might not be able to pay the deferred obligation was enough to block current taxation under the common law doctrine of constructive receipt.

This of course raises the question regarding what is it about the nature of such a risk that prevents common law taxation of the employer's promise to pay. Is the IRS unwilling to specu-
late on the value of such a promise or is there a more fundamental question at stake?

c. *The Role of Valuation, Cash Equivalency and Economic Benefit*

NQDCPs established after WWII but before 1960 and those established after the promulgation of Revenue Ruling 60-31\(^{257}\) generally contained common themes which were primarily designed to avoid the constructive receipt doctrine, which is currently expressed in Treasury Regulation § 1.451-2(a).\(^{258}\) The common theme was that the executive was given no choice as to (1) the amounts to be deferred, (2) the time of the deferment, or (3) the manner in which the deferred amounts would actually be paid.\(^{259}\) Care was taken never to allow the employee to elect compensation already earned and cautious counsel often subjected the future payment of the deferred compensation to contingencies, such as working until retirement, death or disability, and post-employment covenants not to compete.\(^{260}\)

The pre-1960 notions of constructive receipt avoidance\(^{261}\) were based upon the 1947 case of *Veit v. Commissioner* (*Veit I*)\(^ {262}\) and the 1949 case of *Veit v. Commissioner* (*Veit II*).\(^ {263}\) In *Veit I*, the taxpayer had earned the compensation in 1940 which was to be received in 1941.\(^ {264}\) The taxpayer negotiated an extension in November 1940 of the time to receive the compensation, until 1942. The court held the amounts were not constructively received in 1941 since the 1940 agreement was at arm’s length, not a sham, and not a tax subterfuge.\(^ {265}\) In *Veit II*, the taxpayer extended the date of the receipt from 1942

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259. *See* McDonald, Deferred Compensation, supra note 258, at 205-06 (payments usually made in installments after employment terminated).

260. *Id.* at 206. Another possible covenant was that the employer require personal services by the departing employee. *Id.*

261. *See* McDonald, Deferred Compensation, supra note 258, at 206-07.

262. 8 T.C. 809 (1947) [hereinafter *Veit I*].

263. 8 T.C.M. (CCH) 919 (1949) [hereinafter *Veit II*].

264. *See* Veit I, 8 T.C. at 811.

265. *Id.* at 816 (The arrangement in *Veit I* was mutually profitable, confirming the arm’s-length nature of the transaction.).
until a subsequent date.\footnote{Veit II, 8 T.C.M. (CCH) at 920.} The court held that constructive receipt did not apply if (1) the agreement was entered before payment was due, and (2) the agreement to defer was not a sham.\footnote{Id. at 922.}

Prior to \textit{Veit I} and \textit{Veit II}, the Supreme Court decided \textit{Commissioner v. Smith},\footnote{324 U.S. 177 (1945).} enunciating the economic benefit doctrine and a plausible theory for taxation of nonqualified deferred compensation beyond the constructive receipt doctrine:

Using the \textit{Smith} case as a springboard, the . . . [IRS] hinted that at the time the employer agreed to pay deferred compensation, the employee received an economic benefit from the employer's promise which could be valued and currently taxed if not subject to such contingencies as would make it impossible to value. . . . The [IRS's] . . . suggestion was that the unqualified promise of a solvent employer was not appreciably different from the unqualified promise of an insurance company. Further, the [IRS] . . ., probably taking its lead from the \textit{Sproull} case, suggested also that the unqualified promise of a solvent and financially strong company to pay deferred compensation in the future was not significantly less valuable to an employee than the promise of an escrow agent or trustee to which his employer transfers funds to make the deferred payments in the future, especially if it were assignable and could thus become an immediate source of funds.\footnote{McDonald, \textit{Deferred Compensation}, supra note 258, at 208.}

Even though it is doubtful the IRS could have prevailed on such a theory, since it would completely emasculate the distinction between cash and accrual method employees,\footnote{See also Knight, \textit{Income Tax Consequences of Nonqualified Deferred Compensation}, 21 \textit{TAX LAW.} 163, 175-76 (1967-1968).} the informal maintenance of such a position had a chilling effect on such agreements.\footnote{See McDonald, \textit{Deferred Compensation}, supra note 258, at 209.} This required most employers to continue conditions of forfeiture in the agreements relating to future service requirements as well as covenants not to compete. Such provisions were unpopular since the employee and the employer generally considered the deferred compensation as belonging to the employee when the services were
Finally, in 1960, the IRS issued Revenue Ruling 60-31, clarifying its position on economic benefit in Example 4. This example relates to a football player who signed a two-year contract to play football entitling him to a salary and, as an inducement for signing the contract, the player was to be paid a signing bonus. The player could have received the payment at the time of the contract execution but rather chose to have the amount deferred pursuant to a paragraph added to the agreement by his suggestion:

"The player shall receive the sum of 150X dollars upon signing of this contract, contingent upon the payment of this 150X dollars to an escrow agent designated by him. The escrow agreement shall be subject to approval by the legal representatives of the player, the Club, and the escrow agent." 

The player chose a bank as escrow agent which agreed to pay the amount plus interest to the player over a five-year period. The ruling provides the following with regard to the economic benefit doctrine:

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. . . . [Such] taxpayers . . . are required to report only income actually received no matter how binding any contracts they may have to receive more.

This should not be construed to mean that under the cash receipts and disbursements method income may be taxed only when realized in cash. For, under that method a taxpayer is required to include in income that which is received in cash or cash equivalent.

The ruling found that the sum paid into the escrow was taxable to the player at the time paid as opposed to when that amount was subsequently received. The ruling reasoned...
that the amount was nonforfeitable and unconditionally paid by the employer to the escrow agent on behalf of the employee.\textsuperscript{278}

From 1960 until 1969 when IRC § 83 was enacted, the issue was when an employer's promise was the equivalent of cash and therefore subject to valuation and inclusion in income under the economic benefit doctrine. In \textit{Cowden v. Commissioner},\textsuperscript{279} the court stated the following regarding the cash equivalency test in the context of a sale of property:

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.\textsuperscript{280}

In \textit{Warren Jones Company v. Commissioner},\textsuperscript{281} the Ninth Circuit Court of Appeals rejected the tax court reliance of the above quoted language in \textit{Cowden} to find that a land contract received in a sale was not to be valued because it had a market discount in excess of fifty percent.\textsuperscript{282} The Ninth Circuit held that in property sales the doctrine of cash equivalency had been congressionally disapproved in 1924 with a change in statutory language and in 1926 with the passage of the predecessor to

\textsuperscript{278} \textit{Id.} The situation found analogous in \textit{Sprout} involved a trust of which the taxpayer (or, if he died, his estate) was the sole beneficiary. The amount transferred in trust was held to be taxable income in the year of the transfer, rather than when it was paid out. \textit{Sprout}, 16 T.C. at 248.

\textsuperscript{279} 289 F.2d 20 (5th Cir. 1961).

\textsuperscript{280} \textit{Id.} at 24. The taxpayers in \textit{Cowden} had elected to receive a deferred bonus obligation from the lessee oil company, even though the lessee was willing to make a lump-sum payment. The tax court held that the taxpayers had realized income in the amount of the foregone lump-sum payment. The court of appeals reversed, holding that the proper inquiry was about the nature of the obligation, not the option foregone. \textit{Id.} at 24-25.

\textsuperscript{281} 524 F.2d 788 (9th Cir. 1975).

\textsuperscript{282} \textit{Id.} at 792.
the installment sale provisions. The Ninth Circuit believed that Congress intended only two options in property sales: (1) including the contract in the amount realized under IRC § 1001(b) to the extent of its fair market value regardless of how substantial the market discount was on the contract, or (2) reporting the sale under the installment sale provision of now IRC § 453.

Regardless of the Warren Jones interpretation, the installment sale revision measure of IRC § 453 is not available in service transactions and therefore the cash equivalency doctrine should still be applicable. In addition, the IRS's own Revenue Ruling 60-31 notes the applicability of the doctrine. This is also consistent with the early 1918 regulations definition that income includes the fair market value of the notes received.

From this analysis, the receipt of a note or a contractual obligation instead of current cash compensation will usually not be regarded as a currently taxable event because it lacks cash equivalence. Three basic generalizations follow from the analysis: (1) the receipt of a mere promise to pay is not a current taxable event provided the promise is not evidenced by a note, bond or other evidence of indebtedness that is readily tradable in the marketplace; (2) even where the promise is evidenced by a note, bond or other indebtedness readily tradable in the marketplace, it will not be a currently taxable event if the promise is accepted as security for the debt rather than payment; and (3) if the promise is evidenced by tradable notes, bonds or other form of such debt, it will be taxable if accepted as payment and not security if it has a currently ascertainable fair market value.

A secured, negotiable obligation issued by a financially solvent maker, bearing interest and actually paid at maturity will generally have a fair market value even though some discounting may be necessary in order to arrive at taxable value. However, the distaste of the Warren Jones court for the cash equivalency limitation on fair market value does not extend to

283. Id. at 793.
284. Id. at 792.
286. See supra text accompanying note 221.
287. See Metzer, Constructive Receipt, supra note 176, at 554 n.110.
Thus, if the discount is too severe, no current fair market value will be found under the principles of Cowden.

d. Maximizing Employee Economic Security

Money transfers by the employer for the benefit of the employee which are beyond the reach of the employer’s creditors create issues pertaining to tax lability. Resolving such issues is simply a matter of determining tax “ownership” of the monetary fund while in the “possession” of the employer or until the funds are actually disbursed to the employee. It is clear that, in such transactions, the common law economic benefit doctrine requires that the employee accept the risk of non-payment due to the financial failure of the employer.

When the money transfer or future payment obligation takes this form, the question remains what steps the employee may take to minimize the risk of non-payment. Restrictive bank loan documents, an analogous area of the law, place a myriad of lender restrictions on the borrower to reduce the risk of non-payment of the loan. In essence, the employee has made a common law loan to the employer. Economic performance of the employee’s services has occurred and the employer is postponing payment until a future time. Economic performance has preceded payment and the employer’s promise to pay the employee in the future, albeit with market rate interest, places the employee in precisely the same economic condition and risk as a lender. Therefore, negotiated lender-type restrictions on employer activities are appropriate in this context, particularly when they are not unduly burdensome to the employer.

1) Surety Bond Security

The most secure method to guarantee that the deferred compensation payments will be made is to purchase insurance to guarantee employer payment. Such insurance traditionally takes the form of a surety bond, the cost of which can be significantly reduced if the employer agrees to indemnify the insurance company against nonpayment. In such cases, the employee can eliminate the risk that the employer will not be

288. See supra text accompanying note 285.
289. The tax court in Warren Jones thought 50% too severe. Warren Jones Co. v. Commissioner, 60 T.C. 663, 668-69 (1973), rev’d, 524 F.2d 788 (9th Cir. 1975).
able to pay the deferred compensation amount because of financial failure.

The IRS has considered the taxability of this type of an arrangement. In Private Letter Ruling 84-06-012, the IRS considered the tax consequences of a nonqualified deferred compensation arrangement where the employee purchased such a surety. The terms of the plan provided for an irrevocable election to defer compensation prior to the time the compensation was earned. The deferral continued until termination of employment. Although the compensation earned interest and was not forfeitable, the employee could not assign, transfer, pledge or hypothecate her interest in any portion of the amount in her account. The plan was unfunded and no employer assets were segregated or earmarked with respect to the amount in the employee's account.

The employee intended to purchase a surety bond to insure against the risk of employer nonpayment. The bond was to be purchased from an independent insurance company, and was renewable every five years and would pay the deferred compensation if the employer failed to pay the sums due for any reason. The employee represented that she would personally pay the premiums for the surety bond and that the employer would not pay or reimburse the employee for the premiums.

The ruling suggests that such an arrangement is analogous to the purchase of a life insurance policy and that, where the employee is the beneficiary of the policy and the employer pays the premiums on the policy, the employee must include in gross income the amount of the premium payments by the employer. Where the employee pays the premiums herself and is not reimbursed by the employer, the payment of the premiums is not included in gross income since the economic benefit is provided by the employee herself. Thus, the ruling held that "the purchase of a financial surety bond by you to protect your future deferred compensation payments will not, by itself, cause the deferred amount to be included in your taxable in-

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291. Id.
292. Due to financial reasons, the employer might not be able to pay the amount in the account at service termination. Id.
293. Id.
294. Id.
come either at the time you purchase the surety bond or at the time you pay the premiums thereon." \(^{295}\)

The IRS has subsequently announced that it is reconsidering its position and that future rulings may reach the opposite conclusion. \(^{296}\) In any event, the ruling may not be relied upon as it is an unauthoritative private letter ruling which suggests that such transactions not be attempted without a private letter ruling. \(^{297}\)

The ruling appears to be intellectually inconsistent because it bases the issue of taxation of the deferred fund on the taxability of the premiums paid for the surety bond. Although not specified as such, the tax principle at work may be that, if the employer pays the premiums for the bond, then the employer must be providing security for the payment of the deferred compensation. This is another way of suggesting that, under these circumstances, the employer is substituting the insurance company’s unsecured promise to pay for its own. This would cause current taxation under the principle of *United States v. Drescher*. \(^{298}\)

Assuming this posture is correct, it raises the factual question of under what circumstances the employer’s promise is to be considered “secured” versus “unsecured” but very safe. In the past, tax law has not been concerned with how financially realistic it was to expect the employer’s unsecured promise to pay to be performed according to its terms. All such obligations were treated the same regardless of the financial condition of the employer.

In addition, the ruling does not address the extent to which the deferred compensation will be considered “property” under IRC § 83 since it may be considered “funded” and secured by insurance regardless of whether the employer or the employee pays the insurance premiums on the surety bond. \(^{299}\)

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295. *Id.*


297. *See I.R.C. § 6110(j)(3) (1990), which states in pertinent part, “[u]nless . . . otherwise established] by regulations, a written determination may not be used or cited as precedent.” *Id.*

298. 179 F.2d 863, 865 (2d Cir. 1950), cert. denied, 340 U.S. 821 (1950).

299. *See Treas. Reg. § 1.83-3(e) (as amended in 1985). Treasury Regulation § 1.83-3(e) provides in relevant part that ‘property’ includes real and personal property other than either money or an unfunded and unsecured promise to pay money or property in the future.” *Id.* (emphasis in original). The issue then becomes
2) Separate Employer "Rabbi" Trusts

If the surety bond method is not elected, either because of the cost of the surety bond compared to the risk of employer nonpayment or because of the uncertainty with regard to the current taxation on the deferred compensation fund as described above, other methods may be sought to separate the employer from possession of the funds to provide additional financial payment comfort to the employee. In such cases, the goal is to insulate the funds from the operational working capital uses of the employer. Although the funds are not protected from the employer's risk of financial failure, such an approach does protect the liquidity of the funds.

Such is the case with the so called "rabbi" trust plan. In Private Letter Ruling 81-13-107, the IRS ruled that the congregation of a Jewish synagogue could create an irrevocable trust and contribute to it the deferred compensation due its rabbi. The trustee would manage, invest and pay the trust net income to the rabbi at least quarterly with the trust corpus of deferred compensation payable to the rabbi on the earlier of death, disability, retirement or termination of service to the congregation. The payment was not forfeitable by the rabbi. The rabbi's interest in the trust was not subject to assignment, alienation, pledge, attachment, or claims of his creditors. The synagogue could not alter, amend, revoke, change, or annul any provisions of the trust estate; however, the terms of the trust provided that the trust estate remained subject to the claims of the synagogue's creditors precisely the same as its general assets.

The IRS ruled that the economic benefit doctrine resulted in taxation of deferred compensation when the taxpayer has vested rights to the fund: "A 'fund' is created when an amount is irrevocably placed with a third party, and a taxpayer's interest in the fund is 'vested' if it is nonforfeitable." The IRS ruled that "[b]ecause the assets of the trust are subject to the
claims of [the synagogue's] creditors and are not made available within the meaning of § 451 [.] . . we conclude that the funding of the trust will not constitute a taxable event for [the rabbi]." 304

In Private Letter Ruling 86-34-031, 305 an irrevocable trust was created with a local financial institution acting as a trustee over nonqualified deferred compensation plans for directors and executives. The plan was much the same as the "rabbi trust" created in the ruling discussed above, except that (1) limited advance payments were permitted in the case of severe financial hardship where the payments reduced the amounts payable in the future to the employee; (2) each employee's benefits were completely forfeitable upon a violation of a post-service covenant not to compete; and (3) the employer had a responsibility to inform the trustee of the employer's insolvency upon notice of which the trustee suspended all payments to employees and held all trust assets for the benefit of the employer's general creditors.

The IRS noted that "although the assets are held in trust, in the event of the [employer's] insolvency they are fully within the reach of the [employer's] general creditors, as any other assets of the [employer]." 306 The IRS therefore ruled that, provided the creation of the trust did not cause the plan to be other than "unfunded" for purposes of ERISA, the "transfer[s] to the trust[s] . . . will not be transfers of property for purposes of [IRC §] 83 . . . or [Treasury Regulation §] 1.83-3(e) . . . ." 307 Accordingly, amounts were included in income of each employee when actually received or earlier if made available under the constructive receipt doctrine of IRC § 451.

Several aspects of this ruling were explained and amplified in Private Letter Ruling 88-44-020. 308 After detailing the IRS's constructive receipt position expressed in Revenue Ruling 60-31, 309 the ruling elaborated on the outlines of an ac-

304. Id. (citing Sproull v. Commissioner, 16 T.C. 244, 247 (1951), aff'd, 194 F.2d 541 (6th Cir. 1952); I.R.C. § 451(a) (1990); Treas. Reg. § 1.451-2(a) (1980)).
306. Id.
307. Id.
309. Rev. Rul. 60-31, 1960-1 C.B. 174. The employee's irrevocable deferral election must be made by December 31 of the year prior to the year in which the services were performed. Id.
acceptable financial hardship provision:

A participant will not be permitted to change his or her election during the period of deferral except in the case of severe financial hardship. In this regard, the Plan provides for possible withdrawals in the case of a proven unforeseen emergency which creates a severe financial hardship. To qualify, the hardship cannot be able to be reasonably be relieved by reimbursement (by insurance or otherwise), liquidation of the participant's assets (to the extent that such liquidation would not in itself cause a financial hardship), or cessation of deferrals under the Plan. Withdrawals made under the Plan because of a severe financial hardship are limited to the amount reasonably needed to satisfy the emergency.\(^\text{310}\)

The ruling also (1) elaborates on the definition and conditions of employer insolvency requiring the trustee to terminate payments to employees and (2) contains a reference that, pursuant to Revenue Procedure 88-3,\(^\text{311}\) the ruling does not apply to any participant who is or becomes a controlling shareholder of the employer.\(^\text{312}\)

In summary, the following criteria appear relevant to the IRS in a favorable private letter ruling with regard to a "rabbi trust": (1) the trust must have an independent trustee; (2) the trust assets must be subject to the claims of the employer's creditor's in the event of insolvency; (3) the trust must require that the employer give the trustee timely notice of insolvency and the trustee must thereafter suspend benefit payments to the employees and hold the assets for the employer's creditors; (4) the trust creation and asset transfer to the trust must not create a funded plan within the meaning of ERISA\(^\text{313}\) (The trust should provide that the employee receive no beneficial ownership in or preferred claim on the trust assets.); (5) the claims of the employer's creditors must be enforceable under federal and state law;\(^\text{314}\) and (6) the ruling will not apply nor be granted to any controlling shareholder of the employer.

If these requirements for private letter rulings are satisfied, it also appears that the plan may include a provision for limited

\(^{314}\) Priv. Ltr. Rul. 89-36-040 (June 12, 1989).
emergency\textsuperscript{315} withdrawals for financial hardship. There are a number of "rabbi trust" private letter rulings,\textsuperscript{316} but as of yet no published rulings. Therefore, because of the nonprecedential effect of these rulings, taxpayers will continue to be forced to make their own ruling requests to gain assurances for the tax treatment of their particular plan.

3) Payment Acceleration Provisions

The question exists as to the nature and permissible boundaries of payments under the plan prior to service termination. Resolution of this question may rest on the definition of unforeseeable emergency, as stated in Treasury Regulation § 1.457-2(h)(4):

[A]n unforeseeable emergency is, and if the plan provides for payment in the case of an unforeseeable emergency must be defined in the plan as, severe financial hardship to the participant resulting from a sudden and unexpected illness or accident of a participant or of a dependent . . . , loss of the participant's property due to casualty, or other similar extraordinary and unforeseeable circumstances arising as a result of events beyond the control of the participant.\textsuperscript{317}

Many employees may be willing to accept the financial risk of employer non-payment due to employer insolvency as expressed and narrowed under the "rabbi trust" rulings, but many may not be willing to accept the risk if the employer undergoes a leverage buyout. Such a leverage buyout may significantly increase the risk that the employer may be unable to pay benefits when due. In addition, if the buyout occurs as part of a hostile takeover, the employee may not be terminated but may be unwilling to work with the new management group thereby increasing tension and perhaps the likelihood of non-payment, particularly if the plan contains any forfeiture provisions.

In order to avoid these results, the employee would prefer to


trigger a prepayment of the funds if the employer’s debt level exceeds predetermined formula amounts or in the event of a hostile takeover. Will such payment acceleration provisions pass muster? As a general rule, a deferral election must be irrevocable without the ability to alter the terms and timing of the payout in the NQDCP. Will such provisions be considered substantive modifications? Apparently not, provided the prepayment acceleration is conditioned on the IRC § 457 “unforeseeable emergency” standard. This would require that the provision satisfy the language of Treasury Regulation § 1.457-2(h)(4) “or other similar extraordinary and unforeseeable circumstances arising as a result of events beyond the control of the participant.” Since the hostile takeover or the debt load breach would be both unforeseeable and beyond the control of the employee, presumably such acceleration provisions would qualify for inclusion in future “rabbi trust” rulings.

In Bagley v. Commissioner, the tax court examined the tax consequences of an acceleration provision. In Bagley, the tax court considered the taxability of an employer’s payment to an employee pursuant to the employer’s obligation to pay the employee a sum equal to the difference between the exercise price and the fair market value of stock relating to unexercised stock options on the date of a sale by the employer. The court held that the option was property transferred to the employee under IRC § 83 but that an IRC § 83(e)(1) exclusion was not applicable since the option had not yet been exercised.

Having determined that the option was governed by IRC § 83, the court next determined the taxability of the payment received to cancel the unexercised option. Under IRC § 83(a) and IRC § 83(e)(3), the option is taxed at the time of

320. See, e.g., Priv. Ltr. Rul. 84-35-031 (May 24, 1984) (A lump-sum payment acceleration is permitted where the employer corporation was liquidated and no successor corporation assumed the assets and liabilities of the employer corporation.).
321. 85 T.C. 663 (1985), aff’d, 806 F.2d 169 (8th Cir. 1986).
322. Id. at 668.
323. Id. at 669 (citing Alves v. Commissioner, 734 F.2d 478, 481 (9th Cir. 1984)).
324. Id. at 673-74.
its grant if it has a readily ascertainable fair market value.\textsuperscript{325} If the option does not have a readily ascertainable value when granted, IRC \textsection 83(a) and IRC \textsection 83(e)(4) tax the option value as compensation at the time the option is exercised or disposed.\textsuperscript{326} Under IRC \textsection 421(a), if the option is exercised pursuant to a qualified incentive stock option plan under IRC \textsection 422A, then the compensatory element at the time of exercise may be converted to capital gain at the time of the sale of the stock provided certain holding period requirements are satisfied.\textsuperscript{327} The taxpayer argued therefore that the amount received should be taxed as capital gain. The tax court, however, held that it was to be taxed as ordinary income under IRC \textsection 83 at the time of the payment and disposition of the option.\textsuperscript{328}

4) \textit{Policy Considerations}

As the employee's economic status approaches that of a lender because of the presence of these employee-lender restrictions, one cannot escape the question of whether the employee should continue to postpone the taxation of the funds. The critical difference between employees and true lenders is that the lender is loaning the employer funds which have already been the subject of taxation. In short, the true lender loans the employer after-tax dollars. The lender-employee, of course, is loaning the employer pre-tax dollars, which have yet to be taxed to the employee-lender.

Is this difference significant enough to justify the current taxation? Not under today's law\textsuperscript{329} where employees continue to place restrictions on the employer's ability to incorporate uses of the funds in its normal operations. On the other hand, it is difficult not to be troubled by this fact. A fresh look, contrasting the before- and after-tax aspects, might benefit the IRS in the future. Nevertheless, perhaps it is enough that the line between a naked unsecured employer's promise to pay and an

\textsuperscript{325} \textit{Id.}
\textsuperscript{326} \textit{See Commissioner v. LoBue, 351 U.S. 243, 249 (1956).}
\textsuperscript{327} \textit{Bagley v. Commissioner, 85 T.C. 663, 670 (1985), aff'd, 806 F.2d 169 (8th Cir. 1986).}
\textsuperscript{328} \textit{Id.} The court did not consider whether the taxpayer could have made an IRC \textsection 83 election and therefore the court converted this amount to capital gains. Presumably the taxpayer could make such an election. \textit{See also Pagel v. Commissioner, 91 T.C. 205 (1988).}
\textsuperscript{329} \textit{See Minor v. United States, 772 F.2d 1472 (9th Cir. 1985).}
unsecured but "enhanced" employer's promise is too difficult to draw. Our own sense is that courts are uniquely structured for just this kind of factual inquiry and thus, should openly address this point in order to determine when taxation will occur.

4. Employer Deduction

Under IRC §§ 404(a)(5) and 404(b)(1)(B), where the arrangement constitutes a "plan" of deferred compensation an employer's deduction is postponed until the employee includes the compensation in income. The rule is the same for both cash and accrual method employers and, since most employees are cash method taxpayers, the employer's deduction is postponed until the employee's actual or constructive receipt. IRC § 404(b) was added in 1984 to clarify that an employer's compensation deductions related to NQDCPs were exclusively governed by the rules specified under IRC § 404(a)(5) and not by IRC § 83 or IRC § 461(h), which still govern compensatory transfers which do not constitute part of a plan of deferred compensation.

Prior to 1984, accrual method taxpayers were entitled to a deduction for future expenses, including deferred compensation liabilities, under the "all events test" which simply required that all events had occurred to fix liability and the amount thereof was reasonably ascertainable. In 1984, the "all events test" was modified significantly because accrual method taxpayers were taking current deductions for future liabilities, without regard for the present value of the future payment. In 1984, IRC § 461(h)(2)(A)(i) modified this

333. The "all events test" was first established in United States v. Anderson, 269 U.S. 422, 441 (1926). The Ninth Circuit, in Kaiser Steel Corp. v. United States, 717 F.2d 1304, 1306 (9th Cir. 1983), further explained the two requirements which must be satisfied under the "all events test."
334. See Mooney Aircraft v. United States, 420 F.2d 400 (5th Cir. 1969). In Mooney, the taxpayer was the manufacturer and seller of single engine executive aircraft. The case involved the years 1961 through 1965 in which the company provided each purchaser of its aircraft a "Mooney Bond," which required the company to pay $1,000 to the bearer of the bond in the year his purchased aircraft was retired from service. In 1965, there were 1,908 bonds outstanding. The accrual method company attempted to deduct the entire $1,000 face amount of the bond in the year the aircraft was sold and the bond was issued even though the payment was not expected to be made for 15 to 30 years. The court held that, although the expense
traditional “all events test” accrual-method analysis by requiring that an accrual deduction not occur prior to “economic performance,” where generally it occurs when the services are actually performed.\textsuperscript{335}

In addition, § 461(h)(2)(C) provides a special limitation on the economic performance standard with respect to liabilities incurred in connection with workers compensation and tort liability.\textsuperscript{336} In such cases, economic performance will not be deemed to occur until actual payment is made. The original House version of IRC § 461(h)(2)(C) contained a reference to deferred compensation liabilities in addition to torts and workers compensation, effectively denying a deduction for such NQDCP amounts until actually paid by the employer.\textsuperscript{337} The inclusion of deferred compensation liabilities would have been redundant with IRC § 404(a)(5), albeit tying the employer deduction to payment rather than employee income inclusion. In order to eliminate this potentially confusing overlap between IRC § 404(a)(5) and IRC § 461(h), the reference to deferred compensation liabilities was removed in conference.\textsuperscript{338} In addition to this IRC § 461(h) elimination, IRC § 404(b) was added, clarifying that an employer deduction for amounts attributable to an NQDCP is governed by IRC § 404(a)(5).\textsuperscript{339}

The effect of the 1984 clarifying amendment, IRC § 404(b), satisfied the “all events test,” the current deduction of a future expense deferred well into the future and did not clearly reflect income. \textit{Id.} at 405-07.

The case also contains an excellent discussion of the statutory and regulatory evolution of the accrual method of taxation, noting that the Revenue Acts of 1909 and 1913 did not recognize the accrual method, only the cash method. The court also noted that the apparent purpose of the first accrual legislation in the Revenue Act of 1916 was to recognize other accounting methods, provided they clearly reflected income. The idea behind the early legislative efforts of the accrual method was to conform tax accounting more closely with actual accounting methods for financial purposes. \textit{Id.} at 403-05.

337. H.R. REP. No. 432, 98th Cong., 2d Sess., pt. 2, at 1252, \textit{reprinted in} 1984 U.S. CODE CONG. & ADMIN. NEWS 914-15 (The courts, in earlier cases, have held that “expenditures are deductible when the activities that the taxpayer is obliged to perform are in fact performed, not when the ‘fact’ of the obligation to perform is determined.”). \textit{See also} United States v. General Dynamics Corp., 481 U.S. 239 (1987).
is to defer the accrual method employer’s compensation expense deduction from the date the services are actually performed under IRC § 461(h)(2)(A)(i) (“economic performance”) to the date of actual payment. Effectively, the accrual method employer is virtually relegated to a cash method of accounting with regard to compensation deductions.

C. Model II (§ 83)

1. General Analysis

IRC § 83 governs the tax consequences to employers and employees[^340] when the employer transfers property to the employee in connection with the performance of services.[^341] IRC § 83 applies only to non-cash property transactions.[^342]

The employee tax consequences generally include a determination of when and how much ordinary compensation an employee will have from a non-cash property transfer.[^343] Generally, an employee will have ordinary income in the amount of the fair market value of property received in the transfer less any amount paid either at (1) the time of the transfer (if the property is transferable or is not subject to a substantial risk of forfeiture), or (2) the time at which an employee makes an IRC § 83(b) election, or (3) the first time the property becomes transferable or is not subject to a substantial risk of forfeiture.[^344]

The employer tax consequences generally include a compensation deduction under IRC § 83(h) at the same time and in the amount of the employee’s inclusion of the compensation

[^340]: The term “employee” is used illustratively only. The statute applies to all service-related transfers of all types of property other than cash. See Treas. Reg. §§ 1.83-1(a)(1), 1.83-3(f) (1978). Thus, the statute is not limited to common law employer-employee relationships and therefore includes, for example, independent contractors and their beneficiaries.


[^343]: Id.


Compensatory property transactions are not taxable until the property has been “transferred” (as defined in Treasury Regulation § 1.83-3(a)) to the employee and the property becomes “substantially vested” (as defined in Treasury Regulation § 1.83-3(b)) in the employee. See Treas. Reg. § 1.83-1(a)(1) (as amended in 1985). The property becomes substantially vested in the employee when it is either (1) transferable or (2) not subject to a substantial risk of forfeiture. Until such time, it is considered substantially nonvested property, i.e., subject to a substantial risk of forfeiture and nontransferable. See Treas. Reg. § 1.83-3(b) (as amended in 1985).
in income. 345 Under Treasury Regulations §§ 1.83-6(a)(4) and 1.83-6(b), an employer will be required to capitalize the compensation expense if it constitutes a capital expenditure. To the extent the employer satisfies the compensation obligation with appreciated property, the employer will also be required to recognize gain on the transfer. 346

a. Restricted Property "Owner"

Where property is transferred to an employee and is either not transferable or subject to a substantial risk of forfeiture, the employee is deemed to have a beneficial interest in the property until the restrictions lapse, but the employer is deemed the "tax owner" of the property. 347 Thus, any income from the property during this period is taxable to the employer. 348 If any such income is transferred to the employee, it is considered additional compensation paid by the employer to the employee and is taxable to the parties as such. 349 The employee’s IRC § 83(b) election will change this result. Once the election is made, the employee is deemed the owner of the property, notwithstanding the fact that the property continues to be substantially nonvested until the restrictions lapse and the employee could forfeit the property. 350

346. United States v. Davis, 370 U.S. 65, 67 (1962). The Court set up a two-step analysis: "(1) [W]as the transaction a taxable event? (2) If so, how much taxable gain therefrom?" Id.
348. See id.
349. Id. Since the employer is deemed the owner of the property while the restrictions are pending, problems can be created with other related income tax provisions. For example, if the receipt of interest in the profits of a partnership is "property" under IRC § 83, and the service partner is not treated as the owner of the partnership interest while the restrictions are pending, the service partner would apparently not be treated as a partner at all. This could cause unintended results where, for example, the service partner is the only general partner in a limited partnership. Presumably, the partnership would not be deemed a limited partnership while the restrictions were pending. These and other effects can be avoided by the service partner making an IRC § 83(b) election which treats the service partner as the owner of the interest.
350. See Treas. Reg. § 1.83-2(a) (1978) (Where the election is made, "the substantial vesting rules of section 83(a) and the regulations thereunder do not apply . . . "); see also Treas. Reg. § 1.83-1(a)(ii) (1978) ("[T]he transferor shall be regarded as the owner of such property . . . ").
2. IRC § 83(b) Election

Thus, as previously discussed, the employee may make an election to be treated as the owner of the property notwithstanding the transfer and forfeiture restrictions. To make an election under IRC § 83(b), the employee must file one copy of a written statement with the Internal Revenue Service Center where she normally files her return. This statement must be filed no later than thirty days after the property is transferred, but may be filed before the date of the transfer. An additional copy must be submitted with the taxpayer's tax return. The election is irrevocable without consent of the Commissioner. The Commissioner will give consent to revoke only when the taxpayer is mistaken about the facts of the transfer. The request to revoke must be filed within sixty days of the discovery of the mistake of fact. Mistakes of fact do not include mistakes in property valuation or a failure to perform an act contemplated at the time of the transfer.

a. Gambler’s Choice-Disappearing Basis

An IRC § 83(b) election creates two separate risks. The first is attributable to a decline in the value of the property. The second relates to the actual forfeiture of the property. Once the election is made and the property is subsequently forfeited, the taxpayer will not be entitled to take any deductions with respect to forfeiture.

In answering the question of what is meant by “no deduction shall be allowed in respect to such forfeiture,” Treasury Regulation § 1.83-4(b)(1) provides that the taxpayer’s basis in

352. Id.
355. See Priv. Ltr. Rul. 78-30-097 (Apr. 28, 1978). An employee’s mistaken belief that he would be financially able to pay the tax created by the election was not a ground for revocation. This ruling requires that a taxpayer carefully evaluate the alternative minimum tax consequences of the election prior to making the election. Id. See also Priv. Ltr. Rul. 78-30-138 (Apr. 29, 1978) (Turmoil surrounding the employer after the election will not constitute a valid revocation basis.); Priv. Ltr. Rul. 82-24-047 (Mar. 16, 1982) (The IRS refused to allow a revocation where misrepresentations occurred relating to collateral matters but not to the underlying transaction.).
the property subject to an IRC § 83(b) election is equal to the sum of (1) the amounts paid for such property and (2) any amount included in income by reason of the IRC § 83(b) election.\textsuperscript{359} It is only the second basis element that is denied a deduction by IRC § 83(b)(1) upon forfeiture.

1) Deferral and Conversion Risk

If property subject to an IRC § 83(b) election declines in value after the election, the taxpayer will create ordinary income with the election. This will be offset by a capital loss on the disposition of the property, which will cost the taxpayer both the deferral cost of accelerated income and the conversion cost of having the lost "compensation" income subsequently deducted at capital loss rates.

Assume that on January 1, 1988, when X Corporation stock has a fair market value of $2 per share, it sells 10,000 shares to A, an employee, for $1 per share or $10,000 (a $20,000 value) under the conditions that the stock is subject to transfer restrictions and a substantial risk of forfeiture for five years. X Corporation agrees that it will refund A's $10,000 purchase price should A forfeit the stock.

A makes the IRC § 83(b) election and does not forfeit the stock and, thus, the stock becomes substantially vested to A on January 1, 1993, a time when the X Corporation stock has a fair market value of $10,000. The stock has declined in value contrary to A's prediction. If A sells the stock for its then $10,000 value, a $10,000 capital loss will be recognized, assuming the stock is a capital asset to A under IRC § 1221.\textsuperscript{360} Thus, A has exchanged $10,000 or ordinary income in 1988 for a $10,000 capital loss in 1993.

Even in the current tax world, without a preferential tax rate for capital gains, this is not a valid exchange. Unless the taxpayer has adequate capital gains to absorb the $10,000 capital loss, the loss will be deductible only against ordinary income to the extent of $3,000 per year with an unlimited carryover period for unused losses.\textsuperscript{361} The IRC § 83(b) election does not make sense at all if one expects the value of the property to decline.

\textsuperscript{360} I.R.C. § 1221 (1990).
\textsuperscript{361} See I.R.C. §§ 1211(b), 1212(b) (1990).
Of course, this is seldom the case. These compensatory property transfers are in the nature of incentive compensation. The property selected for the transfer has great appreciation potential to give the employee the greatest incentive to increase its value in the interim.

2) Disappearing Basis

Where the taxpayer forfeits the property rather than taking it subject to a decline in value, the statutory scheme is worse for the taxpayer than where the property simply declines in value and the taxpayer takes the property.\(^{362}\) In the first example, assume that A forfeited the stock in 1992. A's basis under Treasury Regulation § 1.83-4(b)(1) is still $20,000 but, under Treasury Regulation § 1.83-2(a), A must now compute the capital loss by using a basis that includes only the amount paid (if anything) for the stock and not the amount included in income by reason of the IRC § 83(b) election. Thus, as in the previous example, A would be entitled to a $10,000 capital loss but unlike the previous example, A did not receive a return of $10,000 in capital. In short, A was denied a deduction with respect to the portion of the basis relating to the amount included in income by reason of the IRC § 83(b) election.\(^{363}\)

The IRC § 83(b) compensatory portion of the taxpayer's basis which is disallowed (and therefore "disappears") on forfeiture was added by the Senate.\(^{364}\) This provision is intended to provide relief and flexibility from the compensatory conse-

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362. Treas. Reg. § 1.83-2(a) (1978). Because forfeiture is worse for the taxpayer than a sale of property which has declined in value, taxpayers are encouraged to not allow a forfeiture to occur. However, where the substance of the sale of property appears to be a forfeiture, Treasury Regulation § 1.83-2(a)(2) provides a warning that "[a] sale or other disposition of the property that is in substance a forfeiture, or is made in contemplation of a forfeiture, shall be treated as a forfeiture." Treas. Reg. § 1.83-2(a)(2) (1978).

363. See Treas. Reg. § 1.83-2(a) (1978) (A forfeiture is treated as a sale or exchange, confining the loss of the amount paid for the property to capital loss treatment); see also Priv. Ltr. Rul. 80-25-127 (Mar. 28, 1980) (The participant's stocks are not forfeited upon termination due to participant's death, disability, or retirement, where the participant's employment is terminated more than ten years after the issuance of the stock.).

Interestingly, the regulation does not contemplate a gain from forfeiture, presumably on the theory that the taxpayer under such circumstances would not allow forfeiture. Of course, forfeiture is not always within the control of the taxpayer.

quences of holding restricted transfers open until the restrictions lapse,365 but in order to insure that the election is meaningful, the lost deduction is added. It is apparently designed to enable the taxpayer to limit the amount of compensation from the transfer, while risking the loss of a deduction for lost basis.366 Without this risk, of course, all taxpayers would routinely make the election and all transfers would be treated as if they were not subject to a substantial risk of forfeiture. Although draconian, it seems a fair result under the circumstances.

b. Election Rationale

Under what conditions would a taxpayer find it attractive to make an IRC § 83(b) election? The previous discussion shows why an election should not be made where it is anticipated that the property will decline in value. However, most taxpayers anticipate an increase in the post-transfer value of property since, otherwise, it would not be the subject of a restricted transfer in the first place. Thus, under what circumstances would the taxpayer make an IRC § 83(b) election, where the taxpayer expects the value of the property to increase? The answer, in part, depends upon an analysis of the taxation of capital gains and ordinary income.

Once the employee becomes the tax owner of the property (1) through receipt of property which is either transferable or not subject to a substantial risk of forfeiture, (2) through receipt of property subject to such restrictions but where the restrictions have lapsed, or (3) because the employee makes an IRC § 83(b) election, any future appreciation or depreciation in the property is deemed attributable to the property itself.367 Assuming that the property is a capital asset under IRC § 1221,368 any future appreciation in the property will be deemed capital gain. Absent the election, only the appreciation occurring after the date when the restrictions lapse will be deemed capital gain. Thus, the § 83(b) election converts the appreciation, from the date of the election through the date

the restrictions would lapse, from ordinary income to capital gains. The cost of this conversion from ordinary income to capital gain is the current taxation as ordinary income of the current value of the property interest in excess of the amount paid. This amount would have been taxed as ordinary income anyway at the time the restrictions lapsed. An example may help illustrate the point.

Assume the same facts as above where X Corporation sells 10,000 shares of its stock to A on January 1, 1988, for $10,000 subject to § 83 restrictions for five years. The stock has a value of $20,000 on the date of the transfer. Now assume that A anticipates that the stock will be worth $50,000 on January 1, 1993, when the restrictions lapse and that A anticipates holding the stock and selling it on January 1, 1998, when the value is anticipated to be $100,000.

If A makes the IRC § 83(b) election, she will include $10,000 in income in 1988 taxed at an assumed combined federal and state rate of 40%. Thus, A pays $4,000 in tax in 1988. A will have no further gain or income until 1998 when she will have $80,000 of capital gain and paying a 40% tax of $32,000.

If A had not made the IRC § 83(b) election, she would have had a $10,000 1988 basis and included $40,000 as ordinary income in 1993 which would produce a 40% tax of $16,000. A would then realize and recognize a 40% tax of $20,000 on her remaining $50,000 capital gain in 1998. These results can be contrasted as follows:

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<tr>
<td>§ 83(b) Election</td>
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<td>0</td>
<td>$32,000</td>
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<tr>
<td>No Election</td>
<td>0</td>
<td>$16,000</td>
<td>$20,000</td>
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Thus, under this example, A would compare the deferral cost of prepaying $4,000 tax in 1988 rather than in 1993 (the maximum date it can be postponed) with the deferral advantage of deferring the payment of $12,000 ($16,000 less $4,000) from 1993 until 1998. In this case, it clearly would be advantageous for A to make the IRC § 83(b) election since she is deferring paying $12,000 for five years at the cost of prepaying $4,000 for five years.

A few generalizations exist. The deferral advantage will increase (1) as the value of the property received in the year of
the transfer decreases, (2) as the anticipated appreciation in the property increases during the restriction period, and (3) as the holding period of the property extends beyond the date restrictions lapse. Taking the election seems to be a good business judgment, even without a current capital gains preference, particularly with the possibility that capital gains could reenter the tax system post-election.

1) Employer Perspective

Of course, the employee's tax position mirrors the employer's tax position under IRC § 83. Even though it may have been advantageous for the employee to make an IRC § 83(b) election in the above case, the employer may be correspondingly disadvantaged. Under IRC § 83(h), the employer obtains a compensation deduction only for the portion of the property transfer classified as "compensation." The employer does not receive a deduction for any portion of the transfer which is taxed as capital gains to the employee.369

In the above example, the employer receives a compensation deduction for $10,000 in 1988 if the employee exercises her IRC § 83(b) election versus a $40,000 compensation deduction in 1993 if the employee does not make the IRC § 83(b) election (ignoring the time value of money which would decrease this difference). If the corporation is in the 50% tax bracket, the employer is "giving up" a net deduction of $30,000 or a $15,000 tax reduction so that the employee can balance a deferral of prepaying $4,000 for five years against not paying $12,000 for five years in the future.

This appears to swing the net tax cost to the combined employer-employee to the side of a non- § 83(b) election. Moreover, this would appear to be the case in most circumstances. In today's tax regime, without a capital gains preference, if the employee would find a deferral advantage in exercising the § 83(b) election, the employer would suffer a far greater loss from the reduced tax deduction. Stated simply, the employee's deferral advantage can never be expected to offset the employer's actual dollar loss in the form of an increased tax liability. Of course, this conclusion is premised on the tax rates set forth above.

From the above analysis, two conclusions can be drawn. The first is that, at the expense of the combined employer-employee taxable unit, the Treasury Department appears to be a net winner from the employee’s unilateral exercise of the IRC § 83(b) election. The second is a corollary of the first. The employer-employee may simply negotiate for the best combined tax outcome. Under this win-win scenario, the Treasury Department loses. Theoretically the employer should be prepared to transfer to the employee more value in property if the employee contractually agrees not to exercise the IRC § 83(b) election. Although the IRC § 83(b) election is the exclusive tax province of the employee, the employer could provide, in the transfer document, a warranty providing that the employee not exercise the election, secured by a liquidated damage provision designed to return the employer to its negotiated status.

Unfortunately, this kind of “sophistication” may take the bloom off the compensation package for the employee, thereby costing the employer more in decreased employee performance in the long run. Assuming this is not the case, bargaining over an IRC § 83(b) election appears to be an unexplored frontier of opportunity for both employers and employees.

2) Future Changes in the Law

When capital gains are taxed at the same rate as ordinary income, why would a taxpayer elect to be currently taxed on an amount of future compensation income to convert a portion of the restriction period compensation income to capital gains? The answer is that the taxpayer would not make the election unless she anticipated that she would hold the property long enough after the restrictions lapsed so that the deferral gain of not paying the additional tax at that time offsets the deferral loss of prepaying a portion of the tax.

Presumably, if taxpayers thought there was any remote chance of a future capital gains tax, this would encourage them to make the election. Of course, the taxpayer may not wish to accept the income tax risk that Congress will not reinstate a preferential capital gains tax after the time for making an IRC § 83(b) election. In addition, the taxpayer may have excess unused capital losses and may wish to use the losses against excess capital gains.
3) Section 16(b) Issues

IRC § 83(c)(3) governs compensatory transfers of securities whose sale by an employee would create liability under § 16(b) of the Securities Exchange Act of 1934\(^{370}\) and provides that this potential liability creates both a substantial risk of forfeiture and reduces the transferability restrictions under IRC § 83(a). Accordingly, unless an IRC § 83(b) election is made, IRC § 83(a) will tax such transfers of securities at the time the potential § 16(b) liability lapses, rather than at the time of the transfer. Thus, unless the IRC § 83(b) election is made, the securities will be taxed at the time of and at the value on the date the § 16(b) liability lapses. Any appreciation occurring during this period will be taxed as ordinary compensation income at the time of the § 16(b) lapse, rather than as capital gain at the time of the disposition of the stock.

Immediate taxation of the gain will be the most surprising event for most unsuspecting taxpayers. Moreover, since the securities are received without any employment or employer related contractual restrictions, the taxpayer may overlook the opportunities for an IRC § 83(b) election until long past the thirty-day election period.\(^{371}\)


a. General Analysis

If an employee receives property that is not subject to a substantial risk of forfeiture, IRC § 83(a) provides that it is taxable to the employee upon receipt to the extent of its fair market value less whatever the employee paid for the property, if anything. If the property is subject to a substantial risk of forfeiture, the fair market value of the property at the time the restrictions lapse will be income to the employee unless the employee makes an IRC § 83(b) election to treat the fair market value of the property on the date of the transfer of the property as income.

Since these compensatory transfers are often subject to employee-related performance restrictions, the property selected


\(^{371}\) See Treas. Reg. § 1.83-3(j)(2) (as amended in 1985) (Example (1) illustrates the IRC § 83(b) election in connection with a transfer of securities subject to § 16(b) of the Securities Act of 1934.).
for these transfers tends to be property that the employer and the employee expect to appreciate over time. Moreover, the primary motivation for restrictions on enjoyment of the property are related to employer performance, not tax considerations. Accordingly, the purpose of the review of the nature of restrictions and conditions on transfers of property that will or will not constitute a substantial risk of forfeiture is to provide the employee with some certainty with regard to the taxability of property received subject to various kinds of restrictions. In addition, as noted above, most employers will prefer transfers of property subject to a substantial risk of forfeiture not only for nontax reasons, but also for tax reasons. This is because, under IRC § 83(h), the employer receives a compensation deduction for the fair market value of restricted property when the restrictions lapse. In the case of property expected to substantially increase in value in the future, the employer’s deduction will be greatly enhanced. Moreover, under IRC § 461(h) the employer cannot take a compensation deduction on the transfer of payment at any rate and must wait until the services are performed. Why not maximize the employer’s deduction in these cases by subjecting the property transfer to restrictions that constitute substantial risks of forfeiture under IRC § 83(c)(1)? Complicating the process is the employee’s unilateral right to control both the amount and timing of the employee’s income and the employer’s deduction with an IRC § 83(b) election. Thus, certainty and precise definition of the rights of the employee and employer under IRC § 83 is the motivating cause for a complete examination of the substantial risk of forfeiture provisions of IRC § 83.

b. “Transferability” Defined

“Transferability” is defined as follows: “[T]he rights of a person in property are transferable if such person can transfer any interest in the property to any person other than the transferee but only if the rights in such property of such transferee are not subject to substantial risk of forfeiture.” The transferee must be able to take the property free of the risk of

372. See supra notes 340-71 and accompanying text.
any risk of forfeiture that was imposed upon the employee. Moreover, the rights of a person in property are transferable only if the rights of the person are not subject to a substantial risk of forfeiture. In this way, the transfer restrictions of IRC § 83 overlap with the substantial risk of forfeiture provisions that become dispositive.

The reason IRC § 83(c)(2) requires that a property interest be both (1) nontransferable and (2) subject to a substantial risk of forfeiture is to prevent an employee from postponing current taxation under IRC § 83 where all or a major portion of the economic benefit can be realized by the employee at any time by transferring the interest to a third party “subject to” the risk of forfeiture placed on the employee. Under such circumstances, there appears to be no reason to postpone taxation because the risk of forfeiture is not significant.

c. “Substantial Risk of Forfeiture” Defined

The rights of a person in transferred property are subject to a substantial risk of forfeiture “if such person’s rights to full enjoyment of such property are conditioned upon the future performance of substantial services . . . .” Additionally, whether a substantial risk of forfeiture exists is a “facts and circumstances” test dependent upon whether

rights in property that are transferred are conditioned, directly or indirectly, 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.

The regulation also cites three conditions under which a substantial risk of forfeiture will not be deemed to exist: (1) where the employer is required to pay the fair market value of a portion of the property to the employee upon the return of the property to the employer; (2) where the risk that the property may decline in value is an economic risk but not a risk of forfeiture for this purpose; and (3) where an isolated

374. *Id.* (Property is not transferable merely because the employee can designate someone to receive the property in the event of death.).
"nonlapse restriction exists." 378 "Nonlapse restriction" is a permanent restriction requiring that the property be sold at a formula price and is enforceable against the transferee and all subsequent holders of the property. 379 An example would be a formula price "right of first refusal" granted to the employer. 380

d. Future Service Requirements

The open question, of course, is what level of future service performance requirements will be deemed "substantial" under IRC § 83(c)(1). 381 In addition, since the regulation provides that refraining from performance of services is also contemplated by IRC § 83(c)(1), the question arises as to what level of covenant not-to-compete restrictions will be "substantial" for purposes of the statute.

Once again, Treasury Regulation § 1.83-3(c)(2) relies upon a "facts and circumstances" test: "The regularity of the performance of services and the time spent in performing such services tend to indicate whether services required by the condition are substantial." 382 A factor indicating that a future service condition is not substantial is whether the employee may decline to perform the services without forfeiture. The regulation discusses five separate service requirements that are analyzed below.

1) "Best Efforts" Underwriter

A substantial risk of forfeiture exists with respect to stock or other property transferred to an underwriter who will be only entitled to keep the stock or property provided the "best efforts" offering is successful.

2) Employer Earning Condition

A substantial risk of forfeiture exists where property is transferred to an employee subject to the forfeiture condition that total company earnings increase.

378. Id.
380. Id.
381. See also Treas. Reg. § 1.83-3(c)(1) (as amended in 1985).
3) Employee Discharge for Cause

A requirement that property will be forfeited if an employee is discharged for cause for the commission of a crime is not a substantial risk of forfeiture.

4) Covenants Not to Compete

An enforceable condition that property will be returned if an employee accepts a position with a competing firm will ordinarily constitute a substantial risk of forfeiture unless facts indicate a contrary result. Factors which will be considered include: (1) employee's age; (2) employee's alternative employment opportunities; (3) likelihood of the employee obtaining other employment; (4) employee's skill level; (5) employee's health; and (6) employer's practice of enforcing such restrictions.

The regulation refers only to enforceable covenants. The law of the state governing the restrictive covenant must be examined to determine whether the covenant would be enforceable if violated. Generally, this includes determining the reasonable geographic area of the employer's competition, the time period of the restriction, and the nature of the competitive services proscribed. Since many lawyers will refuse to opine on the precise validity of these restrictive covenants, inclusion of severability clauses giving courts the opportunity to scale back overbroad restrictions, as opposed to eliminating them entirely, becomes important. One should not deliberately draft a known unenforceable covenant to create an artificial restriction.

5) Post-Retirement Consulting

Property transferred to a retiring employee, on the condition that the property must be returned if the former employee does not render consulting services on request, will be considered subject to a substantial risk of forfeiture unless the former employee is in fact expected to render substantial services.

e. Employer Enforcement

Certain relationships between employers and employees will necessitate questioning whether forfeiture provisions that are
admittedly substantial are in fact being enforced.\textsuperscript{383} Ownership in the employer is the critical focus and calls into question a whole host of other considerations including: (1) the employee’s relationship to other stockholders and the extent of their control; (2) the employee’s position in the company; (3) the employee’s relationship to the officers and directors; (4) the relationship to the person who must approve a discharge; and (5) past conduct in enforcing such forfeitures.

4. Property Transfers Governed by IRC § 83

Treasury Regulation § 1.83-3(e) defines “property” as including “real and personal property other than either money or an unfunded . . . promise to pay money or property in the future.”\textsuperscript{384} However, a beneficial interest in assets, including money, will be considered property if the money or other assets are “transferred or set aside from the claims of creditors of the transferor, for example, in a trust or escrow account.”\textsuperscript{385}

In \textit{Alves v. Commissioner},\textsuperscript{386} the tax court held, in a reviewed decision with five dissenting judges, that IRC § 83 can apply to a transfer of property at its fair market value. The majority of the court reasoned that the IRC § 83 threshold is a compensatory transfer with respect to past, present or future services.\textsuperscript{387} The fact that there is no bargain element in the transfer or that the employee has received nothing of current value does not remove the post-transfer appreciation from the application of

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\textsuperscript{383} Treas. Reg. § 1.83-3(c)(3) (as amended in 1985).

\textsuperscript{384} Treas. Reg. § 1.83-3(e) (as amended in 1985) (emphasis added). The IRS ruled that an overriding interest in oil and gas, as previously defined in Revenue Ruling 67-118, is a “property” interest within the meaning of IRC § 83. \textit{See Rev. Rul. 83-46, 1983-1 C.B. 16.}

The IRS also subsequently ruled that the transfer of stock appreciation rights (SAR) were not IRC § 83 “property” because they constituted unfunded and unsecured promises to pay money or property in the future. Thus, upon the SAR exercise, the employee had cash income and IRC § 83 would apply to any stock received. Priv. Ltr. Rul. 86-42-025 (July 16, 1986).

\textsuperscript{385} Treas. Reg. § 1.83-3(e) (as amended in 1985) (A special valuation rule for transfers of a “life insurance contract, retirement income contract, endowment contract, or other contract providing life insurance protection” under which only the cash surrender value of the policy is considered to be property.).

\textsuperscript{386} 79 T.C. 864 (1982), \textit{aff’d}, 734 F.2d 478 (9th Cir. 1984).

\textsuperscript{387} This interpretation is consistent with Treasury Regulation § 1.83-3(f) and the language of IRC § 83(a), which provide that IRC § 83 is applicable to property transfers “in connection with the performance of services.” Treas. Reg. § 1.83-3(f) (1978); \textit{see also} Treas. Reg. § 1.83-1(a) (as amended in 1985). After \textit{Alves}, it seems reasonably clear that IRC § 83 will apply to all compensatory property transfers.
IRC § 83. This means that most, if not all, compensatory transfers will now be governed by IRC § 83.

a. Current vs. Future Money Transfers

The distinction between the actual receipt of money and a receipt of a beneficial interest in money to be received in the future would appear to be warranted. An actual receipt of money, the full enjoyment of which is subject to a risk of forfeiture in the future, would be currently taxable under the claim of right doctrine expressed in *North American Oil Consolidated v. Burnet.* If, in fact, the employee is required to repay the money in a future year because of the forfeiture provision, the employee would be entitled to a deduction or a recomputed tax credit under IRC § 1341 in the year of repayment.

Why is there a distinction between current transfers of money and transfers of money which the employee does not currently receive, but which are separated for the employee's benefit by the employer from the claims of the employer's creditors by, for example, placing the money in a trust or an escrow account? In the first instance, the employee is not currently taxable on the employer's naked promise to pay a sum of money in the future. A contrary result would emasculate the distinction between the cash and accrual method of accounting for the employee, in addition to creating a host of other taxation problems in other contexts. Where the employee is admittedly taxable under the economic benefit doctrine—when the employer's promise is protected from its general unsecured creditors—current taxation is premised upon the fact

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388. The *Alves* decision surprised many employees who held stock subject to restrictions which had appreciated significantly. These employees had assumed that their stock was ineligible for an IRC § 83(b) election when received because of no bargain element. IRC § 556 of the Tax Reform Act of 1984 allowed employees, who had received *Alves* type property between June 30, 1976, and November 18, 1982, to make a special IRC § 83(b) election without regard to the thirty-day limit, provided that the employer consented to the election. IRC § 556 did not make any changes to the Internal Revenue Code.


390. The transfer requirement of the statute, requires "actual receipt" and is defined as follows: "A transfer of property occurs when a person acquires a beneficial ownership interest in such property (disregarding any lapse restriction)." Treas. Reg. § 1.83-3(a)(1) (as amended in 1985). The transfer requirement operates primarily as a limitation on the availability of IRC § 83, which in turn postpones the employee's ability to make an IRC § 83(b) election. As discussed, this limits the employee's ability to limit the timing of the ordinary income.
that receipt is now certain and that the only thing that separates the employee from realizing the economic benefit of the money is the passage of time.

b. IRC § 83(b) Election

If an unrelated substantial risk of forfeiture is placed on the employee’s receipt of the funds in the future, placing the funds in a trust account may well insure protection of the funds from the employer’s general creditors, but this act does not guarantee that the employee will receive the funds with the mere passage of time. In this sense, the fact that the employee suffers from the risk that the funds may never be enjoyed, because of the substantial risk of forfeiture, puts the employer in no different position relative to any other property subject to a similar risk of forfeiture. Accordingly, a different result based upon the nature of the property as money would not be warranted. Stated another way, the substantial risk of forfeiture sufficiently places the value of the receipt of the promise into question so as to intercept or block the application of the economic benefit doctrine.

This of course means that the employee will have all the rights of an employee receiving a transfer of restricted property granted under IRC § 83, including the IRC § 83(b) election. However, in contrast with the discussion above which suggests an employee advantage in making an IRC § 83(b) election where appreciated property is the subject of the transfer, there appears to be no advantage to the employee in making the election where the property to be received is money.

In making the election, the employee is merely accelerating the timing of income inclusion. The employee does this at the IRC § 83(b)(1) risk of receiving no deduction for the basis created thereby, if the receipt is subsequently forfeited. Nevertheless, at least two factors suggest that the election be made: (1) the employee is fairly certain that the conditions supporting the risk of forfeiture will not materialize; and (2) the employee expects that the tax rate in the year of receipt will increase in the year the restrictions lapse. The latter could occur from a variety of different circumstances, including a risk that the income tax rates will change. Current taxation of ordinary income at a maximum effective rate of 28% may well be at a historic low. Certainly one could more easily predict a rate
increase than a rate decrease. On the other hand, the year-of-receipt rate might be lower because of a net operating loss that will expire before the restrictions lapse. In addition, the employee may wish to increase her regular tax in the year of receipt to avoid the imposition of a non-credit or non-deferral alternative minimum tax.

c. Employer's Perspective

The employer's perspective is less important here since the compensatory element will be the same in any event. Since the employer does not stand to lose a compensation deduction from the employee's conversion of ordinary income into capital gains, the employer will, in most instances, be indifferent to whether the employee makes an IRC § 83(b) election. This means that in the context of such transfers of money for the benefit of employees, the substantial risk of forfeiture provisions may be more important to the employee than to the employer. Once again, certain factors, which would include the employer expecting that her income tax rate will decrease from the year of the employee's receipt to the year the restrictions lapse, could change this result. In such a case, the employer would prefer the employee actually make the IRC § 83(b) election and, if this were important, the parties would be free to negotiate the employee's IRC § 83(b) election as part of the bargain, as discussed above.

5. Legislative History of IRC § 83

IRC § 83 originated in 1969\(^{391}\) and was principally targeted to correct a perceived abuse in the taxation of restricted non-statutory employee stock plans.\(^{392}\) Under then existing Treasury Regulation § 1.421-6(d),\(^{393}\) when property was transferred to an employee subject to restrictions which substantially affected its value, the employee was (1) not taxed until restrictions lapsed, and (2) the amount on which the employee was taxed was limited to the fair market value of the property when originally received.\(^{394}\)


\(^{393}\) Treas. Reg. § 1.421-6(d) (as amended in 1966).

\(^{394}\) Treas. Reg. § 1.421-6(d)(2)(i) (as amended in 1966) reads as follows:
Thus, the entire amount of post-transfer and pre-restriction appreciation of the property was taxed as capital gains when the property was subsequently sold. This conversion of ordinary compensation income into capital gains and attendant deferral was the driving force behind the enactment of IRC § 83.395

6. Taxation of Options

a. Compensation vs. Capital Gains

The principal difficulty in the transfer of compensatory options is properly identifying and segregating the amount of compensation income from the capital appreciation. The former is taxed as ordinary income and the latter as capital gains. In the early common law case of *Commissioner v. LoBue*,396 the Court essentially stated that, where the option does not have a readily ascertainable fair market value at the time of the grant because of certain factors, including an option price equal to or greater than the stock fair market value at the time of the grant, risk of forfeiture for the option and lack of transferability for the option, the employee will measure the amount of her compensation income by the difference between the fair market value of the stock and the option price at the time of

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If the option is exercised by the person to whom it was granted but, at the time an unconditional right to receive the property subject to the option is acquired by such person, such property is subject to a restriction which has a significant effect on its value, the employee realizes compensation at the time such restriction lapses or at the time the property is sold or exchanged, in an arm’s length transaction, which even occurs earlier, and the amount of such compensation is the lesser of—

(a) The difference between the amount paid for the property and the fair market value of the property (determined without regard to the restriction) at the time of its acquisition, or

(b) The difference between the amount paid for the property and either its fair market value at the time the restriction lapses or the consideration received upon the sale or exchange, whichever is applicable.

If the property is sold or exchanged in a transaction which is not at arm’s length before the time the employee realizes compensation in accordance with this subdivision, any amount of gain which the employee realizes as a result of such sale or exchange is includable in gross income at the time of such sale or exchange, but the amount includable in gross income under this subdivision at the time the expiration of the restriction or the sale or exchange at arm’s length shall be reduced by the amount of gain includable in gross income as a result of the sale or exchange not at arm’s length.

*Id.*


the exercise of the option. The effect is to postpone the compensation income from the date of the grant until the date of exercise and to generally increase the amount of the compensation income realized, assuming that the stock price rose after the grant thereby stimulating the exercise.

The IRC § 83 treatment as discussed above is similar. Unless the option has a readily ascertainable fair market value at the time of the grant, IRC § 83 will not apply to the grant. Instead, IRC § 83 will apply to the receipt of the stock upon exercise, taxing the excess of the stock fair market value at exercise over the exercise price of the option, unless the stock is subject to a substantial risk of forfeiture. In only rare and unusual cases will a compensatory option have a readily ascertainable fair market value since most such options are not traded on an established market.

This scenario has the effect of treating a larger portion of the employee’s gain from the acquisition, ownership and disposition of the stock as compensation and a smaller portion as capital gains. It may be convenient because of the difficult valuation issue attendant to a stock option, but it is hardly accurate. As discussed in the LoBue dissent, the only true measure of the compensation amount is the value of the option.

7. Shared Appreciation Rights

One of the most formidable problems associated with non-money restricted property transfers, particularly where the transferred property is employer stock, is the employee liquidity problem associated with the transfer. Often the employee does not have sufficient liquid resources to either pay the income tax on the compensatory transfer or the interest on a bank loan to pay the tax. Moreover, the employer will generally be forced to withhold a minimum of 20% for withholding tax purposes even if the payout is deemed “supplemental wages.” This will present a problem for noncash benefits (primarily employer stock) which are taxed to the extent of their fair market value. In such cases, the employee will either

397. See Treas. Reg. § 31.3402(g)-1(a) (as amended in 1966) (When supplemental wages such as bonuses, commissions, and overtime are paid, the amount of tax to be withheld shall be determined by a percentage, wage bracket, or compensation method.); see also Rev. Rul. 82-200, 1982-2 C.B. 239 (An employer may withhold supplemental wages at a flat 20% rate rather than according to the employee’s W-4 form.).
have to agree to provide the employer with the funds for the 20% withholding burden generated from unrelated sources or the employer would be required to simultaneously repurchase 20% of the fair market value of the noncash benefit. The latter course would constitute the traditional solution to the problem.\textsuperscript{398} Of course, if the employee is forced to sell part or all of the employer stock to pay the tax, the sale will normally generate a further tax from the gain. This event will dilute the employee's ownership of the employer stock, which in turn operates as a disincentive or, at the very least, detracts from the intended incentive effect.

One solution to counter this reduction-gain effect is an interest-free or below-market interest rate loan from the employer to the employee for the amount of the employee's tax liability. Provided the employee's interest savings is intended to be compensatory, the employee will not be taxed on this economic benefit.\textsuperscript{399} However, the employer also forfeits a compensation deduction for the transferred benefit. In other words, the employer is economically transferring foregone assets to the employee that the employee will use to pay the tax liability. Thus, the employer's true economic loss is the after-tax interest income that it would have earned on the funds until the employee actually pays the funds. In high-growth businesses with low earnings, these amounts can be a very significant expense to the company and are required to be disclosed for financial statement purposes to shareholders.

\textsuperscript{398} Where the noncash benefit is a publically traded and regulated market security, the parties should ensure that the repurchase program does not violate the § 16(b) short-swing profits provision of the 1934 Securities and Exchange Act. One possible exemption for the repurchase program may be found in § 16(b)(3) relating to the treatment of options. See 17 C.F.R. § 240.16b-3 (1990).

\textsuperscript{399} See I.R.C. § 7872 (1990). If the employer loans the employee the 20% withholding requirement and the loan reflects a below market (even zero) interest rate, IRC § 7872 provides that the employee is not taxed on the economic benefit of the lower interest rate. Correspondingly, the employer may not deduct the economic benefit transfer. This dual result of IRC § 7872 is dictated by the decision in Dean v. Commissioner, which reasoned that if the interest for the use of the money were viewed as a taxable economic benefit, the employee would be entitled to an offsetting putative deduction for the interest expense the employee would have paid had the employee been required to actually pay interest. Dean v. Commissioner, 35 T.C. 1083, 1090 (1961). Similarly, the employer's deduction benefit would be offset and cancelled by the putative interest income it would have received had the employee actually paid the interest. See Joyce & Del Cotto, Interest-Free Loans: The Odyssey of Mismemer, 35 Tax L. Rev. 459 (1980) (discussing this and other aspects of Dean v. Commissioner).
This “no-choice” scenario may be modified by a Stock Appreciation Rights plan (SAR). An SAR is essentially an employee right to elect to receive the appreciation in the value of a share of employer stock from the date of the grant of the SAR until exercised in either employer stock or cash. If the employee elects to receive the increment in cash, the receipt will be taxable compensation at the time of actual receipt under IRC § 61(a)(1) rather than IRC § 83 since money is excluded IRC § 83 property. The employer will be entitled to a deduction for the cash transfer under IRC § 404(a)(5) when the employee includes the same amount in income, rather than when the cash is actually transferred to the employee, since the arrangement is considered a plan of deferred compensation. This is true whether the employer is a cash or accrual method taxpayer.

Where the employee elects to receive the appreciation increment in the form of employer stock, the stock receipt is governed by IRC § 83(a) and would therefore be taxable in the year of receipt to the extent of the difference between the fair market value of the stock and any amount paid by the employee (usually zero), unless the stock so transferred is subject to a substantial risk of forfeiture (which is usually not the case) or the employee elects cash. Consequently, the employee has the same result whether receiving cash or stock. The employer’s deduction is controlled by IRC § 83(h), which ties the deduction to the employee’s inclusion in income just as IRC § 404(a)(5) does. However, the IRC § 83 regulations liberalize this transactional income and expense matching by permitting the employer to take a deduction under its normal accounting rules provided the property is substantially vested at the time of transfer. Thus, an accrual method employer’s deduction

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401. See Priv. Ltr. Rul. 82-30-147 (Apr. 30, 1982) (holding that cash payment made upon exercise of an SAR is deductible by the employer in accordance with IRC § 162); Priv. Ltr. Rul. 82-06-070 (Nov. 10, 1981) (holding that employer and its subsidiaries shall not recognize gain or loss as a result of the grant, transfer of shares, or substantial vesting of the shares).
403. Treas. Reg. § 1.83-6(a)(3) (1978). This regulation states that this benefit will only occur with regard to amounts (1) that are "properly includable" in the employee's income; and (2) that the employer properly withholds under IRC § 3402. Since the withholding obligation arises under IRC § 3402, rather than IRC § 83, this latter requirement appears meaningless and the first requirement is similarly without
would be governed by IRC § 461 as limited by the economic performance rules of IRC § 461(h), whereas the cash method employer is entitled to a deduction only when the stock is actually transferred. Accrual would generally occur at the time of employee exercise, regardless of when the SAR was paid. Finally, the IRS position, that a cash receipt under an SAR is part of a deferred compensation plan and therefore is governed by IRC § 404(a)(5), does not apply to a receipt of stock under such an arrangement. Accordingly, the more liberal rules of the IRC § 83 regulations allowing a deduction under normal accounting rules will prevail. Consequently, the employee is treated the same whether electing to receive cash or stock, but there is no corresponding symmetry between accrual and cash basis employers. An accrual method employer will have a slight deduction acceleration advantage over a cash method employer if the employee elects to receive stock because such an employee receipt is not defined as a plan of deferred compensation which permits the employer to rely on the more liberal deduction rules of the IRC § 83 regulation as opposed to IRC § 404(a)(5).

In addition, the IRS ruled that it will not apply the doctrine of constructive receipt to SARs. Without such a position, it would have been possible for the IRS to argue at the close of every employee’s tax year that the employee was in constructive receipt of the amount of annual appreciation occurring in

404. The regulations under IRC § 404(a)(5) do not contain a liberalization such as that found in Treasury Regulation § 1.83-6(a)(3).

405. A primary concern relating to this treatment is whether the employee will be taxed at the time of the grant of the SAR as opposed to the date of exercise. This would occur if, for example, the right to make the future election were a receipt of “property” within the meaning of IRC § 83 which would then require an immediate tax on the measure of the value of the right. However, Treasury Regulation § 1.83-3(e) defines property to exclude unfunded and unsecured promises to pay, thereby formalizing the common law economic benefit doctrine. The IRS has ruled that the receipt of an SAR is such an unfunded and unsecured promise to pay and, therefore, the grant of an SAR is a nontaxable event as far as IRC § 83 is concerned. For examples of the IRS position, see Priv. Ltr. Rul. 82-30-147 (Apr. 30, 1982); Priv. Ltr. Rul. 79-46-072 (Aug. 20, 1979).

406. See Rev. Rul. 81-300, 1980-2 C.B. 165, 166 (holding that “[a]n employee who possesses stock appreciation rights is not in constructive receipt of income by virtue of the appreciation of the employer’s stock”); Rev. Rul. 82-121, 1982-1 C.B. 79, 80 (holding that income subject to substantial limitations or restrictions, such as an SAR, is not constructively received).
that year because of the right to elect to receive cash for the appreciation at that time. However, such a cash election in one year would create a concomitant loss of the next year’s appreciation since the SAR would have been exercised. The presence of this forfeiture of future appreciation constitutes a limitation sufficient to block the application of the constructive receipt doctrine.  

The advantages of an SAR are that it gives the employee the right to obtain future appreciation in employer stock without risking any investment capital to exercise or purchase the employer stock, albeit while losing the future post-election appreciation on such stock. In addition, if the employee elects to receive cash rather than employer stock, the liquidity problem associated with the tax due upon exercise is alleviated. On the other hand, if the employee elects to take the SAR in stock, the tax liquidity problem persists. For these reasons, many employers offer a combination of SARs and nonqualified stock options in which issued SARs are equal to 20% of the stock options. The employee may elect to receive up to 20% of the stock option in the form of cash under the attached SAR in order to help pay the withholding obligation. In these circumstances, the cash is used to satisfy the withholding obligation and is never actually transferred to the employee. Each SAR election would cancel an option to receive one share of stock. Limiting the SAR program to 20% limits the employer’s potential cash outlay under the program.

8. Employer Deduction

The effect of IRC § 83 as applied in the context of an NQDCP is that the employer’s accrual deduction may be further postponed from the time payment is made with un-

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407. In addition, the IRS noted it would have little basis for imposing the doctrine of constructive receipt at the time of the grant. Rev. Rul. 60-31, 1960-1 C.B. 174, 178.

408. Under limited circumstances involving an exchange of stock for stock of the same corporation, the IRS has ruled that the employee can in effect use appreciated, previously owned stock to “purchase” or “exercise” the stock option under the new plan without incurring a tax on the exchange under IRC § 1036. Rev. Rul. 80-244, 1980-2 C.B. 235. For employees owning such stock, this in part solves the liquidity problem of the investment capital requirement for acquiring the stock while a combined SAR program solves the tax liquidity problem discussed.

409. For discussion of the employer’s deduction under IRC §§ 404(a)(5), 404(b) and 461, see supra notes 330-39 and accompanying text.

http://open.mitchellhamline.edu/wmlr/vol17/iss1/13
restricted property, if the employer pays for the NQDCP services with a transfer of property other than money and such property is subject to an IRC § 83(a) substantial risk of forfeiture. Under IRC § 83(h), an employer is not entitled to a deduction for compensation until the employee is required to include the property transfer in income under IRC § 83(a) or elects to include the fair market value of the property transfer (without regard to restrictions) in income under IRC § 83(b).

III. Economic Rationality Analysis

A. General Analysis

The analysis of NQDCP compensatory relationships reveals that an employee interested in deferring cash compensation under an NQDCP arrangement has essentially a choice between two economic models. Model I is a non-§ 83 model of taxation which is governed by the constructive receipt and economic benefit doctrines. Model II is an IRC § 83 model of taxation which is governed by IRC § 83. In both models, taxation of the future compensation to the employee is postponed until its ultimate receipt because of a significant risk the funds will not actually be received. The Model I risk is that the employer will be unable to pay the funds in the future when the payment obligation matures. In Model II, there is a risk that, in addition to the employer’s inability to pay the funded ERISA promise, the employee may not be entitled to actually receive the funds because of a failure of the employee to meet a condition of the transfer with regard to the performance of future services. Thus, Model II could actually extend the employee’s income inclusion time period by postponing actual receipt until the expiration of the forfeiture restrictions.

Viewed in this manner, there is a difference in the nature of the reasons why the employee might not receive the funds in the future. Under Model I, the nature of the restriction is essentially beyond the control of the employee and is related to the economic performance ability of the employer. This is no small risk and was the primary force behind the funding requirements of ERISA, which now requires the employer to fund its obligations under certain plans in a trust secured from its future operational failures.

In contrast, the additional Model II risk is substantially more within the control of the employee. Under IRC § 83(c) and
Treasury Regulation § 1.83-3(c), the employee must generally only satisfactorily perform substantial future services and avoid being discharged for cause for committing a crime to meet the condition(s) to transfer regarding future services. Most employees consider these matters within their legitimate control. Moreover, in most cases, death\(^{410}\) is not an event of forfeiture so the employee is almost guaranteed to receive the property transfer in the future without forfeiture.

1. Model I Case (Non- § 83)

Model I includes cash compensation to be received in the future which is not subject to a substantial risk of forfeiture within the meaning of IRC § 83. Under Model I, the employer is promising to pay the employee a sum certain in the future for the simple performance of future services. Viewed another way, the employee is simply electing to receive a portion of her future compensation beyond the time period when economic performance occurs, that is, beyond the date when the employee provides the services. In order for taxation on these amounts to be successfully deferred until receipt, as opposed to when earned, the employee must (1) avoid the application of the constructive receipt doctrine by electing to defer the amounts prior to the time when they are earned, that is, when the services are performed; and (2) avoid the application of the economic benefit doctrine by making certain the employer's promise to pay the compensation in the future remains a naked promise requiring that the employee must remain a general unsecured creditor of the employer. In such a case, § 83 would not apply to the arrangement because it involves a promise to pay money which is not set aside from the claims of the creditors as required by Treasury Regulation § 1.83-3(e) and, therefore, the money promise is not considered IRC § 83 "property."

\(^{410}\) Treas. Reg. § 1.83-1(d) (as amended in 1978). This regulation governs the tax treatment of restricted property held by an employee at death. If the employee dies while holding property which is not transferable, and which is subject to substantial risk of forfeiture, or forfeited at death, the employee's death will not be treated as if the restrictions lapse unless the agreement so provides. Id. When the restrictions do not lapse, at death or later, the person holding the property will be treated as receiving income in respect of a decedent at that time under IRC § 691 and, accordingly, will have ordinary income but will not receive a stepped-up basis in the amount to be received. See I.R.C. § 1014(c) (1990).
2. Model II Case (§ 83)

Model II includes cash compensation to be received in the future which is subject to the application of IRC § 83. This would include only transfers of money "which are transferred or set aside from the claims of creditors of the transferor, for example, in a trust or escrow account." In such cases, the promise would be considered funded and subject to ERISA regulation and also immediately taxable under the common law economic benefit doctrine. In order for such covered transfers of money to not be currently taxable under the economic benefit doctrine or IRC § 83(a), the employee's rights to the funds must not be transferable and must be subject to a substantial risk of forfeiture which requires the provision of substantial future security under IRC § 83(c). Of course, the employee could make an IRC § 83(b) election to have the funds currently taxable, but such an election is antithetical to the consensual creation of the deferment agreement in the first place.

B. Qualified Plan Juxtaposition

The general thought is that qualified plans are superior tax vehicles to NQDCPs because of the permitted mismatching of the employer deduction for contributions with delayed income to the employee when the funds are withdrawn. This tax advantage to the parties is offset by the ERISA requirements associated with qualified plans: (1) non-discriminatory coverage; and (2) ERISA funding and reporting standards. The former insures that a broad group of employees will be covered and that the highly compensated participants will have contribution limitations. However, NQDCPs may produce a tax advantage equivalent to qualified plans where the employer's effective tax rate is zero. Furthermore, an NQDCP tax advantage will be close to that of a qualified plan as long as the employer's tax rate is less than the employee's tax rate.

The foregoing conclusion generates astonishing questions, such as why ERISA fails to regulate NQDCPs enjoying this position with the same vigor as qualified plans. This question becomes particularly compelling where an NQDCP is adopted to avoid implementing a more costly qualified plan, more costly

because of the ERISA coverage requirements, contribution limitations, and funding and reporting requirements.

In an informative article,\footnote{412. Halperin, Interest in Disguise: Taxing the Time Value of Money, 95 YALE L.J. 506 (1986).} Professor Halperin discusses the contrast between NQDCPs and qualified plans and concludes that it would be appropriate to consider a special tax on the investment income of an NQDCP enjoying a tax advantage similar to that of a qualified plan.\footnote{413. Id. at 539.} The appropriate tax treatment of a deferred compensation plan, Professor Halperin argues, is one where neither the employer nor the employee is viewed in isolation. Rather, he suggests that appropriate treatment will only follow from a joint consideration of the tax position of both parties to the transaction.\footnote{414. Id. at 523.} Halperin argues that postponing the employer deduction for compensation under an NQDCP until employee receipt effectively taxes the employer on the compensation despite the deferral; however, Halperin notes that distortion nevertheless occurs from a deferral of employee taxation on the investment income where the employer’s tax rate is zero or less than the employee’s tax rate during the deferral period.\footnote{415. Id.}

The suggested cure for this evil is to tax the employee on the investment income as it is realized or to impose a special tax\footnote{416. Id. at 545.} on the compensation transfer to equalize the tax positions of qualified plans and NQDCPs under these special circumstances.\footnote{417. Id. at 541.} The suggestion to subject the NQDCP investment income to a special tax is simply an indirect tax on the employee which corrects the inequity.

If, however, the evil is broader and encompasses the ERISA regulatory scheme as well, the suggestion to simply tax the investment income falls short of the mark. The solution corrects only the tax problem but not the failure to require such plans to be funded. Of course, a funding requirement in itself would subject the compensation to immediate taxation under the economic benefit doctrine. More radical revisions are necessary to extend ERISA regulation.

\footnote{412. Halperin, Interest in Disguise: Taxing the Time Value of Money, 95 YALE L.J. 506 (1986).} \footnote{413. Id. at 539.} \footnote{414. Id. at 523.} \footnote{415. Id.} \footnote{416. Id. at 545.} \footnote{417. Id. at 541.}
IV. Conclusion

This analysis suggests that there is room for improvement in the current legislative, administrative, and judicial treatment of NQDCP arrangements. Creating a surrogate method of taxation to tax the employer on the investment earnings from the compensation has merits if the only evil to be corrected is the NQDCP tax advantage. But if the complaint is deeper and goes to the disparate regulatory treatment as well, then more is necessary. In such circumstances, the compelling question is whether NQDCPs should properly continue to maintain a preferred tax position as well as a preferred regulatory position.

Try as we might, nothing discussed in this article makes a compelling case for the special treatment of NQDCPs. If anything, the opposite is true. Since the fairness object of the qualified plan regulatory regime is premised on such plans offering a superior tax result, when that premise is shaken, the object of qualified plans must either be expanded to safeguard its premise or be restricted to recognize a smaller niche focus. Anything less than these two extremes represents a political compromise and is certainly beyond the scope of this article.

It seems to us that the best of these two alternatives embraces an expansion of the qualified plan regulatory and tax regimes to reach NQDCPs, at least where a significant tax subsidy occurs because the employer's tax rate is significantly lower than the employee's tax rate. Such circumstances are not confined to tax-exempt organizations now governed by IRC § 457 and would generally include insurance companies and taxpayers with a perennial low (if not zero) effective taxable income. In such cases, the evil anticipated by IRC § 457 remains. Such an approach recognizes the political value and momentum inherent in the banking, insurance, actuarial science, and current union and labor positions demanding the maintenance and enhancement of the qualified plan regime. Recognizing this to be true, it seems only logical to draw into the scheme peripheral concepts such as nonqualified plans that cultivate seeds of discontent with the current system and are therefore fundamentally and intellectually inconsistent with the current system governing qualified plans. This tension must be acknowledged and addressed before it erodes the effectiveness as well as the intent of the qualified plan regime.

Elimination of Tax Advantage. Many approaches could be
designed to remedy this situation. One approach would be to include a legislative expansion of IRC § 457. Another would be the expansion of the constructive receipt position posited by the Treasury Department in 1978 when it was dissatisfied with the treatment of NQDCPs relative to government employees418 and employees of tax-exempt organizations.419 Yet another approach would be that advocated by Professor Halperin, which assesses the employer with a special tax on the investment income of the deferred compensation amount.

Because we believe that the current judicial interpretation limiting the constructive receipt doctrine is inaccurate, we propose a modification of that doctrine. In effect, we would create a presumption consistent with a market economy that employers are ready, willing, and able to pay for employee services as those services are actually rendered. Thus, economic performance of the services would become the touchstone triggering the application of the constructive receipt doctrine. The employee should be entitled to rebut this presumption with a showing that the employer is not capable of current payment for financial reasons. Such a showing would postpone taxation until the moment the employer was able to make payment.

This approach has several advantages over the current constructive receipt approach. The current interpretation permits a deferral of the income beyond economic performance provided the employee and employer contract to defer payment before the services are performed. But there is no pre-tax economic reason for the employee deferral once the services are performed. In effect, the current treatment of the compensation constitutes a loan from the employee to the employer after the services are performed and for the duration of the deferral period, and one that would ordinarily not be made absent other factors, most significantly tax consequences. If there are truly compelling economic reasons for the deferral, then the NQDCPs will continue for that reason and not because of a misplaced tax subsidy. One explanation for the use of NQDCPs may be that employees are inherently untrusting of their own ability to set aside a portion of their savings for

418. This treatment was remedied in 1978 with the enactment of IRC § 457. See I.R.C. § 457 (1990).
419. This treatment was remedied in 1986 by an amendment to IRC § 457. See I.R.C. § 457 (1990).
retirement. The personal consumption may be thought too great. Certainly, history demonstrates that the majority of employee retirement cash flow is not generated from personal savings within the consumption control of the employee. For this reason, NQDCPs will most likely continue regardless of the level of regulation and regardless of the lack of tax subsidy.

Finally, although this approach to the application of the constructive receipt doctrine does not eliminate the factual inquiry of the process, it does elevate substance over form. The current application is a purely formalistic approach based upon when the contract to defer is executed. As discussed, there is no essential economic substance to the arrangement apart from the tax consequences. A factual inquiry into the inability of the employer to pay as a rebuttable presumption to taxation is an entirely different focus. Finally, this is essentially the approach proposed by the Treasury Department in 1978 with its proposed regulation coupled with a rebuttable presumption.

**Expanded ERISA Coverage.** In order to preserve and encourage the use of NQDCPs where the tax subsidy is removed, we argue that only the ERISA funding and reporting standards be expanded to include NQDCPs. This allows NQDCPs to continue to be utilized in a discriminatory way but removes the unwarranted employee risk of ultimate employer non-payment. This will continue to encourage employees to utilize employer-sponsored retirement saving plans even where there is no tax advantage to such an arrangement. Indeed, such arrangements exist today, even without a tax advantage, where the employer’s tax rate is not less than the employee’s tax rate. With the maximum effective individual tax rate at 28% and the maximum corporate tax rate at 34%, there may be many existing NQDCPs experiencing a (perhaps unknown) tax disadvantage. Moreover, with the current proliferation of unfunded employee security devices such as the “rabbi trust” arrangement, employers would not (or at least should not) object to ERISA funding and reporting standards for such funds. In addition, we do not believe that expansion of the funding requirement without a concomitant expansion of the discrimination requirements will spell the death knell of qualified plans. They will continue to serve the vital need for coverage of the rank-and-file employees as well as provide a benefits “floor” for the highly compensated employees who utilize
NQDCPs to supplement the retirement benefits available through qualified plans.

Whether or not the expanded notion of constructive receipt is adopted, if the ERISA rules are modified to require funding of NQDCPs, the common law doctrine of economic benefit would also require taxation of the "funded" amount even absent constructive receipt expansion. In addition, once the money promise to pay deferred compensation is funded, it becomes IRC § 83 property. This means that deferral of the funded amount is still possible through substantial employee forfeiture restrictions. A comparison of the employee risk of never receiving the deferred compensation in the future because of (1) a lack of funding (employer future financial inability), or (2) the application of the IRC § 83 forfeiture provision reveals that the former presents a more significant employee economic risk.

Accordingly, even if the suggestions of this article are not adopted, risk analysis indicates that the employee would be better off requesting the employer to actually fund the promise through the deferral period. The deferral period under an IRC § 83 restriction, however, would normally be less than the NQDCP deferral period since employees would generally be unwilling to accept a substantial risk of forfeiture for periods up to twenty years. Of course, since employers are already utilizing informal pseudo-funding devices such as the "rabbi trust" to increase employee security, there would be little employer resistance associated with the recommended approach but for the current ERISA regulations. Since employers have already effectively lost the use of these funds from operations because of "rabbi trust"-like devices, the objection to complete funding would only come from the additional costs of ERISA compliance associated with such a process.

As previously discussed, once the deferred compensation arrangement becomes "funded," the NQDCP loses its essential ERISA exemption, thus subjecting the employer to discrimination and reporting provisions with respect to the non-covered employees. This is an additional critical reason in support of relaxing the ERISA stranglehold. If the ERISA exemption either requires funding of NQDCPs or deregulates "funded" NQDCPs, no doubt more employees would elect funded programs because the tax benefits of deferral are not significant.
In short, fewer employees would face losing a major portion of their critical retirement benefits.

It is the assessment of this article that eliminating the NQDCP tax subsidy accorded to employees of employers with a lower tax rate will not seriously affect the offering of such plans and may even eliminate a perhaps unrecognized disadvantage of some plans. With this impairment, an extension of the ERISA funding and reporting rules would eliminate the risk of employer non-payment of an essential retirement asset without expanding ERISA’s non-discrimination provisions. At a minimum, the ERISA exemptions should be modified to eliminate the disincentive to fund such plans. These modifications should improve the fairness of the administration of NQDCPs without discouraging their use in appropriate circumstances.