# Self-Directed Investments in Nonqualified Plans: The Devil Is in the Details

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"The Prince of Darkness is a gentleman. . ."

William Shakespeare, *King Lear* (Act III, Scene 4)

A trend throughout the 1990s in small, medium, and large 401(k) plans was to allow participants to direct the investment of their account balances. Initially popular with the bundled service providers of insurance companies and mutual fund families, self-directed investments now include individual stock selection through discount brokerage houses. The administration of such a self-directed feature is obviously complex, and the complexity increases with the number of participants. Nevertheless, the self-directed investment phenomenon of the qualified plan world has led to requests from boardrooms across the country for versions of self-direction in nonqualified plan design.

The thinking seems to be that if we can have 401(k) "wrap"[1] and 401(k) "mirror"[2] nonqualified arrangements, it is not much of a stretch to include participant direction as a feature. Consequently, the proverbial cart does seem to be in front of the horse on this matter. We, as practi-

1. Ltr Ruls 9530038, 200012083.
2. Ltr Rul 8607022, supplemented by Ltr Rul 8702021.



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tioners, are getting sloppy. Designing a nonqualified arrangement to include a participant self-directed investment option can have serious, and fatal, Employee Retirement Income Security Act (ERISA) and income tax consequences that are far beyond the vision of such plans contemplated by many plan sponsors.

This article reviews and explains the fundamental differences between qualified and nonqualified arrangements and highlights the counterintuitive nature of ERISA as it applies to nonqualified deferred compensation.

## TAXATION OF NONQUALIFIED DEFERRED COMPENSATION

"Though he be as good a gentleman as the devil is. . ."

William Shakespeare, *Life of King Henry V* (Act IV, Scene 7)

Deferral of compensation in itself constitutes a tax advantage. Generally, the advantage permits executives to defer the date on which they are taxed. Ancillary to this advantage is the potential for executives to receive deferred amounts at a lower tax rate because their individual income tax rates have decreased; they have lower taxable income, more deductions, credits, etc., or a combination of the foregoing.

To achieve the objective of deferral, executives are not taxed until the date on which they actually receive cash benefits under an arrangement. Deferring taxation until the cash is paid also allows executives to pay taxes from current cash flow. If executives had to pay taxes before receiving benefits, they would have to use another source of cash to pay the taxes due and owing.

The determination of whether a nonqualified arrangement succeeds in deferring taxation to the date of actual receipt is dependent on the applicability of two tax concepts of income inclusion, i.e., constructive receipt and economic benefit. Constructive receipt is interrelated with economic benefit and often confused with it. A clear understanding of the two concepts and their differences is necessary to analyze whether a particular nonqualified deferred compensation arrangement will, in fact, achieve the objective of tax deferral.

Constructive receipt provides that

> Although income is not actually reduced to an executive's possession it will be "constructively" received by the executive in the taxable year in which the cash is credited to the executive's account, set apart for the executive, or otherwise made available so that the executive may draw on it

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at any time, or so the executive could have drawn on it during the taxable year if notice of intent 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.[3]

The concept of economic benefit is set forth in various judicial decisions and is statutorily represented in Section 83 of the Internal Revenue Code (Code) and Treasury Regulations Section 1.83-3. The regulations provide that "a transfer of property occurs when a person acquires a beneficial ownership interest in such property disregarding any lapse restriction, as defined in Regulation 1.83-3(i)."[4] In other words, an executive could receive a transfer of a property right with a determinable value regardless of whether that property right has been reduced to cash. In reality, an executive receives property that is included in income for tax purposes in exchange for services. The property will be currently recognized as income provided that the executive's right to the transferred property is not subject to a substantial risk of forfeiture.[5]

From the Internal Revenue Service (IRS) perspective, constructive receipt preserves the symmetry between when the executive is taxed and when the employer is entitled to a tax deduction. Economic benefit is concerned with the proper tax recognition of the transfer of valuable property rights.

## CONSTRUCTIVE RECEIPT DOCTRINE

"The devil can cite Scripture for his purpose."

William Shakespeare, *The Merchant of Venice* (Act I, Scene 3)

Any analysis of the statutory and regulatory framework of the constructive receipt doctrine begins with a review of Code Section 451(a). This section provides that the amount of any item of gross income shall be included in gross income for the taxable year in which the taxpayer receives it, unless, under the method of accounting used in computing taxable income, that amount is to be properly accounted for in a different period. Under the cash receipts and disbursements method of accounting (cash method), amounts are includable in gross income in the taxable

3. Treas Reg § 1.451-2(a).
4. Treas Reg § 1.83-3(a).
5. Pamela Baker, *Nonqualified Deferred Compensation*, American Society of Pension Actuaries (Sonnenschein, Nath & Rosenthal, Chicago, 2000).

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year in which they are actually or constructively received.[6] The foregoing statutory interpretation thus suggests that under the constructive receipt doctrine, if an individual has an unqualified right to receive income that is not subject to a substantial risk of forfeiture or some other substantial restriction, the individual is taxable on that amount on the date that right first arises. The constructive receipt doctrine is set forth in Treasury Regulations Section 1.451-2(a), which states in part:

> Income is constructively received in the taxable year during which it is credited to his [the taxpayer's] account, set apart for him or otherwise made available so that it can be drawn on at any time. . .. However, income is not constructively received if the taxpayer's control of its receipt is subject to substantial limitations or restrictions.

Revenue Ruling 60-31[7] is viewed as the seminal pronouncement concerning constructive receipt of nonqualified deferred compensation. This ruling reviews five examples of possible nonqualified deferred compensation plans. In general, the ruling establishes that deferred income will not be treated as constructively received if (1) the agreement to defer is entered into before the taxpayer has earned the compensation; (2) the agreement specifies the time, the events, or the circumstances under which the deferred compensation will be paid; and (3) the deferred amounts are not placed in trust or escrow for the benefit of the taxpayer beyond the reach of the general creditors of the employer and those amounts remain an unsecured contractual obligation of the employer

It seems from a close reading of Revenue Ruling 60-31 that the determination of whether the doctrine of constructive receipt is applicable to a case involving a deferral of compensation is a facts-and-circumstances test. As the IRS stated:

> A taxpayer may not deliberately turn his back on income and thereby select the year for which he will report it. Nor may a taxpayer by private agreement postpone receipt of income. . .. The doctrine of constructive receipt is to be sparingly used. . ..

The IRS announced in Revenue Procedure 71-19[8] that it would issue advance private letter rulings concerning the application of the doctrine of constructive receipt to unfunded deferred compensation arrangements only if the initial election to defer compensation was made before the beginning of the period of service for which the compensation is payable. The IRS generally has regarded the period of service for pur-

6. Treas Reg § 1.451-1(a).
7. 1960-1 CB 174, *modified by* Rev Rul 64-279, 1964-2 CB 121.
8. 1971-1 CB 698, *modified by* Rev Proc 92-65, 1992-2 CB 428.

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poses of this requirement as the calendar year for cash-basis, individual taxpayers.[9] In addition, Revenue Procedure 71-19 requires that if the plan permits elections other than the initial election (such as an election regarding the timing of distributions) to be made subsequent to the beginning of the service period, the plan must provide substantial forfeiture provisions that will remain in effect throughout the entire period of deferral.

Revenue Procedure 71-19 was modified by Revenue Procedure 92-65[10] to provide that a deferral election may be made in the year in which the plan is first implemented if the employee makes an election within 30 days of the establishment of the plan and the election applies only to compensation for services rendered after the election. Similarly, in the first year in which a participant becomes eligible to participate in a previously implemented plan, the newly eligible participant may make an election to defer compensation for services performed subsequent to the election provided the election is made within 30 days after the date the employee becomes eligible.

Revenue Procedure 92-65 also established four additional requirements that must be satisfied before the IRS will issue an advance ruling concerning the application of the doctrine of constructive receipt to an unfunded deferred compensation arrangement. First, the plan must define the time and method of payment of deferred compensation for each event (such as termination of employment, regular retirement, disability, or death) that entitles a participant to receive benefits.[11] Second, the plan may provide for early withdrawal of benefits in the case of an "unforeseeable emergency," which must be defined in the plan as an unanticipated emergency that is caused by an event beyond the control of the participant or beneficiary and that would result in severe financial hardship to the individual if early withdrawal were not permitted, provided that any early withdrawal approved by the employer is limited to the amount necessary to meet the emergency. Third, the plan must provide that participants have the status of general, unsecured creditors of the employer and that the plan constitutes a mere promise by the employer to make benefit payments in the future; the plan must provide that any trust created by the employer and any assets held by the trust to assist it in meeting its obligations under the plan will conform to the terms of the model "rabbi" trust described in Revenue Procedure 92-64;[12]

9. Rev Rul 68-86, 1968-1 CB 184.
10. 1992-2 CB 428.
11. Rev Proc 92-65 required a payment date or a payout upon contingency to be specified in a document.
12. 1992-2 CB 422.

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and the plan must state that it is the intention of the parties that the arrangements be unfunded for tax purposes and for purposes of Title I of ERISA. Fourth, the plan must provide that a participant's rights to benefit payments under the plan are not subject in any manner to anticipation, alienation, sale, transfer, assignment, pledge, encumbrance, attachment, or garnishment by creditors of the participant or the participant's beneficiary.

Revenue Procedures 71-19 and 92-65 establish procedural requirements that must be met before the IRS will issue an advance ruling concerning application of the doctrine of constructive receipt to a deferred compensation plan.[13] These requirements do not constitute a substantive interpretation of the law governing that doctrine, however. Accordingly, failure to satisfy one or more of these requirements does not necessarily mean that the doctrine of constructive receipt is applicable to a deferred compensation plan. Rather, the particular features of the plan must be tested against the substantive law governing application of the doctrine of constructive receipt as it has developed, principally through case law.

Although the IRS has traditionally taken a fairly restrictive view of deferral agreements under the doctrine of constructive receipt, case law has proved significantly more lenient to taxpayers. For instance in *Commissioner v. Olmsted Inc. Life Agency*[14] and *Commissioner v. Oates*,[15] the Seventh and Eighth Circuits held that an agreement entered into by an insurance agent and an insurance company to defer the agent's receipt of renewal commissions did not result in constructive receipt even though the deferral agreement was entered into after all the services giving rise to the renewal commissions had been performed.

In *Veit v. Commissioner* (Veit I)[16] the Tax Court held that compensation deferred to a later year pursuant to an amendment to an employment agreement did not result in constructive receipt of the accrued but unpaid compensation in the year in which the amounts would have been paid under the original agreement. Under the terms of the original employment contract entered into in 1939, the employee was entitled to receive a percentage of the employer's 1940 profits payable in two equal installments in 1941. On November 1, 1940, the employee and the employer entered into a subsequent agreement under which the percentage of 1940 profits payable in 1941 under the original agreement would

13. Treasury Department, Internal Revenue Service Priority Guidance Plans for 1995, 1996, and 1997.
14. 304 F2d 16 (8th Cir 1962).
15. 207 F2d 711 (7th Cir 1953).
16. 8 TC 809 (1947).

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be paid in quarterly installments in 1942.[17] The Tax Court noted, "The whole agreement. . . was an arm's length business transaction. . . The only way we should be justified in holding that petitioner constructively received. . .. would be to hold that the agreement to defer was a mere subterfuge and sham."

The employee and the employer in *Veit I* entered into a subsequent agreement on December 26, 1941, in which monies payable in 1942 were further deferred until 1943. The IRS challenged this subsequent deferral in *Veit v. Commissioner* (Veit II) claiming that this amount was constructively received in 1942. The IRS sought to distinguish the Tax Court's earlier opinion in *Veit I* on the ground that at the time of the November 1, 1940, agreement, the amount of the 1940 profits had not been ascertained, whereas the full amount had been ascertained and credited on the employer's corporate books as of the December 26, 1941, agreement. The Tax Court amplified, "Under existing contracts there was never a time when the money was unqualifiedly subject to petitioner's demand or withdrawal." Veit II (*Veit v. Commissioner*, 8 TCM 919 in 1949) is noted for the clear principle that an agreement to extend a prior deferral of income does not become a trigger for application of the constructive receipt doctrine when the second deferral agreement is entered into before the amounts are payable under the first deferral agreement.

On February 3, 1978, the IRS sought to overturn the long-standing doctrine of constructive receipt by issuing Proposed Treasury Regulations Section 1.61-16, providing that compensation deferred at the election of an employee (even if the election is made irrevocably and unconditionally prior to the date the compensation is earned) will be taxable at the time that compensation would have been received in absence of such an election. The proposed regulation stated that plans qualified pursuant to Code Section 401(a) and tax-sheltered annuity arrangements qualified pursuant to Code Section 403(a) or 403(b) would be exempt from the application of Treasury Regulations Section 1.61-16.

The public hue and cry against the IRS's attempt by regulation to overturn long-standing judicial and administrative precedent resulted in the passage of the Tax Reform Act of 1978, which included Section 132(a) prohibiting the IRS from changing the constructive receipt rules with respect to taxable entities.[18] Therefore, by legislative action, Congress effectively froze the doctrine of constructive receipt as set forth

17. Id at 816.
18. Section 457 governs nonprofit and nontaxable entities.

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in the applicable regulations, rulings, and judicial decisions in effect as of February 1978.[19]

In Private Letter Ruling 8632003 issued on April 18, 1986, the IRS concluded that an election to further defer receipt of compensation that is not yet payable, but that has been earned and the amount of which is definitely ascertainable, should be disregarded in determining when that deferred compensation is taxable. This ruling involved a plan pursuant to which an employee would be entitled to receive the value of his or her shadow stock units in a lump-sum payment following termination of employment. Alternatively, the employee could elect at any time prior to termination to instead receive the post-termination payment in 10 annual installments with interest credited on the deferred amounts.

The IRS concluded that "as to amounts earned and determinable, the subsequent and further deferral should not be recognized." The IRS distinguished cases in which an election to defer had occurred after services were performed and before the compensation was payable. *Oates* was distinguished in that the renewal commissions were contingent payments and were not "earned" at the time of election. *Veit I* and *Veit II* were distinguished on the basis that those cases arose from parties in negotiation whereby both parties provided consideration.[20]

In *Martin v. Commissioner*, the Tax Court concluded that two employees who elected installment payments under a shadow stock plan shortly before the payments began, when they could have elected a lump sum, were not in constructive receipt of the value of the shadow stock. The two employees were participants in their employer's deferred compensation plan for key management employees. Under the terms of this plan, benefits were payable only in 10 equal annual installments. In 1981, the company adopted a new shadow stock plan in which participants in the old deferred compensation plan could elect to participate by relinquishing their rights under the old plan. Under the new plan, benefits were payable in a lump sum unless participants elected to receive payment in 10 annual installments. The election was generally required to be made prior to the termination of employment. Participants under the new plan could elect to surrender their shares of shadow stock at any time but would forfeit the right to any unvested shares and would no longer be entitled to participate in the plan. Shortly thereafter, two employees elected to participate in the new plan and to receive their benefits in 10 annual installments. A short time later and within the same year the two employees terminated employment.

19. The statute applies to constructive receipt only and not to the economic benefit rules.
20. *Supra*, n5.

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The IRS determined that the employees were in constructive receipt of the entire amount of their benefits under the shadow stock plan because they had an unfettered right to elect a lump-sum benefit after electing into the new plan. The IRS argued that the election of installments was self-imposed and insufficient to preclude application of the doctrine of constructive receipt.[21] The Tax Court held that the employees were not in constructive receipt of their benefits either when they elected to participate in the new shadow stock plan or when they terminated employment. The court concluded that because the taxpayers were required to elect between a lump sum and installments prior to the surrender date, they did not acquire an unconditional right to receive payment prior to that date.[22]

The facts in *Martin* are substantially similar to those presented in Private Letter Ruling 86320032. In that ruling, the IRS concluded that any election between a lump-sum and an installment method of payment of shadow stock shares made after the services giving rise to the deferred compensation that has been earned results in constructive receipt of the lump-sum payment amount when benefits under the plan become payable. This ruling is inconsistent with the analysis in *Martin* and other applicable case law. For example, in *Goldsmith v. United States*[23] a doctor's ability to terminate his deferred compensation agreement with a hospital on 30 days notice did not render him in constructive receipt of the deferred compensation, and in *Veit v. Commissioner*,[24] an employee's election to extend the payment date of his deferred compensation prior to the date he had an unconditional right to receive payment did not result in constructive receipt.

Despite the IRS's position in Private Letter Ruling 8632003, the cases decided both before and after the ruling have held that an agreement to defer compensation should not be considered a subterfuge or sham merely because the employer or service recipient is willing to presently and immediately pay the compensation agreed to be deferred, even when the predominant or sole motivating factor is the employee's tax advantage.[25] The Tax Court's holding in *Martin* stands for the proposition that an election to defer compensation (including an election to extend the deferral period of previously deferred compensation) may be filed after the date the compensation is earned without triggering constructive receipt, provided that, at the time of the election, the compensa-

21. 96 TC 814 (1991).
22. Id at 826.
23. 586 F2d at 819, n5.
24. 8 TCM 919 (1949).
25. *See Goldsmith, supra*, n23.

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tion has not become unqualifiedly subject to the employee's demand or withdrawal. If, however, an election to defer compensation is made at the time an employee has an unconditional right to receive payment, the employee will be in constructive receipt of the deferred compensation.[26]

## ECONOMIC BENEFIT DOCTRINE

"Terms! Names!; Lucifer, well, yet they are all devils additions. . ."

William Shakespeare, *Merry Wives of Windsor* (Act II, Scene 2)

Applicable case law stands for the proposition that an employee will receive a taxable economic benefit in the year cash or other property is transferred to a trust or escrow account that is outside the reach of the employer's general creditors and the employee's right to receive payment is not subject to any significant contingencies or is transferable by the employee. As stated above, the economic benefit doctrine has now been codified in Code Section 83 and the regulations thereunder.

In *Commissioner v. Smith*,[27] the U.S. Supreme Court held that an economic benefit was conferred on an employee when he exercised a stock option granted by his employer. On exercise, a taxable transfer of property to the employee occurred, providing the employee with income equal to the difference between the option price and the fair market value of the stock on the date of the exercise.

In *Cowden v. Commissioner*,[28] the Tax Court held that a taxpayer had received an economic benefit because the contractual promise to pay was a cash equivalent. The court held that the contract was a cash equivalent because it was assignable and convertible.

In *E.T. Sproull v. Commissioner*,[29] the Sixth Circuit held that an employer-created irrevocable trust of which the employee was the sole beneficiary was property set aside from the claims of the employer's creditors for the employee. Therefore, the employee received an economic benefit in the year in which the property was transferred into the trust. In *Jacuzzi v. Commissioner*[30] the Tax Court also applied the economic benefit doctrine when holding that a taxpayer was required to

26. *See* Sainte Claire Corporation v Commissioner, TC Memo 1887-171.
27. 324 US 177 (1945).
28. 20 TCM 1134 (1961).
29. 194 F2d 541 (6th Cir 1952).
30. 61 TC 262 (1973).

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include in income amounts transferred to a trust as compensation for services.

In *Casale v. Commissioner*,[31] the Second Circuit held that, because a corporation was the owner and beneficiary of a life insurance policy on the life of one of its employees and the policy was a general asset of the employer subject to the claims of its general creditors, the corporation had not conferred an economic benefit on the employee by purchasing the policy.

More recently, in the Tax Court ruling in *Childs v. Commissioner*,[32] the IRS rejected the argument that the right to receive payments under annuity contracts constituted "property" that was transferred in connection with the performance of services. In so holding, the court focused on whether the promises to pay under a settlement agreement and corresponding annuity purchases constituted property within the meaning of Code Section 83. An unfunded and unsecured promise to pay money or property in the future is not considered property within the meaning of Section 83.[33] Analyzing the economic benefit doctrine, the Tax Court held that funding does not occur as long as the obligor remains the owner of the fund and the fund remains subject to its general creditors. The ruling also stated that because the payment under the settlement agreement could not be accelerated, deferred, increased, or decreased and because the defendant's insurers were owners of the annuity contracts and therefore endowed with the contractual rights and the ability to exercise those rights without the consent of the taxpayer, the promises to make structured payments were not funded or secured.[34] Accordingly, the Tax Court held that the promises to pay were unfunded and unsecured and therefore did not constitute property within the meaning of Code Section 83.[35]

Although an employer may not be able to secure employees' benefits in a nonqualified deferred compensation plan without subjecting the employees to current taxation, the employees themselves may be able to secure their benefits in the nonqualified plan by purchasing a surety bond. In Private Letter Ruling 8406012,[36] the IRS ruled that a surety bond purchased by an employee to protect his interest in an unfunded plan did not put the employee in constructive receipt of the benefits due him under the plan. The IRS did not address the Section 83 economic benefit theory aspects of this plan, and it is questionable whether the

31. 247 F2d 440 (2d Cir 1957).
32. 103 TC 634 (1994).
33. *See* Treas Reg § 1.83-3(e).
34. Id.
35. Id.
36. Nov 3, 1983.

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employer could have provided a surety bond with the employee as obligee because the result would likely be that of a transfer of property in connection with the performance of services.

The impact of the distinction between an employee-purchased surety bond and an employer-purchased surety bond on whether the purchase of the surety bond confers an economic benefit was addressed in Private Letter Ruling 9344038.[37] Under this ruling, the employee participated in an unfunded deferred compensation plan maintained by his employer. The employee purchased an insurance policy from an insurance company under which the insurance company agreed to pay the employee any unpaid deferred compensation on the occurrence of an "insured event" specified in the policy. The insurance company would then be subrogated to the employee's rights under the deferred compensation plan. The terms of the policy were negotiated solely by the insurance company and the employee. The employer neither participated in these negotiations nor entered into any ancillary policy or any other contractual relationship with the insurance company. In addition, in issuing the policy, the insurance company relied solely on publicly available information about the employer; the employer did not provide any other information to the insurance company.

The IRS ruled that because the employee independently obtained the policy, the employer did not transfer property to the employee or set aside property from the employer's creditors for the employee. Also, because the employee negotiated the terms of and obtained the policy without involvement by the employer, and the life insurance company issued the policy without entering into any side agreements with the employer and without obtaining any information about the employer other than what was publicly available, no economic benefit was conferred on the employee by the employer.

The private letter ruling further indicated that the employer might increase the employee's compensation by an amount equal to the premium payments on the policy. The IRS noted that its conclusion was based on the assumption that the payment of additional compensation is not excludable from the employee's gross income as a working-condition fringe benefit under Code Section 132 and is not deductible by the employee as a trade or business expense under Code Section 162. The treatment of the additional compensation as a working-condition fringe benefit, the IRS noted, would be inconsistent with the conclusion that the employer lacked any involvement in the employee's obtaining the policy.

37. Aug 2, 1993.

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The IRS further opined that the payment of the premium by the employee was a nondeductible family expense under Code Section 262.

The IRS expressly noted that the issue is whether the employer has transferred property to the employee or has set aside assets beyond the reach of the employer's creditors. In concluding that the employer did not confer an economic benefit on the employee, however, the IRS apparently attempted to demonstrate that the employer in this ruling did not engage in any action or activity that, although not involving the transfer of property, might nevertheless have conferred an economic benefit on the employee by way of reducing the cost of the insurance policy.

On further review, it would appear that the IRS's focus on whether the employer provides the insurance company with nonpublic information is misplaced. The appropriate analysis under Code Section 83 and under the economic benefit doctrine is whether the employer has transferred any property (including contractual rights) to the insurance company in exchange for the insurance company's agreement to issue the policy. By way of example, if an employer transfers contractual rights in addition to the subrogation of the employee's rights to an insurance company in exchange for the insurance company's agreement to issue the policy to the employee, then the employer arguably would have conferred an economic benefit on the employee. The mere transfer of nonpublic information about the employer, without more (including any contractual rights against the employer to provide additional information in the future, and without any representations, warranties, or covenants concerning the validity of the information disclosed), should not constitute an economic benefit resulting in the inclusion in income of the deferred compensation secured by the surety bond.

## HISTORY AND SCOPE OF ERISA

"With old, odd ends stolen out of one holy writ, and seem a saint when most I play the devil."

William Shakespeare, *King Richard III* (Act I, Scene 3)

ERISA was enacted in 1974 to regulate the operation and administration of employee benefit plans maintained by an employer. As stated in the declaration of policy in Title I, this legislation was enacted because Congress was concerned with the rapid and substantial growth of employee benefit plans; the continued well-being and security of millions of employees and their dependents are directly affected by these plans;

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the plans are affected with a national public interest; disclosure must be made and safeguards provided with respect to the establishment, operation, and administration of such plans; and minimum standards must be provided ensuring the equitable character of such plans and their financial soundness.[38]

The declaration of policy goes on to state:

> The policy of this act is to protect interstate commerce and the interests of participants and their beneficiaries, by requiring the disclosure and reporting to participants and beneficiaries of financial and other information with respect to establishing standards of conduct, responsibility and obligation for fiduciaries, and by providing for appropriate remedies, sanctions and access to federal courts. It is further declared to be the policy of ERISA to protect the Federal taxing power, and the interests of participants in private pension plans by improving the equitable character and soundness of such plans by requiring them to vest the accrued benefits of employees with significant periods of service, to meet minimum standards of funding and by requiring plan termination insurance.[39]

ERISA is divided into four distinct titles, each having different areas of application. Title I is called "Protection of Employee Benefit Rights" and is enforced by the Department of Labor (DOL). Title II is called "Amendments to the Internal Revenue Code Relating to Retirement Plans" and contains the operating rules that apply to qualified plans that are enforced by the Department of the Treasury's Internal Revenue Service. Title III is called "Jurisdiction, Administration and Enforcement" and is a coordinated effort between the DOL and Treasury establishing the responsibility of both groups. Title IV is called "Plan Termination Insurance" and relates to the creation and administration of the Pension Benefit Guaranty Corporation (PBGC). The main thrust of ERISA as it applies to nonqualified deferred compensation arrangements is found in Title I. The applicable compliance requirements under Title I vary with the type of employee benefit plan, either pension plans or welfare benefit plans. Most forms of deferred compensation plans are treated as pension plans.[40]

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38. *ERISA: Selected Legislative History 1974-1986* (BNA Books, 1986) at 1–111.
39. ERISA § 2.
40. ERISA, Title I, Subtitle B, Parts 1-5.

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## ERISA TITLE I

"The devil hath power to assume a pleasing shape."

William Shakespeare, *Hamlet* (Act II, Scene 2)

As mentioned above, Title I contains the DOL regulations. Title I has five subcategories: Part 1—Reporting and Disclosure, Part 2—Participation and Vesting, Part 3—Funding, Part 4—Fiduciary Responsibility, and Part 5—Administration and Enforcement. Certain plans are exempt from the application of Title I:

- Government plans;
- Church plans;
- Workers' compensation, unemployment, or disability;
- Plans maintained beyond U.S. borders for nonresident aliens; and
- Unfunded excess benefit plans.[41]

Qualified plans and nonqualified plans that are not exempt must comply with all five subcategories of Title I. Full Title I compliance for a nonqualified pension plan requires that the plan be established, operated, and administered in virtually the same manner as a qualified plan. This imposition would defeat many of the advantages of establishing a nonqualified deferred compensation plan in the first place, such as selective participation, lack of funding requirements, and vesting flexibility.

With respect to Title I, the Code and ERISA have many parallel provisions. While the Code provisions are primarily applicable to qualified plans, the ERISA provisions apply to both qualified and nonqualified plans that do not fall under any of the available ERISA exemptions.

Employee benefit plans are required under ERISA Title I, Part 1, to provide detailed financial information to various government agencies as well as to plan participants and their beneficiaries. Depending on the required level of compliance, Part 1 reporting can be as simple as a one-page notice or an extremely complex process requiring several government forms and schedules, i.e., Form 5500 and Schedules A, B, C, E, F, G, P, and SSA. Disclosure to participants can involve either providing an accounting of accruals/benefits on request, or the additional administrative burden of providing summary plan descriptions, summary annual reports, and summaries of material modifications.

Unless exempted, the participation and vesting provisions of Part 2 of ERISA apply to an employee benefit plan. Although employee welfare

41. ERISA § 4(b).

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benefit plans and excess benefit plans are exempt from Part 2, pension plans must comply. For Part 2 to be applicable, the plan must be an employee benefit plan under ERISA Section 3(3), the employee benefit plan must be subject to Title I, and the plan must not fall under any of the exemptions from Part 2 available under Treasury Regulations Section 2530.201-2.

With respect to participation, if Part 2 is applicable, an employee must be entitled to participate on the later of the date the employee attains age 21 or completes one year of service.[42] If an employee is entitled to 100 percent vesting after two years, completion of two years of service can be substituted for the single-year service requirement.[43] A year of service is defined as a 12-month period in which the employee has at least 1,000 hours of service. The computation of the 12-month period is made with reference to the day on which the employee commenced employment, or the first day of the plan year for an employee who does not complete 1,000 hours of service during the first 12-month period of employment.[44]

Vesting is directly related to an employee's length of service with the employer. Every pension plan must provide that an employee's right to his or her normal retirement benefit is nonforfeitable on the attainment of retirement age. In addition, the plan must provide that an employee's own contributions are nonforfeitable (100 percent vested) and that employer contributions comply with the vesting schedules prescribed under ERISA Section 203(a)(2).

In general terms, a plan satisfies ERISA's vesting requirements if employees who have at least five years of service have a nonforfeitable right to 100 percent of their accrued benefit derived from employer contributions. As an alternative, employees' nonforfeitable right to benefits can be accrued using the following chart:

| *Service Years* | *Vested Percentage* |
|---|---|
| 3 | 20 percent |
| 4 | 40 percent |
| 5 | 60 percent |
| 6 | 80 percent |
| 7 | 100 percent |

If the employer desires, a less-stringent vesting schedule can be used. The plan can designate any 12-consecutive-month period as the

42. ERISA § 202(a)(1)(B)(i).
43. ERISA § 202(a)(1)(A).
44. ERISA § 202(a)(3)(A).

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vesting computation period as long as the period applies equally to all participants and the period chosen does not artificially postpone the vesting of benefits.[45] The definition of a "year of service" is the same as for participation purposes.

ERISA requires minimum funding standards to ensure that the funds needed to pay the promised benefits will be available when required. Certain types of plans are exempted from the minimum funding standards: welfare plans, top-hat plans, voluntary deferral plans, insurance contract plans, excess benefit plans, profit sharing plans, and stock bonus plans. The minimum funding standards apply to any type of defined benefit plan (including supplemental executive retirement plans (SERPs) that use a defined benefit formula) and money purchase pension plans.

If funding is required, an actuarial funding method must be used to determine the minimum funding standard each year. All normal plan costs, accrued liability, past service liabilities, and experience gains and losses must be calculated under the funding method used to determine the costs under the plan.[46] All costs, liabilities, rates of interest, and other factors must also be determined on the basis of reasonable actuarial assumptions and methods.[47] The value of the plan's assets may be based on any reasonable actuarial method of valuation that is permitted under the Treasury regulations. The plan document does not have to specify the actuarial assumptions to be used to determine the funding method; however, even if the method is specified in the plan, this does not mean that the method is reasonable or acceptable.

Title 1, Part 4, contains provisions concerning the establishment of a plan document, the establishment of a trust, fiduciary duties, and prohibited transactions. Unfunded plans maintained primarily for providing deferred compensation for a select group of management or highly compensated employees are exempt from Part 4.[48]

## NONQUALIFIED DEFERRED COMPENSATION AND ERISA

"O thou invisible spirit of wine, if thou has no name to be known by, let us call thee devil!"

William Shakespeare, *Othello* (Act II, Scene 3)

45. DOL Reg § 2530.203-2(a).
46. ERISA § 302(c)(1).
47. ERISA § 302 (c)(3).
48. ERISA § 401(a)(1).

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As mentioned previously, some of the primary advantages of a nonqualified deferred compensation plan are the pre-tax deferral of funds by highly compensated executives, selective participation and vesting, and minimal compliance with the provisions of ERISA. Unless the plan is properly structured to avoid ERISA compliance, many or all of the benefits of a nonqualified plan can be lost. This discussion addresses the issue of ERISA compliance for deferred compensation plans and explains how plans can be structured so that compliance with most of the provisions of Title I can be avoided.

The requisite level of ERISA compliance varies with the type of employee benefit plan. Pension plans require greater conformity than welfare plans. Thus it is important to establish the category of employee benefit plan to determine what provisions of ERISA might apply.

ERISA defines a pension plan as any plan, fund, or program that is established or maintained by an employer that provides retirement income to its employees or results in the deferral of income by employees extending to the termination of covered employment or beyond.[49] Consequently, voluntary deferral plans and SERPs are treated as pension plans for ERISA purposes. If the plan is designed in a manner whereby the principal effect is the evasion of the standards or purposes of ERISA applicable to pension plans, the payment or arrangement will be treated as a pension plan.[50] Therefore, any attempt to disguise a pension plan as a welfare plan will cause the plan to be treated as a pension plan for ERISA purposes.

An employee benefit plan that is considered "unfunded and maintained by an employer primarily for the purpose of providing deferred compensation to a select group of management or highly compensated employees" (top-hat plan) is exempt from Parts 2, 3, and 4 of Title I.[51]

The enforcement and reporting and disclosure requirements do apply to these top-hat plans. Under the enforcement provisions, a top-hat plan must comply with ERISA's claims review procedures and provide participants with access to the federal courts to pursue a claim for benefits. The reporting and disclosure requirements that apply are simplified. The employer need only file a letter with the DOL setting forth its name, address, and tax employer identification number; the number of top-hat plans it maintains; and the number of employees in each plan.[52]

An excess benefit plan provides benefits that cannot be provided through a qualified plan solely because of the Code Section 415 limits on

49. ERISA § 3(2)(A).
50. ERISA § 3(2)(B).
51. ERISA §§ 201(2), 301(a)(3), 401(a)(1).
52. DOL Reg § 2510.104-23.

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benefits and contributions. If it is unfunded, an excess benefit plan is completely exempt from Title I of ERISA. If it is funded, it is subject to Title I's reporting and disclosure, fiduciary responsibility, and enforcement provisions.

A supplemental retirement plan that provides benefits a qualified plan cannot provide for reasons other than the Section 415 limitations—including the limit on compensation under Section 401(a)(17) and the dollar limit on elective deferrals under Section 402(g)—would not fall within the excess benefit plan exemption. Such a plan might be considered a top-hat plan, however.

Assume that an employer designs and implements what the DOL or a court concludes is really a pension plan and further, that it is not a top-hat plan. What are the ERISA risks? Although the employer may have violated a number of ERISA rules, three issues may involve significant penalties. First, the plan will be considered a "funded pension plan" and the employer must comply with the rules of Title I of ERISA governing reporting and disclosure, participation, vesting, funding, and fiduciary responsibilities.[53] Second, compliance with ERISA's vesting, funding, and trust requirements results in accelerated, current tax consequences to executives.[54] Finally, the joint and survivor (including the involuntary cashout) rules impose a cash outlay on the employer.[55]

It is not much of a stretch to find that funded status not only creates accelerated tax recognition for executives but also creates funding problems for the employer. ERISA sets forth the minimum funding standards, which would be applied separately to fund the benefits of those employees who elect to participate in a nonqualified plan.[56] The basic requirement for a defined benefit plan is to amortize over 30 years the unfunded liabilities for past service benefits arising from a new plan.[57] If a plan has no accumulated assets, this requirement is overridden by the deficit reduction contribution, which calls for immediate funding of 30 percent of the unfunded liabilities for remaining past service benefits.[58]

It is normally not possible for a nonqualified plan to meet the minimum funding requirements merely by paying current participant benefits through a dry trust, unless the benefits consist almost entirely of immediate lump sums.[59] The employer must also make quarterly contri-

53. Towers Perrin, *Handbook of Executive Benefits* (McGraw-Hill, New York, 1995) at 50.
54. Code §§ 61, 83, 451.
55. ERISA § 205.
56. ERISA § 302(b)(2)(B)(ii).
57. ERISA § 302.
58. ERISA § 302(d)(4).
59. Towers Perrin, *op cit* at 49.

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butions to meet the minimum funding requirement.[60] Although the funding requirements are not nearly as stringent for voluntary deferral plans, they too must nevertheless be complied with, and it is interesting to note that under Title I of ERISA, nonqualified pension plans are subject to accrual rules identical to those found in Code Sections 411(b) and 411(d).

Finally, on the fiduciary front, a funded nonqualified plan has assets that must be held in trust.[61] Because plan assets must be held for the exclusive benefit of participants,[62] a grantor or rabbi trust (i.e., a trust that is not considered a separate entity for federal income tax purposes) cannot be used, although a secular trust satisfies this requirement.[63] Failure to maintain a trust or to meet the minimum funding requirements may result in prohibited transactions, because such failures amount to an indirect extension of credit to the employer from the plan or use of plan assets by the employer.[64] Further, breaches of general fiduciary duty could result.[65]

## SELF-DIRECTED INVESTMENTS AND NONQUALIFIED DEFERRED COMPENSATION

"With devotion's visage and pious action we do sugar o'er the devil himself!"

William Shakespeare, *Hamlet* (Act III, Scene 1)

Deferred compensation plans for a select group of management or highly compensated employees almost universally credit the deferred account balance with some sort of investment return, usually interest.[66] This crediting rate may be fixed in advance, but sometimes it is a floating rate in plans in which the deferral period is expected to be long. The crediting rate can be tied to such external indexes as the prime rate of a named bank, the employer's cost of borrowing, rates on various Treasury securities, or the rate credited under a corporate-owned life insurance policy maintained in connection with the plan.[67]

60. ERISA § 302(e).
61. ERISA § 403.
62. ERISA § 403(c)(1).
63. *See* Ltr Ruls 8841023, 8843021; Code §§ 674-677.
64. ERISA § 406(a)(1)(B) and (D).
65. ERISA § 404(a).
66. *Supra* n53, at 36, 74.
67. Id at 36.

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More recently, deferred compensation plans credit account balances with gains or losses on a hypothetical investment in, for example, employer stock or a designated mutual fund. Regardless of the investment, the employer pays the deferred compensation. Thus, the company might want to consider hedging its risk when it offers hypothetical mutual funds by purchasing shares of the mutual fund as a corporate investment. Note, however, that mutual fund dividends credited to employer sales of mutual fund shares generate a tax liability for the employer.

In early opinions and rulings, the IRS determined that involvement in the investment process by a participant could cause benefits to be currently taxable; however, subsequent opinions and rulings have indicated that such involvement is acceptable as long as the trustee of a rabbi trust is not obligated to offer investment options that are participant-requested.[68]

The seminal ruling on participant-directed investments in a nonqualified deferred compensation plan is General Counsel Memorandum (GCM) 36998, which was released in February 1977. Although rejecting recognition of income to the executive under the constructive receipt and economic benefit doctrines, the IRS found that income inclusion was required because of the exercise of "dominion and control" by the executive regarding direction of the investments. The key in the analysis, according to the IRS, was the "degree" of dominion and control exercised by the executive over his or her compensation. Under the GCM, dominion and control (directing investments) was substantial enough to give rise to taxation and the compensation is taxable in the year it was deferred.[69]

The dominion and control theory has not, however, been advanced in subsequent rulings and opinions regarding the investment of assets in connection with a nonqualified deferred compensation plan. In fact, just the opposite has occurred. Subsequent rulings have relied on analysis of the constructive receipt doctrine and the economic benefit doctrine, creating a de facto negation of the viability of GCM 36998.

By way of summation, rulings subsequent to GCM 36998 have held that the investment of assets by the employer at the direction of the employee does not result in current taxation. The manner of selection of investments under these IRS rulings has varied. In some cases, the employer set aside funds and the executive was permitted by the plan or trust to suggest the manner of investing the assets but the employer or

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68. Bruce McNeil, *Nonqualified Deferred Compensation Plans* (West, 2000) at 240.
69. Id at 240–42.

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trustee was not required to follow the advice. In other rulings, funds were invested by a fiduciary in the type of asset requested or selected by the participant.[70] In fact, it can be considered well-settled by IRS rulings that investment in hypothetical accounts does not give rise to current taxation to the executive participant, but this is not the real issue.

The issue that most often presents the thorniest design obstacle is the funding requirements and limitations of a nonqualified plan versus a qualified plan. Pursuant to Code Section 401(a), tax-qualified arrangements are required to escrow all executive and employer contributions for the benefit of each participant to claim both the tax deferral advantages for the plan participant and the tax deduction for the employer.[71] In contrast, to obtain current income tax deferral for participants in a nonqualified plan, contributions to the plan cannot be escrowed or trusteed for the exclusive benefit of the participant. Therefore, the legal design of a nonqualified deferred compensation plan is the opposite of a qualified retirement plan.

ERISA issues hidden in these funding differences are constantly overlooked and hence not in the mainstream of the current debate. As stated earlier, the tax issues related to constructive receipt and economic benefit appear to be well-settled. It is the ERISA issues that are often overlooked and that can give rise to administrative nightmares if not addressed.

Prior to the enactment of ERISA, a single funding issue had an impact on plan design and structure—the income tax issue. Although there were numerous transition rules, ERISA became effective in 1975 for new plans. Prior to 1975, the tax issue was the primary consideration in obtaining a current income tax deduction for contributions to pension plans. ERISA was primarily focused on the issue of the funding of plans seeking to claim the tax-advantaged status of "qualified." Prior to the enactment of ERISA, many retirement plans were unfunded or substantially underfunded.

ERISA's enactment posed two issues. For a nonqualified deferred compensation plan to claim the safe harbor from the full gamut of ERISA's burdensome reporting and disclosure requirements, it must not only be limited to the so-called top-hat select group but must also be unfunded.[72] The ERISA "unfunded" requirement is significant because it was initially presumed to be the same as the IRS's economic benefit doctrine but has proved to be broader and more elusive.[73] It may rightly be

70. Id at 244–50.
71. Code §§ 401-417.
72. *See* ERISA §§ 4(b)(5), 201(2), 301(a)(3), 401(a)(1); DOL Reg § 2520.104-23.
73. Id.

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assumed from the taxation discussion above that the courts rarely distinguish clearly between the concepts of constructive receipt and economic benefit in written opinions. Likewise, the finding of an ascertainable economic benefit typically brings with it a constructive taxable receipt of income. Thoughtful scrutiny of ERISA, therefore, requires that the issue of funding (segregating assets) be considered in tandem with whether there is an economic benefit on the tax side.

From the tax perspective, a nonqualified benefit can be nothing more than an "unsecured promise to pay" on the part of the employer, a contractual obligation, if you will. As long as the benefit promised and any assets earmarked to ensure its payment are subject to a risk of loss to the employer's general creditors, there will be no constructive receipt or economic benefit and taxation will occur when the benefit is actually or constructively received. As an unsecured promise to pay, any investment choices permitted by the nonqualified plan document for the investment of deferral contributions must therefore be hypothetical, notional, or deemed.

The DOL has never defined the term "unfunded" as used in ERISA exemptions and regulations, although it has started, partially completed, and restarted the effort over the years.[74] It has become clear that the ERISA definition of unfunded is not necessarily the same as the IRS's definition of the economic benefit concept. Whether or not a plan is "unfunded" for tax purposes, "unfunded" may also include the ERISA concept of participant "beneficial ownership interest" generated by the administration, and operation of the plan itself.[75] Dealing with IRS and DOL pronouncements and cases means that attorneys and consultants must carefully design plans to find the path of least resistance on two fronts—the IRS and ERISA—to ensure both the desired income tax deferral and ERISA exemption.

The problem is that a nonqualified deferred compensation plan may become funded for ERISA purposes as a direct result of the actual plan design and operation, regardless of the language in the plan document. If the nonqualified arrangement is determined to be ERISA-funded in that the plan itself provides an executive with a real or beneficial interest in a specific investment, account, or property, the executive becomes currently liable for income tax purposes.[76] In any given instance, if executives participating in a nonqualified deferred compensation plan have a

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74. *See* DOL Reg § 2550.401b-1; DOL Adv Op 91-16A, 94-31A.

75. Dependahl v Falstaff Brewing Corp, 491 FSupp 1188 (ED Mo 1980); DOL Adv Op 81-11A (Jan 16, 1981). *See also* Belka v Rowe Furniture Corp, 571 FSupp 1249 (D Md 1983); Belsky v First National Life Ins Co, 818 F2d 661 (8th Cir 1987).

76. Frost v Commissioner, 52 TC 89 (1969); *Goldsmith*, *supra*, n23.

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real or beneficial interest in an investment fund, pool, portfolio, or separate account, the plan benefits should be deemed sufficiently escrowed, segregated, and secured for income tax purposes to be taxable under the economic benefit doctrine.

This author suggests that in theory, the ERISA beneficial interest concept should parallel the income tax law economic benefit, Section 83 beneficial ownership concept.[77] In practice, the executive's interest in the property will become taxable if substantial economic benefit, i.e., beneficial ownership, is conferred even though the executive may not possess legal title to the interest. The simple point is this—it is not clear that a plan must cease to be an unsecured promise to pay to be deemed a funded plan for ERISA purposes.[78]

Naturally, the starting point to avoid creating a funded plan under ERISA is a well-drafted plan document. Proper plan drafting also extends to the ownership and beneficiary provisions of any investment vehicles or property in which the employer invests to support the liabilities created under the plan. Lack of attention to proper drafting might result in an executive receiving a real interest and not just a beneficial interest in property acquired in connection with the plan. The plan document, however, is not the only concern.

The more troubling issue is that a plan may become funded for ERISA purposes through its administration and operation. Such a result could occur when the employer suggests or implies to an executive in plan communications that he or she has a beneficial interest in specific property that is not subject to the general creditors of the business enterprise instead of merely having an unsecured promise to pay.

Specifically, plan administration and day-to-day operations can potentially create an ERISA funded plan in the following scenarios:

- When periodic plan communications such as annual reports suggest a property interest in the supporting investment vehicles;
- When executives change investments in virtually the same manner as applicable to a 401(k) plan; and
- When the employer does not disclaim the executive's property interest in supporting investments.

The ability of executive participants to act directly on investment accounts apparently runs counter to the IRS regardless of the ERISA impact. An IRS official has resurrected the dominion and control verbiage, especially in situations in which participant direction is permitted

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77. *See Dependahl, supra*, n75; Miller v Heller, 915 FSupp 651 (SDNY).
78. *Miller, supra* n77.

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with respect to investment vehicles inside a rabbi trust.[79] Whether a nonqualified arrangement is funded for ERISA purposes necessarily comes down to a facts-and-circumstances test[80]—has a beneficial ownership interest been created (something more than an unsecured interest) from a composite of plan document language, disclaimers (or lack thereof), plan communications, and day-to-day operations?

## THE RISK PIPELINE

"And when he falls, he falls like Lucifer, never to hope again."

William Shakespeare, *King Henry VIII* (Act III, Scene 2)

It goes without saying that some nonqualified arrangements that permit a form of participant-directed investment are more at risk than others. Which are which? Along the risk pipeline, the types of nonqualified plans with a self-directed investment feature that are the most at risk, in the view of this commentator, are "fund of funds" or "401(k) bookkeeping" plans. Under a fund of funds design, executive participants have the right to contact the account manager and make direct changes to their own individual accounts. In essence, there is no hypothetical account (as was waxed so elegantly in the private letter rulings discussed above; see, McNeil, footnote 68 et al) at all and the plan operates for a participant virtually like a 401(k) plan. The nonqualified fund representing the participant's account is in fact the funds used by the employer to satisfy plan benefits, hence fund of funds.

The risk becomes dicey if the investment fund manager for the plan administrator provides the identical fund reporting to a plan that it would to a nonqualified plan investment fund client. The risk becomes riskier if the investment fund manager for a nonqualified deferred compensation plan fails to provide consolidated or aggregate reports of plan accounts and liabilities to the plan sponsor. The riskiest fund of funds approach is a nonqualified deferred compensation plan in which the employer/sponsor provides, absent disclaimers, the same prospectuses to executive participants that it provides to its 401(k) or other qualified retirement plan participants.

79. T Brisendine, "Selection of Investment Options Under Nonqualified Plans—Is There a Problem?" *Benefits LJ* Spring 1998, 81.
80. Id.

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Insurance companies, brokerage firms, and mutual fund companies that adopt a prototype or cookie-cutter design for nonqualified deferred compensation plans are the most likely to take the riskiest fund of funds approach. This is because many large vendors handle the nonqualified side of the ledger exactly like they handle the qualified side. Communication and enrollment materials that constantly use the phrase "for the benefit of" are dead giveaways to a nonqualified arrangement that is funded for ERISA purposes.

If a nonqualified deferred compensation plan operates in direct contradiction to the plan's contractual language, there is a significant risk that the plan may be considered funded for ERISA purposes notwithstanding the exculpatory language in the document. That said, it may be necessary for a fund of funds nonqualified plan to add clear statements in the plan document and any plan summary, to wit:

> Participant's ability to directly and actually make changes to his or her own individual investment account is not a suggestion that he or she has any beneficial ownership interest in the individual investment account.

The least risky nonqualified deferred compensation plans in terms of running afoul of ERISA's funding strictures are those arrangements that are both drafted conservatively and have bookkeeping accounts that are truly hypothetical. Under such arrangements, there is a separate and distinct set of real investment funds and a separate accounting system for the investments that is independent of the executive participant's hypothetical account. This design sharply contrasts with the fund of funds approach in that in a true hypothetical arrangement, the tracking of the plan's general assets can be set up independently of the executive participant's account. Going further, executive participants may be allowed under a hypothetical account to change their allocations daily, but the employer/plan sponsor might normally adjust its plan investments monthly or quarterly.

Taking the differences in types of plans even further, any changes an executive participant makes in an account are reflected in changes in a hypothetical crediting index. No automatic change is made in the actual underlying investments, which is what makes the fund of funds approach so risky. The hypothetical approach even further minimizes the risk of being considered funded under ERISA because the employer/plan sponsor's funding is done on an aggregate basis rather than on an executive account by executive account basis. Therefore, a hypothetical self-directed plan in actual operation clarifies the distinctness and separateness of the plan and financing arrangement and, in fact, supports the contractual language of the nonqualified plan document.

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