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ENRON: JOINT COMMITTEE ON TAXATION INVESTIGATIVE REPORT ON COMPENSATION-RELATED ISSUES

HEARING

BEFORE THE

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ENRON: JOINT COMMITTEE ON TAXATION INVESTIGATIVE REPORT ON COMPENSATION-RELATED ISSUES

TUESDAY, APRIL 8, 2003

U.S. SENATE,
COMMITTEE ON FINANCE,
Washington, DC.

The hearing was convened, pursuant to notice, at 10:06 a.m., in room 215, Dirksen Senate Office Building, Hon. Charles E. Grassley (chairman of the committee) presiding.

Also present: Senators Baucus, Breaux and Lincoln.

OPENING STATEMENT OF HON. CHARLES E. GRASSLEY, A U.S. SENATOR FROM IOWA, CHAIRMAN, COMMITTEE ON FINANCE

The CHAIRMAN. I am going to go ahead and start the hearing. Normally, I do not, without a member of the Democrat party being here as well, because that is the tradition of our committee, to do everything in a very bipartisan way. But I have had the permission of Senator Baucus to move ahead, and I want to do that.

So, it gives me an opportunity to thank all of you for being patient. It gives me an opportunity to thank all of you for coming on a very important hearing. This is a hearing is in a series of hearings on executive and deferred compensation, and particularly as it is related to the Enron investigation.

We did have a hearing about a month ago in February, when the Joint Committee on Taxation released a study involving Enron corporate tax forms. We then had Staff Director Lindy Paull, who now has left the Joint Committee on Taxation, report findings on both the general manipulation of the tax system and also on nonqualified deferred compensation.

Last year on April 18, Senator Baucus held a hearing on stock options and nonqualified deferred compensation. At that hearing, I said that I am not bothered by the existence of executive or deferred compensation arrangements.

If an executive wants to make what is essentially an unsecured loan to his or her company by not taking all of their compensation in cash, and the money is completely at risk, my advice was, well, go ahead. That money is not taken into account by the executive and the wages are not deductible by the company. Under those arrangements, it is a wash.

If an executive works hard and does well, there is no reason to not let them have what they want to defer some compensation. But if I can stop here, I want to make an observation.

No one is complaining about the athlete who gets huge amounts of pay in endorsement contracts, nor is anyone complaining about how much money movie stars make, nor is anyone here complaining about how much money rock stars make and can defer from their compensation.

The answer is that is, no, no one is fussing about the entertainment set. This hearing is just about executives who abuse discretionary authority. I do not care about the existence of executive compensation so long as it is all transparent, honest, and ethical. What bothers me, are abuses of the system. That extends to any abuses of nonqualified deferred compensation.

Congress provides significant tax benefits for qualified retirement plans. To control the revenue loss, Congress has placed severe limits on the deferrals and benefits of highly compensated employees. Those limits on qualified plan benefits place pressure on employers to supplement the benefits for executives.

In 2001, Congress even raised the limits for qualified plans, but we raised them very modestly. Those increases in the limits for qualified plans are attractive for a majority of workers, but they were simply not geared for executives, directors, and officers.

It was very difficult for Congress to agree on the modest increases we made to retirement plan limits in 2001. Because of the difficulty in reaching that agreement, I do not believe that we would ever consider the levels of changes necessary to make qualified plan limits attractive to executives for all of their pay. We are simply not going to do that.

So, executive compensation arrangements continue to exist. Last year, this committee added language to the Chairman's mark, to S. 1971, to first of all repeal the moratorium on Treasury's ability to promulgate regulations on deferred compensation arrangements, next, to prohibit offshore rabbi trusts, next, tax executives at the top rate on bonuses of $1 million or more, and last, limitations on loans to executives.

Except for the last item, which was made moot later by the Sarbanes-Oxley Act, all these provisions will be in any pension bill considered by the committee.

Last year, I also introduced the Corporate Accountability in Bankruptcy Act. My bill was drafted to clarify that the bonuses and other excessive compensation of corporate directors and wrongdoers can be pulled back into the estate of a bankrupt firm.

Corporate wrongdoers who have violated securities and accounting laws should not be able to make off with outrageous sums of money from bankrupt companies. Why should they profit when shareholders, creditors, and employees are left to finance the company's debts?

Moreover, corporate officers and executives should not be permitted to keep large bonuses when a company has performed so poorly that it is then forced into bankruptcy.

Frankly, I do not understood why Enron's bankruptcy judge has not demanded the return of $53 million in deferred compensation that was removed near the end of Enron's existence. Under current law, that money should all be returned to the estate of Enron.

Just to make that clear, however, I will be re-introducing my bankruptcy legislation and hopefully get speedy enactment.

Let me conclude by saying that I am greatly troubled by the facts in this Enron case. I hope we can learn from what happened. My view is that a great many of the failures at Enron were failures of corporate governance.

Literally, no one was managing, supervising, or exercising oversight over that organization, and it has been a horrible scandal that has ruined the lives of many innocent people.

I have many other comments and observations about Enron, corporate governance, executive compensation, and bankruptcy rules. I will leave them for another time.

Since Senator Baucus is not here, and since the Senator from Louisiana might have something to say, I would be glad to let you have opening comments.

OPENING STATEMENT OF HON. JOHN BREAUX, A U.S. SENATOR FROM LOUISIANA

Senator BREAUX. Thank you very much, Mr. Chairman. Thank you for having the hearing. I think that the original report that we got on Enron was received on the same day that we had the hearing, so it was really impossible to understand anything in the report, which was very extensive.

I think it is appropriate that we now have this opportunity to further learn from what really was a national tragedy from a business perspective. If we do not learn from the mistakes that are out there, then shame on us.

We should use this as an example of trying to make sure that whatever allowed the debacle to occur is corrected, is fixed, is addressed. I think this hearing will be an opportunity for us to learn more about what we need to be doing, and I thank you for having it.

The CHAIRMAN. Thank you, Senator Breaux.

It is now my privilege to introduce everybody on the panel all at once. We will hear from the panel before we have questions. We have Mary M. Schmitt, Acting Chief of Staff, in other words, acting in place of Lindy Paull, where she was at one time while the new director takes over, from the Joint Committee on Taxation. She has been a long-time, very able executive of that committee.

We have Pamela Olson, Assistant Secretary, Tax Policy, Department of Treasury. We have Charles Essick, Principal, Towers Perrin, in Houston, Texas; Professor Kennedy, John Marshall Law School, Chicago; and Bruce J. McNeil, Partner, Dorsey & Whitney, Minneapolis, Minnesota.

I would like to also announce that I am going to leave the record open for 1 week. Also, I will announce, so you will not have to ask permission, each of the witnesses, that your statement as a whole will be put in the record as submitted, and then we have asked you to summarize.

Because Ms. Schmitt is reporting on the report of the committee, we have given her more time. She will have 15 minutes. It is my understanding that the rest have been advised of the usual practice of the Senate to have five minutes of summary before we have questions.

Also, let me announce that members who are not here, as well as members who may come, we do not all get to ask all of our ques-

tions orally, so you might get questions for answer in writing from you. So, I would appreciate those answers in about a 2-week period of time.

We will start with Ms. Schmitt.

STATEMENT OF MARY M. SCHMITT, ACTING CHIEF OF STAFF, JOINT COMMITTEE ON TAXATION, WASHINGTON, DC

Ms. SCHMITT. Thank you, Mr. Chairman and Senator Breaux. I am happy to present today the testimony of the staff of the Joint Committee on Taxation with respect to the executive compensation and company-owned life insurance arrangements of Enron Corp and its related entities.

The Joint Committee staff presented an official report with respect to Enron to this committee on February 13 of this year. The report contains detailed information about Enron's compensation practices in general, and executive compensation and company-owned life insurance, in particular.

Prior to bankruptcy, executive compensation at Enron was generally comprised of base salary, annual incentives, and long-term incentives. Approximately 400 executives participated in nonqualified deferred compensation arrangements, and a select few executives had other, special compensation arrangements.

Enron's compensation costs for all executives increased significantly over the years immediately preceding its bankruptcy. In the year 2000, total compensation for the 200 highest paid employees of Enron was $1.4 billion, an average of $7 million per employee.

This consisted of $57 million of bonuses, $1.1 billion attributable to stock options, $132 million attributable to restricted stock, and $173 million of base salary and other income. As these numbers show, incentive compensation was a significant element of Enron's executive compensation arrangements.

Notable features of Enron's executive compensation structure included the following: nonqualified deferred compensation was a major component of executive compensation at Enron. Participants were eligible to defer all, or a portion of, salary, bonus, and long-term compensation into Enron-sponsored deferral plans.

Under the deferral plans, participants could defer up to 35 percent of base salary, 100 percent of annual bonus payments, and 100 percent of select long-term incentive payments. Over $150 million in compensation was deferred by the 200 highest paid employees for the years 1998 through 2001.

In late 2001, in the weeks prior to Enron's bankruptcy filing, early distributions totaling more than $53 million were made to 127 executives from two of Enron's nonqualified deferred compensation arrangements.

Enron used stock-based compensation as a principal form of compensation for executives. Enron's stock-based compensation program included nonqualified stock options, restricted stock, and phantom stock.

Enron's deduction for compensation attributable to the exercise of nonqualified stock options increased by more than 1,000 percent from 1998 to 2000.

In the weeks immediately preceding Enron's bankruptcy, the company implemented two special bonus programs, one for approxi-

mately 60 key traders, and one for approximately 500 employees who Enron claimed were critical for maintaining and operating Enron on a going forward basis. The combined cost of this program was $105 million.

Enron had certain special compensation arrangements for limited groups of people or for specific individuals. One executive received the use of a fractional interest in a jet aircraft as part of his compensation arrangement. A very limited number of employees received loans or lines of credit from Enron, or split dollar life insurance arrangements.

Enron purchased two annuity contracts from Mr. Kenneth Lay and his wife as part of a compensation agreement for 2001. Enron also had a project participation plan for employees in its international business unit under which they would receive participation interests in certain international projects.

The Joint Committee's staff's written testimony addresses in more detail some of these executive compensation arrangements. However, I would like to focus my oral testimony on two of the specific issues for which our staff has made legislative recommendations: nonqualified deferred compensation and company-owned life insurance.

Nonqualified deferred compensation is a common form of compensation for executives. In contrast to tax-qualified retirement plans, nonqualified deferred compensation arrangements are subject to few restrictions. They are attractive to employees because they offer the ability to defer the payment of Federal income and employment tax on unlimited amounts of compensation.

Under a nonqualified deferred compensation arrangement, the employer is not entitled to a deduction until the employee includes the compensation in income. Thus, in theory, there is a tension between the interest of the employer to receive a current deduction and the interest of the employee to defer tax on his or her compensation.

In practice, in many cases this tension is illusory and does little to impact the amount of compensation that is deferred. In Enron's case, the possibility of a foregone deduction appeared to have little, if any, effect on the amount of deferred compensation it was willing to provide.

Over time, arrangements have developed to provide employees with greater security for nonqualified deferred compensation and greater control over the amounts deferred, while still providing the desired deferral of tax.

Many of these practices, when viewed in isolation, may appear to be within the limits of present law. However, when these features are viewed in their entirety, they appear to provide executives with an excessive level of security and control.

The development of questionable and aggressive practices regarding nonqualified deferred compensation is, in our view, at least in part, due to a moratorium on Treasury guidance that was included in Section 132 of the Revenue Act of 1978. Because of this, the Treasury Department has been restricted in issuing new deferred compensation guidance for over 25 years.

In the process of reviewing Enron's deferred compensation arrangements, the Joint Committee staff identified a variety of fea-

tures that allowed the Enron executives to maintain security and control over the amounts they deferred.

These features included the following. Participants who would normally receive distributions of deferred compensation upon retirement, death, disability, or termination of employment could request the distributions be paid earlier, subject to a forfeiture of 10 percent of the amount distributed. This acceleration feature was used by Enron to distribute $53 million to 127 employees in the weeks immediately prior to the bankruptcy.

Participants could choose to have their deferrals treated as if they had been invested in specific investment accounts. In 2001, participants could allocate deferrals among 17 investment choices that mirrored funds available in the Enron Corp Savings Plan.

Participants could make subsequent elections with respect to the form and timing of the payout of their deferred compensation. Enron established an irrevocable rabbi trust and purchased 100 trust-owned life insurance policies on the lives of 100 participants in one of its deferral plans. This rabbi trust was intended to provide security to Enron's executives for at least a portion of their nonqualified deferred compensation.

Finally, Enron's deferral plans allowed for a second deferral of income attributable to stock options and restricted stock to a time later than they normally would have been taxed.

The Joint Committee staff believes that, at a minimum, specific rules should be provided to limit the type of features that can be included in nonqualified deferred compensation arrangements.

Current income inclusions should be required in the case of plan features that give taxpayers effective control over the amounts deferred, such as provisions that allow accelerated distributions, participant-directed investment, or subsequent elections.

We also believe that consideration should be given to whether additional restrictions should be placed on the use of rabbi trusts to fund nonqualified deferred compensation. In addition, we believe that the use of programs such as Enron's deferral of stock option gains and restricted stock deferral programs should not be allowed.

Annual reporting of deferred compensation amounts should be required to provide the IRS with greater information regarding such arrangements.

Finally, the ability of the Treasury Department to issue guidance on deferred compensation should not be restricted. Thus, we recommend the repeal of Section 132 of the Revenue Act of 1978. The existence of the moratorium on Treasury guidance puts Treasury at a disadvantage in responding to forms of deferred compensation not contemplated prior to 1978. This has a chilling effect on the ability of Treasury to enforce the law in a consistent and effective manner.

I will turn, briefly, to a discussion of company-owned and trust-owned life insurance, otherwise referred to as COLI. During the 1980's and early 1990's, Enron bought approximately 1,000 life insurance contracts covering employees. Over $178 million had been borrowed under these life insurance contracts by the end of 1994.

Half of Enron's life insurance contracts were purchased prior to June 20, 1986, which was the effective date of the 1986 Act legisla-

tion limiting the tax deduction for interest on debt under a life insurance contract.

By late 2001, the amount borrowed under Enron's life insurance contracts had grown to $432 million out of $512 million of life insurance coverage. Enron was able to utilize significant amount of borrowing under its COLI policies because it qualified for the grandfather rule under the COLI legislation that was part of the 1986 Act.

This grandfather rule continues in effect, allowing the continued deduction of interest on debt under contracts that were purchased on or before June 20, 1986. As years pass from the 1986 date, the value of this tax benefit increases with the growth of the cash surrender value of these contracts.

The Joint Committee staff recommends termination of the grandfather rule for pre-June 20, 1986 life insurance contracts. Even though Enron did not purchase any additional life insurance contracts after 1994, Enron's debt and deductible interest under its contracts continued to increase throughout the 1990's, along with the cash surrender value of the contracts.

If the 1986 grandfather rule was intended to provide transition relief to businesses that have purchased life insurance contracts before the 1986 date, sufficient time has passed that a redeployment of such business' assets could have been possible. The grandfather rule can no longer serve any reasonable need for transition relief.

Finally, I would like to note that this committee included some executive compensation provisions in the National Employee Savings and Trust Equity Guarantee Act, or NESTEG, last year.

Two NESTEG provisions specifically address nonqualified deferred compensation arrangements. The Joint Committee staff recommendation to repeal Section 132 of the Revenue Act of 1978 was included in Section 501 of the bill. In addition, Section 502 of the bill provided current taxation of deferred compensation provided through offshore trusts.

In addition to the executive compensation provisions included in NESTEG, additional steps beyond those contained in that bill should be taken to provide rational rules for determining when deferred compensation is includable in income.

This concludes my oral testimony. I would be happy to respond to any questions.

The CHAIRMAN. Thank you.

[The prepared statement of Ms. Schmitt appears in the appendix.]

The CHAIRMAN. Ms. Olson, can I also remind you that we did not receive your testimony until just this morning, and we would appreciate anybody from the administration that testifies for the administration, it is very important that our rules by abided by for receiving testimony on time.

Thank you. Proceed.

STATEMENT OF PAMELA OLSON, ASSISTANT SECRETARY, TAX POLICY, DEPARTMENT OF THE TREASURY, WASHINGTON, DC

Ms. OLSON. Thank you, Mr. Chairman. I apologize for that. I think we had a glitch somewhere. Too many people thought it had gone, when it had not.

Thank you for the opportunity to appear before you regarding the administration's legislative and regulatory proposals on executive compensation.

The Joint Committee's recent Enron report, prepared at the request of this committee, reveals the company's excessive and questionable executive compensation practices. The findings in the report underscore the importance of this hearing.

The practices of Enron make clear that executive pay is about more than tax policy. It is also about corporate accountability. There are six points I think we should bear in mind as we consider appropriate action.

First, many of Enron's executive compensation issues identified by the Joint Committee's report have been addressed, either by legislation passed by Congress and signed by President Bush last year, or by recently-issued Treasury and IRS regulations. Consequently, many of the issues are issues unlikely to recur in the future.

Second, more is at stake here than tax policy, but the corporate accountability concerns should be addressed directly rather than through the Internal Revenue Code.

On the tax side, Enron's executive pay practices push the envelope of current law. Enron permitted its executives to defer significant amounts of income, while taking measures to insulate them from the risk of non-payment that the law requires as a trade-off for tax deferral.

Outdated rules on executive compensation helped Enron in this effort, rules that the Treasury Department and the IRS have been statutorily prohibited from updating since 1978. Those rules govern when an employee is in constructive receipt of income.

They do not address the appropriate amount of pay, the amount of that pay that may be deferred, or whether the company's practices are consistent with and support the underlying corporate governance rationale for deferred compensation, the continuing investment by the executive in the business that increases his or her stake in the business' success, which you alluded to in your opening statement.

The role of the Treasury Department and the IRS is to interpret and administer the tax rules. In particular, it is to ensure that companies and executives adhere to the two principles underlying the tax rules: limits on control over deferred compensation payouts, the so-called constructive receipt rules, and limits on the protection the company can give the executive against non-payment if the company becomes bankrupt or insolvent, the so-called funding rules.

Enforcing the constructive receipt and funding rules fits within the IRS's role and capabilities. We are not well served by assigning to the IRS the responsibility of enforcing rules intended to protect shareholders' interests. We can—indeed, we must—address deficiencies in the constructive receipt rules through changes to the Internal Revenue Code.

As the Joint Committee's report suggests, however, addressing corporate governance and accountability concerns through changes to the tax law is a hazardous undertaking.

Previous Congressional efforts to limit executive compensation through the tax laws would appear to have failed. The tax penalties enacted to protect shareholders have not halted the conduct. Rather, the shareholders have born the tax penalties.

In addition, those rules actually may have contributed to the problems we see today because of the exceptions they contained for performance-based compensation.

Our conclusion is that corporate accountability and governance concerns should be dealt with directly and not through amendments to the Tax Code.

Third, although the committee may conclude it is appropriate to address some of the tax issues with specific statutory changes, we believe the most effective means of dealing with the concerns is to lift the restrictions on the IRS and Treasury writing regulations. Executive pay practices are fluid.

The time it can take for statutes to be changed makes dealing with these issues through the legislative process less than ideal. As a Washington lawyer observed in a similar context, "these guys have feet. They can walk. Heck, these guys have limousines."

A nimble ability to respond is key. Consequently, we urge you to give the Treasury Department as much flexibility as possible to address issues as they develop. I guarantee you that we will not write regulations like the ones that triggered the statutory prohibition on regulations in 1978.

Fourth, the Joint Committee found that massive stock options realized by Enron's executives were the largest category of executive pay. The exception for performance-based compensation under Section 162(m) which includes stock options, together with current financial accounting standards, may have encouraged Enron's heavy use of stock options for its executives.

It is important to separate Enron's questionable use of options from the important role that stock options can play in other contexts, to reward and incentive employees, particularly in the context of broad-based employee stock option programs in considering how best to address these concerns.

Fifth, the Joint Committee's report highlighted the sheer complexity of Enron's tax-motivated transactions, complexity that made it very difficult for the IRS to identify and understand what the company was attempting. Enron hid the ball, and that is cause for concern. Those concerns would be addressed by the tax shelter legislation proposed by Treasury that this committee has reported out.

Finally, it is important that we exercise caution in responding to Enron's excesses. In my experience, Enron's conduct is not the norm. Consequently, we should not paint with too broad a brush, because sweeping rules intended to prevent and punish conduct like Enron's risk harming others outside our area of concern.

That said, we must ensure that the tax rules apply fairly to all taxpayers. Respect for the system is undermined when certain taxpayers can end-run the rules. In 1978, Congress tied the hands of the Treasury Department and the IRS. We call upon Congress to lift the restrictions on new regulation of executive compensation. Give Treasury and the IRS full authority to address appropriate and inappropriate deferred compensation arrangements.

Thank you for holding this hearing and giving the Treasury Department the opportunity to comment on these critical issues. I would be pleased to answer any questions.

The CHAIRMAN. Thank you, Secretary Olson.

[The prepared statement of Secretary Olson appears in the appendix.]

The CHAIRMAN. I will now call on Mr. Essick.

STATEMENT OF CHARLES E. ESSICK, PRINCIPAL, TOWERS PERRIN, HOUSTON, TEXAS

Mr. ESSICK. Mr. Chairman and members of the committee, I am Chuck Essick, a principal of Towers Perrin. I lead the executive compensation consulting practice in Houston.

Towers Perrin was notified that you would like to ask me questions today relating to executive compensation consulting work performed for Enron Corporation. I am pleased to appear before you to address these questions.

If I may, Mr. Chairman, I would like to take a minute, first, to provide an overview of the firm's executive compensation consulting practice.

Towers Perrin has one of the oldest and largest executive compensation practices in the world. We employ approximately 275 executive compensation professionals in about 40 cities around the world.

Our client base is diverse, consisting of large and small clients, clients in established and emerging industries, and clients in many countries throughout the world. Last year, Towers Perrin's executive compensation consulting practice provided products and services to over 2,000 clients.

Central to Towers Perrin's executive compensation consulting practice generally, and more specifically to the work we performed for Enron, is the data we collect and analyze.

Towers Perrin conducts numerous general industry and industry-specific surveys which generate the data we use. The data we collect relating to compensation practices in U.S. companies is the basis for the Towers Perrin U.S. compensation data bank.

This database contains data on base salary, actual and target bonuses, and long-term incentive award levels. The data is organized into an executive compensation database covering 300 positions and 950 companies, and a middle management professional database covering 500 positions and 750 companies.

Using our databases, Towers Perrin can determine how companies are compensating executives in different industries and different functional areas, and in different sized organizations.

Our clients can use the information and analyses we generate from these databases as a basis to make decisions about base pay, bonuses, and long-term incentives.

Much of our executive compensation work involves conducting competitive compensation analyses for executive positions. Our methodology for these analyses is thorough and well-tested. It was this methodology and the data I described above that we employed in the consulting work we performed for Enron.

Mr. Chairman, we at Towers Perrin support the interest of the committee in executive compensation and I will be happy to answer any questions you have as a committee.

The CHAIRMAN. Thank you, Mr. Essick.

[The prepared statement of Mr. Essick appears in the appendix.]

The CHAIRMAN. Now, Professor Kennedy.

STATEMENT OF PROF. KATHRYN J. KENNEDY, ASSOCIATE PROFESSOR, THE JOHN MARSHALL LAW SCHOOL, CHICAGO, ILLINOIS

Professor KENNEDY. Thank you, Chairman Grassley, for this opportunity. Thank you for holding the hearing.

The purpose of my testimony is two-fold, to comment on some of the Joint Committee's specific recommendations regarding executive compensation plans, and to recommend some legislative solutions to halt abusive practices. Proposed legislation has been attached to my written testimony.

First, regarding the Joint Committee's specific recommendations regarding constructive receipt. The Joint Committee calls for the repeal on the moratorium on the Service's ability to issue constructive receipt rulings.

Repeal, though, alone, is not sufficient. Because case law has not affirmed the Service's prior position, specific legislative guidance is necessary for both the Service and the courts to follow.

Second, the Joint Committee equates a participant's control over investments as control for constructive receipt purposes and, thus, calls for immediate taxation. Such observation misses two important points.

First, constructive receipt rules address the participant's control over the timing of benefits, not control as to their level or earnings. And, since this is a feature used under defined contribution plans, its intent is to shift investment risk to the participant, and it accomplished this result in Enron's situation. Participants who had directed their investment in Enron's stock found their accounts to be utterly worthless by the end of 2001.

Next, the Joint Committee recommends the use of haircut provisions used to accelerate distributions and result in immediate taxation. Certainly, under the constructive receipt rules, imposing a financial penalty that forfeits a percentage of the benefits is forfeiture for these purposes, and we are commonly seeing a 10 percent penalty invoked.

As you commented earlier, in the Enron case it is true, $53 million in withdrawals were exercised during the 2 months prior to bankruptcy. However, other executives were continuing to make ongoing deferrals to the tune of $54 million during that same time period.

This suggests to me that certain insiders privy to Enron's financial health took advantage of the haircut, whereas other executives believed the company to be financially healthy. Thus, I would suggest that haircut provisions be permitted for non-insiders and limited then to insiders.

Next, the committee recommends that the use of subsequent elections to alter existing distribution options be prohibited, and that approach is certainly consistent with the Service's position.

However, it is contrary to case law, which does permit certain flexibility. Given that these plans involve long periods of deferral, subsequent elections do not have to be totally eliminated.

However, to fortify the bankruptcy rules, I recommend that subsequent elections be made at least 12 months in advance for non-insiders, and perhaps a longer period of time for insiders.

Next, turning to the economic benefit theory that the Joint Committee addressed. It addressed the issue of rabbi trusts to be used as security arrangements for the underlying executive deferred compensation.

The Joint Committee presumed that the use of a haircut provision within the underlying plan afforded participants with greater protection to the employers' assets, to the benefit of the creditors.

However, none of the $53 million withdrawn under Enron's haircut provisions came from the rabbi trust. Therefore, I believe the question of haircut provisions should be resolved under the constructive receipt rules, not the funding rules.

However, there are other abuses of rabbi trusts which I believe Congress should curtail through legislation. The funding of rabbi trusts for other triggering events, such as company insolvency or bankruptcy, does confer preferential treatment to such participants and should result in taxation. And moving rabbi trust assets offshore should also result in taxation, as it affords participants with greater security.

Last, the Joint Committee reported frustration with the lack of information regarding these plans. That deficiency can be readily cured by directing the Department of Labor to exercise its power under ERISA to require executive deferred compensation plans to provide similar information that is reported by qualified plans, and if distribution options have been accelerated or changed, the Department of Labor, under its investigatory powers, has sufficient power to review such terms.

Thank you for this opportunity, and I look forward to your questions.

The CHAIRMAN. Thank you.

[The prepared statement of Professor Kennedy appears in the appendix.]

The CHAIRMAN. Next, to Mr. McNeil.

STATEMENT OF BRUCE J. McNEIL, PARTNER, DORSEY & WHITNEY, MINNEAPOLIS, MINNESOTA

Mr. MCNEIL. Thank you, Mr. Chairman, for the opportunity to be here and for holding this hearing.

The staff of the Joint Committee on Taxation appears to be primarily concerned with the effectiveness of nonqualified deferred compensation on shareholders, creditors, and the Federal Treasury.

The concerns of the staff can be addressed without substantially modifying the Internal Revenue Code or the interpretation of the application of the doctrines and theories that govern the taxation of deferred compensation, and without losing the social and economic benefits that employers obtain from being able to provide modestly flexible deferred compensation arrangements for the benefit of a select group of individuals.

Section 404 of the Internal Revenue Code provides that compensation paid under a plan deferring the receipt of compensation will be deductible only if the compensation otherwise satisfies the requirements for reasonable compensation, pursuant to Section 162 of the Internal Revenue Code.

The potential loss of a significant tax deduction provides, therefore, a significant incentive to employers to provide only reasonable compensation.

In addition, the boards of directors of employers have fiduciary obligations under the Business Judgment Rule, a feature of the corporation laws of every State, that require them to assure that deferred compensation pay levels and those for whom such pay levels are established are not abusive to the shareholders.

If there is a concern about the fairness to shareholders of the amounts of deferred compensation provided to company executives, the avenue for which the concerns may be addressed is not the Federal tax laws, but the laws and rules governing the obligations and responsibilities of the boards of directors under the Business Judgment Rule and other rules and regulations that may be adopted and enforced by the Securities and Exchange Commission.

Under the Business Judgment Rule, the structure and administration of nonqualified deferred compensation plans should be governed by the conduct of the boards of directors of the employer and the fiduciary duties of care and loyalty owed by the directors to the employer and its shareholders.

This conduct may be governed under Federal law and State law. The governing body of an employer should determine for the key employees the compensation reasonable for the performance of services, the compensation necessary to attract and retain the key employees, and the structure of deferred compensation plans that would serve the best interests of the employer and its shareholders and satisfy the fundamental theories and principals of tax, and the requirements of the Employee Retirement Income Security Act.

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

Similarly, the issues raised by the staff regarding the effects of deferred compensation on creditors may be better addressed under the bankruptcy laws and not by changing the deferral rules of nonqualified deferred compensation plans.

Title 11 of the U.S. Code, the Federal bankruptcy laws, envisions the ratable distribution of assets of a bankrupt or reorganizing entity to creditors in accordance with priorities established under the Bankruptcy Code.

There are sections of the Bankruptcy Code that permit avoidance of transactions that enable creditors to recover more than they would be entitled to if the transferors buy an account of the reorganizing or bankrupt entity. It enables an entity to recover more than it would obtain in a straight liquidation.

Section 546 of the Bankruptcy Code also permits a debtor in possession or trustee the right to use any available State law that would be available for avoidance of transfers.

Section 547 of the Bankruptcy Code enables a trustee to recover transfers made within 90 days prior to the bankruptcy, or in the case that a transfer is made to an insider of the debtor in 1 year, that enables the creditor to receive more than it would receive in a liquidation.

Likewise, Section 548 of the Bankruptcy Code also provides that a trustee can avoid any transfer made within 1 year from the date of filing of a case to the extent the debtor receives less than a reasonably equivalent value in exchange for the transferor obligation, was insolvent on the date that the obligation was incurred, or rendered insolvent as a result of the transfer.

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

Unraveling the established practices of nonqualified deferred compensation plans as a response to the problems of Enron is tantamount to throwing the baby out with the bath water.

More targeted measures could be used to address the concerns of the staff rather than unsettling fundamental deferral principles and losing the economic or social utility that deferred compensation offers employers.

That concludes my remarks. I thank you for the opportunity to provide them.

[The prepared statement of Mr. McNeil appears in the appendix.]

The CHAIRMAN. We will take five-minute rounds. Obviously, Senator Breaux will follow me, unless Senator Baucus shows up.

Mr. Essick, to what extent did Enron direct you to reach specific conclusions regarding what level of compensation they wanted to pay certain executives?

Mr. ESSICK. We provided market data to Enron on an ongoing basis over the course of years. The market data came from the surveys that I referred to in my prepared statement.

The survey methodology that was used to provide that data were based on principles and standards that we used in our consulting business and not based on directions received from the company.

The CHAIRMAN. Could I ask, on this point, whether Joint Tax has the view that that was the arrangement between the law firm on this issue and the company?

Ms. SCHMITT. Mr. Chairman, when we did our study, our investigation, we found that Enron consulted extensively with outside consultants, including Towers Perrin, with respect to executive compensation arrangements. In general, we did not ever find an arrangement that the company wanted to provide that they did not get an opinion letter for.

The CHAIRMAN. All right.

Mr. Essick, this is a characterization that is not mine, but some people have suggested that your field is rather like a bean counter. Some people say that you just compared the beans of Enron with those of other companies. Is that what you were asked to do, or was your assignment to see how high the other companies' scale was to justify Enron's?

Mr. ESSICK. Our role, in the consulting we do, for Enron and for other companies, is to provide a competitive set of data based on certain principles. For example, in looking at Enron's compensation, we looked at it in the context of the size of company as measured by revenues, and later adjusted for market capitalization as well.

We also provided information to them based on our experience on such things as incentive compensation designs. The methodologies that we used, documented, are standard methodologies used in our business, not only for Enron but for other large, complex companies as well.

The CHAIRMAN. Ms. Schmitt, did you find any disagreement ever expressed between Enron and Mr. Essick, any evidence of anything like that?

Ms. SCHMITT. No, Mr. Chairman.

The CHAIRMAN. Mr. Essick, in retrospect, does Enron's compensation to executives seem excessive to you? I have expressed that it seems that way to me.

Mr. ESSICK. When we looked at the Joint Committee's report and we looked at the compensation that was provided to the top 200 people, the largest component of compensation shown was the stock option component.

My understanding, from looking at the materials put together by the Joint Committee, is that the data that was shown for stock options reflects stock option exercise gains in those years. So, they are reflecting the growth in the stock price from the date of the grant of the option to the point of exercising the option.

When we do competitive compensation analyses and we look at long-term incentives, in general, and stock options in particular, we look at stock options using the Black-Scholes option pricing model, on the date of award.

The reason we do that, is it allows us to be able to have a comparison of value on the date of award compared to base salary and bonus opportunities at the same point in time.

To the extent that those options that are granted are held by the executive compensation for multiple years and are not exercised until a later year, it may reflect multiple years of compensation, showing up in the year 2000 or 2001, or whatever year it may be, and it will not be tied to that initial Black-Scholes value, it will be whatever has happened to the stock price of the company.

To put some perspective on this, Enron's stock price for the 10-year period ending in the year 2000 rose 1,400 percent versus the S&P 500 at 400 percent. So actual options' exercised gains that would be reported in the W–2s would be significantly higher than the market numbers originally developed.

The CHAIRMAN. About $53 million came out of Enron's coffers right before the company declared bankruptcy. Those amounts compared roughly to the money that a number of individuals held in their deferred compensation arrangements.

Did you or anyone at Towers Perrin recommend that the money be released upon the request of those executives?

Mr. ESSICK. Let me make sure I understand your question, Mr. Chairman.

The CHAIRMAN. Let me consult with staff.

[Pause].

The CHAIRMAN. Well, whether or not you gave any advice to the companies of when that money ought to be released based upon the arrangements that you made with the company, the advice you gave to the company.

Mr. ESSICK. We did not consult with them on the deferred compensation payments.

The CHAIRMAN. All right. In other words, there was not any advice from Towers Perrin advising executives to kind of dash with the cash.

Mr. ESSICK. We gave no advice on that topic.

The CHAIRMAN. Thank you.

Senator Breaux?

Senator BREAUX. Mr. Essick, Secretary Olson talks about the Enron packages and she said, first of all, "several of the executive pay practices at Enron pushed the envelope of current law."

She further says, "It appears that Enron intended the complexity of the transactions to frustrate detection by the IRS." In other words, Enron was deliberately hiding the ball, and that is cause for concern.

Did your people never catch that?

Mr. ESSICK. Our role at Enron was to consult on base salaries, bonus, and stock-based compensation.

Senator BREAUX. So if you saw any of this, you just ignored it?

Mr. ESSICK. We did not see any of it and did not have reason to see it.

Senator BREAUX. How come you did not see it? I mean, the IRS says it is pretty clear. This is your job, advising them on their executive pay packages. Did it not strike you as unusual, the complexity of it, that they were trying to hide something? I mean, you are a professional in this.

Mr. ESSICK. Senator, we provided consultation to the company on market practices and market pay levels, and pay designs tied to market practices and their philosophies.

The base salary program, bonus program, and long-term incentive programs that we assisted with them—I assisted them with—were standard programs in the marketplace and were not viewed as overly complex.

Senator BREAUX. The IRS, who knows about this, I would think, better than any other group, says they are trying to hide the whole thing. I mean, did it not strike you that they were trying to hide something, or did you have your head in the sand?

Mr. ESSICK. Senator, we saw no evidence of anyone trying to hide anything in the work that we did. The work that we did, again, was focused on the three areas I just indicated, the base, bonus, and long-term incentives.

Senator BREAUX. But you never felt that they were pushing the envelope and going right to the edge on this stuff?

Mr. ESSICK. There were times when we did sense that Enron wanted to push the envelope as an innovative company, and we provided market data and guidance to help bring them within market norms.

Senator BREAUX. Did you ever have any lawyers in this place that said, hey, time out, this is about to blow up?

Mr. ESSICK. Senator, we are not a law firm.

Senator BREAUX. You do not have any lawyers working for you?

Mr. ESSICK. We do have some lawyers working with us.

Senator BREAUX. How many?

Mr. ESSICK. I do not know. I am sorry.

Senator BREAUX. About? Four? Two? One? A hundred?

Mr. ESSICK. I do not know. I do not know.

Senator BREAUX. You do not know how many lawyers you have? How many employees have you got?

Mr. ESSICK. We have 8,000 employees.

Senator BREAUX. And you do not know how many lawyers? I mean, is it 1 percent?

Mr. ESSICK. Senator, I do not know how many lawyers we have.

Senator BREAUX. Do you have any CPAs?

Mr. ESSICK. Yes, sir, we do.

Senator BREAUX. How many?

Mr. ESSICK. I do not know how many CPAs we have.

Senator BREAUX. How much did you get paid for doing all this work at Enron?

Mr. ESSICK. Our fees over the 5 years ending in 2001 for executive compensation services averaged about $130,000 a year over that period of time.

Senator BREAUX. And nowhere in that time you just said, this rings bells and whistles, you cannot do this?

Mr. ESSICK. We saw nothing in the work that we did that caused us to have a question about impropriety. Again, our role was to provide market data and counsel how other companies provide compensation in this type of business.

Senator BREAUX. Well, suppose everybody else is doing something that is pushing the envelope and they are hiding things. Are you going to say you are consistent with everybody else, and that is it?

Mr. ESSICK. We do not test whether people are hiding things. We test competitiveness of the designs of the plans and the levels of compensation provided as an opportunity.

Senator BREAUX. So it seems to me what you are telling the committee, is if everybody else that you are surveying out there is doing something that is pushing the envelope and is hiding stuff from the IRS, then you go to your client and you say, you are right there with them. Good luck.

Mr. ESSICK. We do not consult on the issues. Our consultation is, here is what the pay levels were in the marketplace, here is what the structure of the plan designs is in the marketplace, here is what your pay philosophy is that you have established, and here is where it comes together.

Senator BREAUX. But you in no way tell them whether that is the right thing to do, it is a good idea, or you are pushing the envelope? I mean, you just say, it is consistent with what everybody else is doing out there?

Mr. ESSICK. We provided a view on what real companies do in the outside world.

Senator BREAUX. And even if they are doing it wrong, you can tell your people that, you are consistent, go forward?

Mr. ESSICK. We tell them what is happening in the real world.

Senator BREAUX. Even if it is wrong?

Mr. ESSICK. We tell them what is happening in the real world based on fact and what real companies are doing.

Senator BREAUX. Well, this is just getting to the point of being ludicrous, as far as I am concerned. Suppose you find out that these other companies are doing something that is illegal. Are you not going to tell your client, this is what everybody else is doing, but it is probably illegal?

Mr. ESSICK. We would certainly indicate that. If we had any indication that there was illegal activity going on, we would indicate that.

Senator BREAUX. So everything that Ms. Olson says about what she saw at Enron about hiding and pushing the envelope, it never occurred to you that you ought to pass this on to them?

Mr. ESSICK. We never saw anything hidden. We did not sense anything was being hidden. The place I noted where they might have pushed the envelope was more in saying something like, we want to have restricted stock vests more quickly than what the market was. Our response back would be, here is the way the marketplace vests restricted stock. That is legal. That is within the range of market practice.

Senator BREAUX. I do not know if I will have any other time. Maybe one more question to Ms. Olson. There is a front-page story in the Marketplace section of the Wall Street Journal this morning. The headline is: "Directors Should End Extravagant Packages for Departing CEOs."

The people I represent probably have a hard time understanding the whole nature of this hearing. The average salary in Louisiana is about $22,000 a year. The concept of people not wanting to get paid until later does not resonate with most of the people I represent. They want to get paid sooner, not later.

If I suggested to the people making $20,000, that I have got good news for you, we are not going to pay you for several years, I mean, the concept of it is just off their charts. But here we are, talking about how people defer everything because they are making so much money, they want to take it later, so somehow they can avoid taxes.

But the article goes into a whole series of situations where executives who have been failures, for companies that are being investigated, companies that are going down the tank, are giving millions and millions of dollars of deferred compensation packages to CEOs that literally have failed.

Again, when people read this, they say, I do not understand why you are getting paid millions of dollars for a company that is in bankruptcy. But the thrust of the article is, the directors ought to do this. I mean, you are frustrated, I take it, with the fact that when you hide things like they did at Enron, yo do not have enough people to find out what is happening.

Do we have to do it in Washington or is this not a legitimate function of directors of these companies who somebody approved these extravagant compensation packages that are not based on success or are limited by failure, they are just there. I mean, whose responsibility is this? Can you give me just a generic comment on that?

Ms. OLSON. Yes, Senator. I agree that it is the responsibility of directors, and that is where is it best left. I think one of the things that is interesting to watch in the stories that have rolled out, is that our efforts to restrict executive compensation through the Tax Code have been singularly ineffective. In fact, I think they may have caused some of the problems that we see out there.

Senator BREAUX. The million dollar limitation. That really went to nothing, right?

Ms. OLSON. That is right. In fact, it operates more as a penalty on the shareholders than it does as a penalty on the executive compensation.

Senator BREAUX. All right. Thank you.

Thank you, Mr. Chairman.

The CHAIRMAN. I think you have opened up a very legitimate round of questioning here, Senator Breaux, that I think I want to follow up on for just a minute. You may want to stay and join in, if you want to.

Let me suggest where I am coming from here. So I guess my question would be Mr. Essick, but I am also going to ask Ms. Schmitt to enter in here.

Last year, before the Senate Governmental Affairs Committee, the chairman of the Enron Compensation Committee testified about executive compensation. My understanding is that the sum of his testimony was that he relied upon Towers Perrin for all decisions.

My question to you is, in making decisions here, not to describe for us generally the relationship between Towers Perrin and Enron. I think you have done a good job of that.

But some points that I would like to have you cover would include, did the Enron board ever question or reject any of the findings of Towers Perrin? Did Towers Perrin ever provide advice that the Enron board did not want to hear, or was it a case of deciding the salary first and getting the justification later?

Mr. ESSICK. In the work that we did for Enron, it fell into several categories. In some cases, what we were doing was providing market data on levels of pay and market incentive plan design practices.

So we would do a study at the request of other management or the board of directors, the Compensation Committee of the board, to test levels of pay and the competitiveness of incentive design practices.

There was a study that was done called the Stress Test which was done in the spring of 2001. The Stress Test was commissioned by the Compensation Committee of the board.

What they asked us to do, was to test what the effect would be of higher volatility in their stock price and their financial results. They had a period of very rapid run-up in stock price and financial results and they wanted to see what would happen if they had volatility both up and down in their results.

At the conclusion of the Stress Test, or during the course of the Stress Test, they were experiencing some downward pressure in their stock price. This was, again, the spring of 2001.

In the course of that, there were questions raised by members of management—and I do not remember any questions about this

topic from the members of the Compensation Committee—as to whether they should consider repricing stock options.

What that means, is if the stock option had been issued at $80 a share, and the stock price is now $60 a share, should we restrike the option to be at $60 a share, which in essence gives you an opportunity to re-earn the $20 that the stock went down.

What we concluded in that study was, even if they were going into a period of higher volatility and more difficult times, they should stay the course with the designs they had. So, if earnings went down, the bonuses would go down. If the stock price goes down, there was not going to be a re-pricing.

So what we encouraged them to do, was, in essence, stick with what they had, even if they were to experience more difficult economic times.

The CHAIRMAN. All right. I am going to come at this same thing for Ms. Schmitt with this approach.

The Compensation Committee relied on Towers Perrin each year to determine the compensation package for Ken Lay and two other executives. Now, I think the Joint Committee has basically said that the Compensation Committee essentially rubber-stamped whatever management was seeking.

What as your impression of the Compensation Committee, and did Enron, from your judgment, Ms. Schmitt, ever bring anything to Towers Perrin that Towers Perrin said no to?

Ms. SCHMITT. Mr. Chairman, we did not find any evidence in the course of our investigation of any compensation, specific compensation issues, being taken to Towers Perrin and they recommending to the company that it not be adopted.

In fact, we said in our report issued in February that from our interviews with members of the Compensation Committee of the board of directors, it appeared that many members made decisions relying on the opinions of outside consultants, including Towers Perrin, without understanding the underlying facts of the arrangements that they were approving.

The CHAIRMAN. All right.

I am going to go on to another issue. I wanted to ask Secretary Olson—and for Senator Baucus' benefit I will quit whenever he wants to ask questions. It takes a little while, when you come from one committee to another, to get oriented. So, I want to give him an opportunity to do that.

Anyway, I read yesterday in the Wall Street Journal that the IRS issued guidance on Irish leasing companies. What is the abuse you are trying to stop with those regulations?

Ms. OLSON. Senator, this was a notice that we issued to stop something close to evasion of tax, a transfer of employees, purportedly, to another company, with the compensation then going offshore.

So the notice puts taxpayers on notice that the IRS will challenge those arrangements if they find them. It also encourages taxpayers to voluntarily come in and get their tax affairs straightened out.

The CHAIRMAN. There is no doubt then from Treasury's point of view, that is an abuse of our income tax laws.

Ms. OLSON. That is correct.

The CHAIRMAN. I am going to ask Professor Kennedy, do non-qualified deferred compensation plans afford executives with tax preference unavailable to non-highly-paid workers?

Professor KENNEDY. No, Senator, I do not believe so. The pressure that employers and executives have to set up these arrangements are because of the limitations imposed under qualified plans.

I am sure executives would prefer to have rights under qualified plans that the rank-and-file have, but because of the limitations, they are not afforded those. Therefore, we have seen a surge in the development of these types of plans.

The CHAIRMAN. All right. I am sorry. I did not know the presence of Senator Lincoln. At this point, I would be glad to call on you for questioning.

Senator LINCOLN. I am fine. I will wait my turn.

The CHAIRMAN. Now is your turn.

Senator LINCOLN. All right. Good. [Laughter.]

I thank the Chairman, particularly, for holding the hearing and for his considerations on many things.

I have just a couple of general questions, but have a lot that, if I may, Mr. Chairman, enter into the record so that we will not take too much time. But I ask for unanimous consent to have questions placed in the record.

The CHAIRMAN. Yes. They have 2 weeks to respond to all questions of the committee.

Senator LINCOLN. Great. Thank you very much.

Just a general question that comes back to some things we have talked about in the committee before. But many people have really relied on the argument that the COLI policies are used to fund employer obligations, such as their retiree benefits. To me, it raises a number of questions.

If you all could, any that want to respond, should Congress specifically provide a tax benefit for companies to fund such things as retiree benefits rather than requiring them to go through insurance contracts?

If the COLI is set aside for future benefits, is the income still reported as earnings on the financial statement, or should it be, whether it is appropriate or not? Should we require companies to set these dollars aside as liability on their financial statements? Does anybody want to comment?

Ms. SCHMITT. Senator Lincoln, I guess I will start.

Senator LINCOLN. Good.

Ms. SCHMITT. We stated in our report, and also in our written testimony, that it may be appropriate to reexamine the tax benefits accorded to COLI, that there is still remaining, even after legislation in 1986, 1996, and 1997, an opportunity for tax arbitrage utilizing company-owned life insurance.

As to the funding of specific employee benefit programs, I think that you raise a fair issue of whether there ought to be specific rules addressing these rather than going through the more circuitous approach of purchasing life insurance contracts and then borrowing against those contracts in order to achieve a tax benefit. But I would say that we did state that it may be appropriate to conduct a general review of company-owned life insurance.

Mr. MCNEIL. There has been some tax arbitrage through Section 264, which governs taxation for corporate-owned life insurance, and I think there is still some of that that continues. Some of it is being litigated when it gets to be fairly broad-based. Those cases are litigated. There was one recently decided.

So, those may be handled in courts, but may be subject to further review by Congress as well as to whether or not that is something that would be appropriate, and if appropriate, to what extent. Maybe broad-based is too much, but maybe there may be some room for it.

Funding deferred compensation does have some basis in the statute. Section 457, which governs deferred compensation for governmental plans and tax-exempt plans, requires a trust be set up for governmental plans and that trust can be funded. That is viewed as more of an exception to the constructive receipt/economic benefit rules, and is akin, I guess, to 401(k) plans.

So, you can fund those without necessarily requiring the current taxation of the benefits that are set aside in those funds. That seems to be pretty acceptable. It was done in response to the Orange County circumstance where a governmental entity went into bankruptcy and caused a fair amount of concern with respect to the governmental employees.

Senator LINCOLN. I do not mean to interrupt you, but is there a place where that shows up on the financial statement?

Mr. MCNEIL. Financial statement? I would guess so with respect to that governmental entity when they set aside funds for purposes of funding the obligations.

Senator LINCOLN. I am just wondering if those dollars then can be used for any purpose, over any amount of time.

Mr. MCNEIL. With respect to those trusts set up under Section 457(g), those are assets that are set aside in more of a 501(a) kind of trust. They are not available for creditors, which then would ordinarily cause those benefits to be subject to taxation under the economic benefit doctrine.

Senator LINCOLN. Is there a time on that?

Mr. MCNEIL. No. They are just set aside to pay the obligations under the terms of the plan. It is seen as an exception to the economic benefit doctrine.

Senator LINCOLN. Ms. Olson, did you have any comments on those first three questions I had?

Ms. OLSON. Well, the COLI issue has been addressed more than once through legislation that has essentially eliminated most of the advantages for it. I do not know the answer to the question that you raise about the financial statements and whether or not it is reported on financial statements.

Companies have entered into COLI arrangements to finance different kinds of things, and not necessarily to provide death benefits to employees who are covered by the COLI policies.

Senator LINCOLN. Well, does Treasury have an opinion on whether we should specifically provide a tax benefit for companies to fund such things?

Ms. OLSON. It is something that any be worth looking at. I think it is something that Congress has considered in the past in Section 89 and walked away from.

Senator LINCOLN. I guess another question would be, it always comes back when we talk about this great dispute over some of the proposals to deal with the abuses of life insurance and the examples that we saw in Enron. We hear about the so-called good uses. I mean, I want to believe that.

But I also want to know, when people say that Enron was an anomaly and that the COLI and the split dollar policies are being used properly most of the time, we have no way of really knowing that, do we, if Enron was an anomaly, because really only the parties that are involved have any of the information.

I guess the question then is, what sort of reporting requirements should be mandated in order to effectively regulate the use of the products and ensure that they truly are being used for the purposes that industry argues they need them for.

Ms. OLSON. I think with respect to Enron's COLI policy, it is an old policy. You cannot do it under current law, so it merely exists because it was grandfathered from the tax changes that were made by Congress in previous years.

Senator LINCOLN. So you feel like there is adequate regulation there, disclosure?

Ms. OLSON. I think there probably is. I think that the Joint Committee has recommended that the grandfather be removed, and that may well be a good idea to look at removing that grandfathering provision.

But I think that COLI does serve legitimate purposes for small businesses, which can still cover their employees. The concern that we have had in the past was with leveraged COLI transactions that generate interest deductions, and then the income build-up in the policies is shielded.

Split dollar is a completely different issue. That is an issue that I think Treasury has effectively addressed with regulations that we put out last summer that ensure that the policies are properly taxed.

Senator LINCOLN. So you feel completely comfortable with the regulations that exist in terms of the disclosure and the ability to recognize what anomalies are there? You are saying, eliminate the grandfather, but you feel like the other regulations are sufficient?

Ms. OLSON. Yes, I think that is right.

Senator LINCOLN. May I ask just one follow-up, Mr. Chairman?

The CHAIRMAN. Yes. All right.

Senator LINCOLN. Treasury has issued some proposed regulations concerning split dollar life insurance arrangements, I think, which would require economic benefits given to the employees to be taxed currently. When are those regulations going to be finalized?

Ms. OLSON. We expect to finalize them within the next few months. We did get a lot of comments on them, but we have had the hearing and we are ready to move forward with the laws.

Senator LINCOLN. Since those were proposed, have there been any changes that you have contemplated at Treasury?

Ms. OLSON. Nothing significant. We did leave one question unanswered on how to value a policy in a particular instance, and we will be proposing some additional regulations shortly that answered that question.

Senator LINCOLN. Thank you very much.

Thank you, Mr. Chairman.

The CHAIRMAN. Senator Baucus? Then if Senator Breaux wants a second round, it would be his turn, next.

Senator Baucus?

Senator BAUCUS. Thank you very much, Mr. Chairman, for holding this hearing in the first place. We had an earlier Enron Joint Tax Committee hearing, which was very helpful. This one, I think, is adding more information. I appreciate your holding this hearing, and I apologize for being late. I ask that my statement be included in the record.

[The prepared statement of Senator Baucus appears in the appendix.]

Senator BAUCUS. Ms. Olson, there have been reports in the newspapers about insurance companies taking advantage of a provision in the Code which allows insurance companies to be tax-exempt if they collect premiums under $350,000. According to the press reports, that is currently legal. Your comments about all this, and the degree to which Treasury believes that we should plug this loophole.

Ms. OLSON. We are currently looking at what has happened out there. The IRS is auditing in this area and is gathering data, and we are contemplating making a legislative proposal that would address the issue.

But I think the things that have caused the greatest concern are probably things that can be addressed even without a legislative change. I am not sure that the arrangements that have been reported on would qualify as insurance under current law.

Senator BAUCUS. How many audits have there been?

Ms. OLSON. I do not know.

Senator BAUCUS. Any rough sense?

Ms. OLSON. No. I am sorry, I do not know.

Senator BAUCUS. You, or somebody—it might have been you—at Treasury said, this is a target-rich zone. What does that mean?

Ms. OLSON. That was actually a comment about shelters, in general, that the reporter ascribed to this particular loophole that he was reporting about.

Senator BAUCUS. Does Treasury regard this as a target-rich zone?

Ms. OLSON. From the information that we have, I understand that there are a lot of potential issues out there that the IRS is going to be looking at.

Senator BAUCUS. A part of this can be addressed by IRS regulations that do not require a legislative change. What might require legislative action?

Ms. OLSON. Well, I think it would be a good idea to look at the exemption, in general, to see whether or not it make sense, whether there are things that could be tightened up legislatively.

But I think that we will be able to address the things that have caused the greatest concern just by reviewing whether or not the companies, in fact, are insurance companies.

Senator BAUCUS. On the face of it, it does not sound very reasonable, what has been going on here.

Ms. OLSON. I agree with you.

Senator BAUCUS. So something has got to be done, and done quickly.

Ms. OLSON. I agree with you.

Senator BAUCUS. Again, if you could be more precise what can be done?

Ms. OLSON. We are actively reviewing it. I have gotten some preliminary responses from my staff at the end of last week, and we do expect to have something shortly.

Senator BAUCUS. When you say you "expect to have something shortly," what do you mean?

Ms. OLSON. In the way of a legislative recommendation. The IRS is, of course, on its own track with whatever it is doing on the enforcement side. But to the extent that a legislative proposal would help to clarify and end any problems, we will be working on that.

Senator BAUCUS. When do you think we might see that?

Ms. OLSON. I am hoping within the next couple of weeks. But we are trying to gather some additional data from the information that the IRS has to evaluate what the best course of action is.

Senator BAUCUS. If you could help me a little bit here. Where are the Turks and Caicos islands?

Ms. OLSON. In the Caribbean.

Senator BAUCUS. Where?

Ms. OLSON. The West Indies.

Senator BAUCUS. Sorry?

Ms. OLSON. The West Indies.

Senator BAUCUS. In the West Indies. Is Turks and Caicos one group of islands or are they two separate islands? It says Turks and Caicos.

Ms. OLSON. I believe they are separate islands.

Senator BAUCUS. There is a Turks Islands and there is a Caicos Islands?

Ms. OLSON. I think so, but I am not positive. I have never been there. [Laughter.]

Senator BAUCUS. Well, neither have I.

Ms. OLSON. I think Senator Breaux has.

Senator BAUCUS. Maybe you should go and straighten it out. [Laughter.]

Ms. OLSON. I think Senator Breaux has. Maybe he can help us.

Senator BAUCUS. Well, I ask because, right off the web, there is a KPMG advertisement that they will, in the Turks and Caicos islands, set these up for you.

Senator BREAUX. Sounds like a field hearing. [Laughter.]

Senator BAUCUS. They call them PORCs. Yes. They are producer-owned re-insurance companies. It said, "In the Turks and Caicos islands, KPMG is recognized as the industry leader in the provision of tax and consulting services to producer-owned re-insurance companies, otherwise known as PORCs.

KPMG has developed a standard license and incorporation package for the two major corporation applications, an automobile dealership application and the mortgage guarantee insurance application."

Then it goes on and on and says, call us, because we know how to do this. It sounds like we have got a problem here. If one com-

pany, on its web site, is advertising this, I would guess that there are probably others.

Ms. OLSON. Yes. I am not familiar with the ad in the web site, but we did issue a notice on PORC transactions in particular about 6 months ago, or maybe a little bit longer than 6 months ago, identifying the issues there and warning taxpayers that they may be treading on thin ice to the extent that they go forward with one of those transactions.

Senator BAUCUS. I would just encourage you to aggressively go after this. This is absolutely a loophole. It is an outrage. It was set up, I am told, maybe 50 years ago to help farmers to insure, but it has been abused, obviously, to the tune of millions of dollars of uncollected taxes. I just very much look forward to your letter in a couple of weeks suggesting what legislation is needed to stop this.

Ms. OLSON. Thank you, Senator.

Senator BAUCUS. Thank you.

The CHAIRMAN. Senator Breaux, did you want another round?

Senator BREAUX. Just one other question for Secretary Olson, if I might. I think that in your testimony you talked about the problem with an Enron-type of a situation, with the inability of the Internal Revenue Service to detect the tax shelters that they were involved in because of the complexity and hiding things that were not easily ascertainable.

I take it that the Treasury Department has requested more assistance for corporate audits in their budget.

Ms. OLSON. Right.

Senator BREAUX. Do you know if you requested more help, more financial money for Treasury to be able to look into these horribly complicated situations?

Ms. OLSON. We did request an increase in the IRS budget, specifically focused on the audit of high net worth individuals and businesses. That additional audit staff would definitely help the IRS.

Senator BREAUX. The numbers I have, and the reason why I ask the question, is I think it is a request for an additional maybe $550 million, I think, is the number. Does that sound right, or do you know?

Ms. OLSON. I am not sure what the number is.

Senator BREAUX. I think it is about $550 million, but about 20 percent of that is for EITC investigations. I think the numbers sort of pale in comparison. Is this an area that would be rich for recovering a great deal of money? It seems like it is $100 million for EITC, which seems like, in comparison to what we are talking about today, would be very small numbers, indeed.

Ms. OLSON. The EITC funds are to try to get started a program that would allow the IRS, up front, to identify eligibility for the credit to speed the credit through to eligible recipients.

Right now, the Service has difficulty determining, from the returns that are filed, whether a taxpayer is eligible. If there are questions, they may hold up the taxpayer's refund. So, this is an effort to put in place a program that will make the EITC function more smoothly.

Senator BREAUX. All right. Well, I am glad to hear that. All right. Thank you very much.

Thank you, Mr. Chairman. I have no other questions.

The CHAIRMAN. I have one more question.

Professor KENNEDY. Senator Grassley, especially with respect to elective deferrals where the executive is choosing to defer his or her own salary compensation to subject it to a substantial risk of forfeiture, it will simply eliminate these plans altogether. That could be, actually, to the disadvantage of the corporation.

It certainly does not align the executives' incentives with that of the future financial health of the company. That is something Congress did back in 1978 by imposing a moratorium on the Service, who at that time wanted to eliminate all elective deferrals.

The CHAIRMAN. All right. Thank you all very much. I appreciate your testimony and the hearing.

Senator BAUCUS. Mr. Chairman?

The CHAIRMAN. Oh, I am sorry. Go ahead.

Senator BAUCUS. Mr. Chairman, I apologize. I have a couple of questions that Senator Bingaman would like asked.

The CHAIRMAN. All right.

Senator BAUCUS. He is over at the Energy hearing this morning, and I will ask these questions on his behalf.

The CHAIRMAN. I am going to say thank you all. Senator Baucus will close the hearing down after these questions are asked. I have to go down for a meeting on health care downstairs. Thank you all very much.

Senator BAUCUS. I hope you are healthy. [Laughter.] Thank you, Mr. Chairman.

These are Senator Bingaman's questions. As I understand it, under current law a company can take out a COLI policy on the lives of its employees and use the proceeds and benefits of this policy to fund a deferred compensation arrangement for its executives and give none of the benefits to the employees or their beneficiaries whose lives are insured. Is that accurate? Does anybody want to answer that?

Ms. SCHMITT. Yes, Senator Baucus, that is correct.

Senator BAUCUS. Does the panel agree? Senator Bingaman is actually asking for preliminary responses from witnesses. He is going to submit these for the record, too, but he would like it on the record here verbally.

Ms. SCHMITT. Senator, I would just comment that there is no requirement that the lives covered under the company-owned life insurance policy be the lives that are going to benefit from the funding in the nonqualified deferred compensation arrangement.

Senator BAUCUS. Thank you.

Another question. As I understand it, a company can continue to receive the tax benefits associated with these policies, that is, the tax-free inside build-up of tax-free death benefits, even when the insured is no longer an employee, that is, they have left the company. Is that accurate?

Ms. SCHMITT. Yes, that is accurate.

Senator BAUCUS. Thank you.

Next, and last, do any of the witnesses believe that this is consistent with the policy underlying life insurance, that is, providing

financial relief for families, or even employers, when a loved one unexpectedly passes?

Ms. OLSON. I will take a shot at responding to it. COLI policies have served a legitimate purpose, particularly in the context of small businesses where the proceeds of the policy would go to the small business to allow it to get through, for example, the loss of a key employee. So, it does serve legitimate purposes even if the benefits of the policy are not going to the family or loved ones of the decedent.

Senator BAUCUS. Anybody else want to respond? Mr. NcNeil?

Mr. MCNEIL. I would agree with that comment.

Senator BAUCUS. That is the question here.

Mr. MCNEIL. They do a legitimate purpose.

Senator BAUCUS. Oh, you agree with Ms. Olson?

Mr. MCNEIL. I do, yes. I think the questions seem to go to whether or not there is an insurable risk there and whether or not they are to insure against that risk with respect to that individual, so that companies cannot take out insurance policies on just any individual.

But in the case of corporate-owned life insurance, there is typically a very good business reason for purposes of the insurance policies and there are business reasons for those policies.

Senator BAUCUS. All right. Mr. Essick?

Mr. ESSICK. That is not my area of expertise.

Senator BAUCUS. All right. All right.

Thanks, everybody. We appreciate your coming and spending the time here, taking time out of your day. The hearing is adjourned.

[Whereupon, at 11:34 p.m., the hearing was concluded.]

APPENDIX

Committee On Finance

Max Baucus, Ranking Member

NEWS RELEASE **http://finance.senate.gov**

For Immediate Release
Tuesday, April 8, 2003

Contacts: Laura Hayes, Lara Birkes
202-224-4515

ENRON: Joint Committee on Taxation Investigation of Compensation-Related Issues

Last year, we explored the devastating impact Enron's bankruptcy had on thousands of investors and rank-and-file workers. These individuals lost a lifetime's worth of retirement savings when the company's stock value plummeted.

In February, we heard testimony from the Joint Committee on Taxation on its year-long investigation of Enron's federal tax and compensation issues. The bottom line is that we need to restore confidence in corporate America. Legislation based on our examination of Enron's tax returns and pension plans should go along way to meet that goal.

As such, several Members of the Finance Committee urged us to hold today's hearing before marking up any pension-related legislation. The Joint Committee provided us with an invaluable tool to help identify abuses. The Joint Committee concluded that abuses in executive compensation essentially constituted an alternative system of retirement savings for a limited number of executives.

This has a negative impact on our employer-provided qualified pension plan system – which benefits all workers. We should not allow executive compensation arrangements to undermine qualified pension plans. Although executive compensation has been the subject of other Committee hearings, the taxation of compensation and the tax incentives for certain types of compensation are solidly within this Committee's jurisdiction. And we have a responsibility to explore the practical effects of the tax laws in this area.

The Joint Committee's investigation looked closely at these arrangements and revealed some of these practical effects.

First, the Joint Committee's Enron report shows that some corporate executives may not be playing by the same rules they are imposing on their workers. Some Enron executives engaged in the shameful conduct of juicing Enron's earnings while their stock options soared. And senior executives rushed to the bank to cash-out their own deferred

savings while rank-and-file workers were locked out of their plans. As a result, rank-and-file Enron employees suffered heavy losses. While the executives took specific steps to protect their savings.

Second, Enron's Board of Directors were less than independent. Enron's executives basically set their own compensation. As for oversight over Enron's executive compensation, Enron's Board of Directors simply operated like a rubber stamp.

Third, Enron executives seemed to discourage – rather than encourage – diversification is their pension plans. Enron executives strongly encouraged the rank-and-file employees to invest in company stock. Yet these same Enron executives were, at the same time, cashing out. The rank and file lost a lifetime's worth of savings in their pension plans.

The Joint Committee highlighted problems in these three areas. Executives intentionally misleading employees. Board of Directors lacking independence. And executives discouraging diversification.

I look forward to hearing from today's witnesses as we continue to explore how the tax code was used – or abused – by Enron. Changing the tax laws to address these problems is critical to restoring confidence in corporate America.

Thank you again, Mr. Chairman, for holding today's hearing. It is important that we continue to hold hearings on the numerous issues discovered in the wake of the Enron debacle.

PREPARED STATEMENT OF SENATOR BUNNING

April 8, 2003

I would like to welcome our knowledgeable witnesses to the committee today. I look forward to a meaningful discussion of the insights gained from the recent investigation of the Joint Committee into Enron's tax and compensation issues. As the report provided to us by the Joint Committee shows, there appeared to have been a number of practices at the Enron Corporation that are cause for concern and deserve our attention – practices that are certainly not limited to the subject of today's hearing.

I would like to thank the Chairman for having this hearing today and giving us the opportunity to focus our attention on these issues of executive compensation. It is imperative that we examine these important issues, including non-qualified deferred compensation and company savings plans. As we can all agree, these matters of employee and executive compensation must be examined with an eye toward protecting the investing and working public while also allowing companies to have the ability to attract the best and brightest workforce.

These are very complex and detailed issues and I look forward to our discussion today and to the insights of our panelists.

Thank you.

Statement of Charles E. Essick
Principal, Towers Perrin
Senate Finance Committee

April 8, 2003

Mr. Chairman and Members of the Committee:

I am Chuck Essick, a Principal of Towers Perrin. I lead the Executive Compensation consulting practice in the firm's Houston office. Towers Perrin was notified that you would like to ask me questions today relating to the executive compensation consulting work the firm performed for Enron Corporation. I am pleased to appear and address those questions.

If I may, Mr. Chairman, I would like to take a minute first to provide an overview of the firm's Executive Compensation consulting practice. Towers Perrin has one of the oldest and largest executive compensation consulting practices in the world. We employ approximately 275 executive compensation professionals in about 40 cities around the world. Our client base is diverse, consisting of large and small clients, clients in established and emerging industries, and clients in many countries throughout the world. Last year, Towers Perrin's Executive Compensation consulting practice provided products and services to over 2,000 companies.

Central to Towers Perrin's Executive Compensation consulting practice generally and, more specifically, to the work we performed for Enron is the data we

collect and analyze. Towers Perrin conducts numerous general industry and industry-specific surveys which generate the data we use.

The data we collect relating to compensation practices in U.S. companies is the basis for the Towers Perrin U.S. Compensation Data Bank®. This database contains data on base salary, actual and target bonuses, and long-term incentives. The data is organized into an Executive Compensation Database, covering 300 positions in 950 companies, and a Middle Management and Professional Database, covering 500 positions in 750 companies.

Using our databases, Towers Perrin can determine how companies are compensating executives in different industries, in different functional areas, and in different sized organizations. Our clients can use the information and analyses we generate from these databases as a basis to make decisions about base pay, bonuses, and long-term incentives.

Much of our executive compensation work involves conducting competitive compensation analyses for executive positions. Our methodology for these analyses is thorough and well tested. It was this methodology and the data I described above that we employed in the consulting work we performed for Enron Corporation.

Mr. Chairman, we at Towers Perrin support the interest of this Committee in the Executive Compensation field and I would be glad to address questions from the Committee.

U.S. SENATE COMMITTEE ON
Finance
SENATOR CHUCK GRASSLEY, OF IOWA - CHAIRMAN
http://finance.senate.gov

Opening Statement of Senator Chuck Grassley
Hearing on Enron and Executive Compensation
Tuesday, April 8, 2003

Today's hearing is another in a series of hearings on executive and deferred compensation and the Enron investigation. We had a hearing in February when the Joint Committee on Taxation released its study. Then-staff director Lindy Paull discussed the JCT's findings on both the general manipulation of the tax system and on non-qualified deferred compensation. Last April 18, 2002, Senator Baucus held a hearing on stock options and non-qualified deferred compensation. At that hearing I said that I am not bothered by the existence of executive or deferred compensation arrangements. If an executive wants to make what is essentially an unsecured loan to his or her company by not taking all their compensation in cash, and the money is completely at risk, my advice is: Go ahead. That money is not taken into income by the executive. And the wages are not deductible by the company. It's a wash. If an executive works hard and does well, there is no reason to not let them have what they want of their pay and defer some compensation. If I can stop here I want to make an observation: No one is complaining about the athlete who gets huge amounts of pay and endorsement contracts. Nor is anyone complaining about how much money movie stars make. Nor is anyone here complaining about how much money rock stars earn or can defer from their compensation. The answer to that is: No. No one is fussing about the "entertainment set." This hearing is just about executives who abuse their discretionary authority. I don't care about the existence of executive compensation, so long as it is honest. What bothers me, are abuses of the system. And that extends to any abuses of non-qualified deferred compensation.

Congress provides significant tax benefits for qualified retirement plans. To control the revenue loss, Congress placed severe limits on the deferrals and benefits of highly compensated employees. Those limits on qualified plan benefits placed pressure on employers to supplement the benefits for executives. In 2001, Congress raised the limits for qualified plans, but we raised them only modestly. Those increases in the limits for qualified plans are attractive for the majority of workers, but they were simply not geared for executives, directors and officers. It was very difficult for Congress to agree on the modest increases we made to retirement plan limits in 2001. Because of the difficulty in reaching that agreement, I do not believe we would ever consider the level of changes necessary to make qualified plan limits attractive to executives for all of their pay. We are simply not going to do it. So executive compensation arrangements continue to exist. Last year this committee added language to the chairman's mark in S. 1971 to: repeal the moratorium on Treasury's ability to promulgate regulations on deferred compensation arrangements; prohibit off-shore "rabbi-trusts"; tax executives at the top rate on bonuses of $1 million or more; limitations on loans to executives. Except for the last item, which was made moot by the Sarbanes-Oxley Act of last

summer, all these provisions will be in any pension bill considered by this committee.

Last year I also introduced the "Corporate Accountability in Bankruptcy Act". My bill was drafted to clarify that the bonuses and other excessive compensation of corporate directors and wrongdoers can be pulled back into the estate of a bankrupt firm. Corporate wrongdoers who have violated securities and accounting laws should not be able to make off with outrageous sums of money from a bankrupt company. Why should they profit when shareholders, creditors and employees are left to finance the company's debts? Moreover, corporate officers and executives should not be permitted to keep large bonuses when a company has performed so poorly that it is forced into bankruptcy. Frankly, I don't understand why Enron's bankruptcy judge has not demanded the return of the $53 million in deferred compensation that was removed near the near the end of Enron's existence? Under current law, that money should all be returned to the estate of Enron. Just to make that clear, however, I will be reintroducing my bankruptcy legislation and will be seeking its speedy enactment.

Let me conclude by saying that I am greatly troubled by the facts in the Enron case. I hope we can learn from what happened there. My view is that a great many of the failures at Enron were failures of corporate governance. Literally no one was managing, supervising or exercising oversight over this organization and it has been a horrible scandal that has ruined the lives of many innocent people. I have many other comments and observations about Enron, corporate governance, executive compensation and bankruptcy rules. In the interest of time, I will pause here and turn to Senator Baucus in case he would like to make a statement.

STATEMENT OF PROFESSOR KATHRYN J. KENNEDY
Testimony Before the Senate Finance Committee
Response to the Joint Committee on Taxation's
Investigative Report on Enron: Compensation Related Issues
April 8, 2003

I. Introduction

Chairman Grassley, Ranking Member Baucus, and distinguished members of the Finance Committee, thank you for this opportunity to appear before you today to discuss executive deferred compensation issues. I am Kathryn J. Kennedy, an associate professor of law at The John Marshall Law School in Chicago and director of the school's graduate programs in taxation and employee benefits law. Our school's graduate program in employee benefits is the only one of its kind in the nation. I teach and oversee its curriculum in 18 different employee benefits courses -- ranging from executive compensation to health law to qualified retirement plans to employee stock ownership plans. As well as being an attorney, I am also an actuary. My research and scholarship also address employee benefits and related tax issues.

I had the privilege of testifying before this Committee on February 11, 2003, when the Joint Committee on Taxation (hereinafter referred to as the "Joint Committee") issued its Investigative Report on Enron. At the time of my testimony, the Report had just been issued to the public and my comments were therefore limited to general abuses perceived within the area of executive deferred compensation plans and related security arrangements (such as rabbi trusts). Since the issuance of the Joint Committee's Report, I have had a chance to thoroughly review its specific recommendations regarding executive deferred compensation plans. In an effort to implement many of these recommendations and to curb perceived abuses under these plans, I have proposed legislation, attached to this written testimony. This proposed legislation is substantially similar to the proposal made during my February 2003 testimony, with a few exceptions.

II. Purpose of My Testimony

The purpose of my testimony is twofold -- to comment on the Joint Committee's recommendations regarding executive deferred compensation plans (as elaborated on pages 634 through 637 of Volume 1 of its Report) and to recommend legislative solutions to halt abusive practices with respect to such plans.

Congress provides a significant tax subsidy for *qualified* pension and profit sharing plans in order to encourage their growth. To curb the level of tax subsidies granted to highly paid employees, Congress has imposed significant limitations under qualified plans for such employees. These limitations put pressure on employers and executives to supplement qualified benefits in order to provide executives with replacement income that is proportionate to that which is provided to lower-paid employees. Due to the funding and tax preferential treatment of qualified plans, employers and executives alike opt for these nonqualified arrangement *only* when adequate benefits cannot be achieved through a qualified plan. The nonqualified plan has features similar to the qualified plan not

to replace the plan but to supplement the benefits/deferrals provided through the qualified plan.

Elective executive deferred compensation plans allow the executive to fund for this additional retirement income. As this is the executive's current compensation, he/she is disinclined to subject it to future forfeiture (other than possible forfeiture if the employer goes bankrupt or insolvent). *Nonelective* plans are paid for by the employer and thus, may have requirements attached (*e.g.,* future performance by the executive) or forfeitures imposed (*e.g.*, loss of benefits for subsequent employment with a competitor). In the case of Enron, its executive deferred compensation plans involved employee *elective* deferrals, not employer-provided benefits.

The Joint Committee made an initial suggestion that *all elective* executive deferred compensation plans be subject to a substantial risk of forfeiture in order to avoid current taxation. This is something the IRS tried to do back in 1978. Congress responded swiftly by imposing a moratorium on the Service's ability to issue constructive receipt rulings. The elimination of *all elective* deferrals would simply result in more *current* cash compensation payable to the executive which certainly does not align the executive's incentives with that of the future financial health of the employer. Such deferrals are typically used as continuing capital for the employer, thereby preventing the draining of assets from the employer currently but instead deferring such payments until the executive's retirement. Thus, there are legitimate business reasons in permitting executives to make elective deferrals of compensation without triggering current taxation.

The Joint Committee recognizes that its initial suggestion represents a significant change in tax policy and presumes that this Committee would prefer a less drastic approach. Thus, it makes specific recommendations for this Committee to consider in the executive deferred compensation area -- all of which would require Congressional legislation. I would like to analyze these recommendations and proposed legislative solutions to aid Congress in correcting many of the abuses seen in this area. These proposed legislative solutions would require amendments to the Internal Revenue Code (hereinafter referred to as the "Code ") §61 (definition of gross income) and §83 (application of economic benefit doctrine). In making legislative changes Congress needs to strike a proper balance between the desire to provide supplemental retirement income for executives through nonqualified deferred compensation plans with the risk executives must assume to avoid current taxation.

In its discussion of executive deferred compensation plans, the Joint Committee targets three main concerns: the specific *terms* of the executive deferred compensation plan; the use of *security arrangements* to assure executives that promises under these plans will be kept; and the lack of *reporting and disclosure information* for these plans. To promulgate changes, legislative efforts to target the specific terms of the plans will require an amendment to Code §61; to clarify the use of security arrangements to protect benefits under these plans will require an amendment to Code §83; and to improve reporting and disclosure will simply require a directive under ERISA for the Department of Labor to implement such change. The attached proposed legislative solutions address each of these three areas and implement appropriate safeguards.

[redacted]

Statement for the Senate Finance Committee

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

Nonqualified Deferred Compensation

Bruce J. McNeil

April 8, 2003

EXECUTIVE SUMMARY

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

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

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

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

The revenue concern raised by the Staff with respect to an avoidance of current income taxation may be addressed in a manner other than a manner that significantly impacts the

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

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

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

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

INTRODUCTION

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

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

FUNDAMENTAL DOCTRINES AND THEORIES OF TAX

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

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

Prior to 1942, accrual basis employers were generally allowed a current deduction for nonforfeitable liabilities to pay deferred compensation even though the compensation was paid and includable in the income of the employee in a later year (*Globe-Gazette Printing Co. v. Commissioner*, 16 B.T.A. 161 (1929), acq. IX-1 C.B. 20 (1930)). This "mismatching" of the

employer's deduction and the inclusion in income was eliminated by the Revenue Act of 1942, which added Section 23(p)(1)(D) to the Internal Revenue Code of 1939, the predecessor to Section 404(a)(5) to the Code. That provision tied the deduction to the time of payment, but no deduction was allowable for a transfer when taxation was postponed because the transferee's rights were forfeitable (*see* Section 1.404(a)-12(c) of the Regulations). The Tax Reform Act of 1969 corrected the language in the statute.

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

A. Reasonable Compensation

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

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

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

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

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

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

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

the employee's gross income in accordance with Section 1.404(a)-12(b)(1) of the Treasury Regulations.

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

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

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

A significant element of Section 404(a)(5) of the Code is that in order to be deductible under Section 404(a)(5) and the regulations thereunder, amounts contributed to a nonqualified plan must also be ordinary and necessary business expenses under Section 162 of the Code. Section 162(a)(1) of the Code allows a deduction with respect to "a reasonable allowance for salaries or other compensation for personal services actually rendered." Section 1.162-9 of the Income Tax Regulations provides that bonuses paid to employees are deductible "when such payments are made in good faith and as additional compensation for the services actually rendered by the employees, provided such payments, when added to the stipulated salaries, do not exceed a reasonable compensation for the services rendered." Whether an expense that is claimed pursuant to Section 162(a)(1) is reasonable compensation for services rendered is a question of fact that must be decided on the basis of the facts and circumstances. Among the elements to be considered in determining this are the personal services actually rendered in prior years as well as the current year and all compensation and contributions paid to or for such

employee in prior years as well as in the current year. Thus, a contribution which is in the nature of additional compensation for services performed in prior years may be deductible, even if the total of such contributions and other compensation for the current year would be in excess of reasonable compensation for services performed in the current year, provided that such total plus all compensation and contributions paid to or for such employee in prior years represents a reasonable allowance for all services rendered by the employee by the end of the current year. See Section 1.404(a)-1(b) of the Regulations. (See *Private Letter Ruling 9347012*, dated August 18, 1993.)

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

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

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

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

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

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

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

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

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

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

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

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

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

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

B. Constructive Receipt

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

Section 451(a) of the Code provides that a taxpayer reporting on the cash method of accounting must include an item in income for the taxable year in which such item is actually or constructively received. Section 1.451-2(a) of the Income Tax Regulations defines the term "constructive receipt" as "[i]ncome although not actually reduced to a taxpayer's possession is constructively received by him in the taxable year during which it is credited to his account, set apart for him, or otherwise made available so that he may draw upon it at any time, or so that he could have drawn upon it during the taxable year if notice of intention to withdraw had been given. However, income is not constructively received if the taxpayer's control of its receipt is subject to substantial limitations or restrictions."

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

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

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

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

The IRS found that although the employee could have applied for a withdrawal of the entire vested account balance of $3,000, he was not considered to be in constructive receipt of that amount since the requirement in the plan for substantiating financial need, obtaining approval of the administrative committee, and the acceptance of whatever terms and conditions such committee could impose, constituted substantial restrictions or conditions on the

employee's right of withdrawal. However, the $500 amount approved for withdrawal by the committee was actually the maximum amount permitted as a withdrawal in this case and, therefore, was made available to the employee. Accordingly, the employee was required to include $500 in gross income for the year the committee's approval was granted for the withdrawal of such amount rather than the $400 actually withdrawn.

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

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

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

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

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

In *Revenue Ruling 80-300,* 1980-2 C.B. 165, a corporation adopted a plan under which key employees of the corporation were granted stock appreciation rights. The stock appreciation rights entitled the employee to a cash payment equal to the excess of the fair market value of one share of the common stock of the corporation on the date of the exercise of the stock appreciation right over the fair market value of a share on the date the stock appreciation right

was granted to the employee. The IRS stated that the forfeiture of a valuable right is a substantial limitation that precludes constructive receipt of income. The employee's right to benefit from further appreciation of stock, in this case, without risking any capital was a valuable right. However, once the employee exercised the stock appreciation rights, the employee lost all chance of further appreciation with respect to that stock and the amount payable became fixed and available without limitation. Accordingly, the employee would be in receipt of income on the day the stock appreciation rights were exercised.

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

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

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

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

sole owner and beneficiary of the policy, and the taxpayer could rely only on the credit of the hospital and the strength of its promise.

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

C. Economic Benefit Doctrine

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

Under the economic benefit doctrine, if any economic or financial benefit is conferred on an individual as compensation in a taxable year, it is taxable to the individual in that year. In *Commissioner v. Smith*, 324 U.S. 177, 65 S.Ct. 591, 89 L.Ed. 830 (1945), *reh. den.* 324 U.S. 695, 65 S.Ct. 891, 89 L.Ed. 1295 (1945), an employer gave an employee, as compensation for his services, an option to purchase from the employer certain shares of stock of another corporation at a price not less than the then value of the stock. In two later years, when the market value of the stock was greater than the option price, the employee exercised the option, purchasing large

amounts of the stock in each year. The Tax Court had determined that the excess of the market value of the shares over the option price in the years when the shares were received by the employee was compensation for his services, and taxable as income in those years. The United States Supreme Court agreed and concluded that the employee received an economic benefit at the time he received the shares and, as a result, the employee had taxable income in each year in which stock was acquired.

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

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

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

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

from Snohomish Physicians' creditors and thus incapable of valuation. Accordingly, the court concluded that Minor's benefits did not constitute property under Section 83 of the Code. However, the court noted that the plan "severely stretches the limits of a nonqualified deferred compensation plan."

D. Assignment of Income Doctrine

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

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

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

In *Commissioner v. P.G. Lake, Inc.*, 356 U.S. 260, 78 S.Ct. 691, 2 L.Ed.2d 743 (1958), *rehearing denied* 356 U.S. 964, 78 S.Ct. 991, 2 L.Ed.2d 1071 (1958), the taxpayers assigned the right to a specified sum of money, payable out of a specified percentage of oil, or the proceeds

received from the sale of such oil, if, as and when produced in return for cash. The Court concluded that, while the oil payments were interests in land, the consideration received for the oil payment rights was taxable as ordinary income because the lump sum consideration was essentially a substitute for what would otherwise be received at a future time as ordinary income. The Court stated:

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

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

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

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

for dissolution of marriage, at the conclusion of which the trial court awarded Brenda a 70% interest in the total marital estate, which was valued at $1,512,920. Dan appealed the award.

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

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

E. Cash Equivalency Doctrine

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

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

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

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

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

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

F. Transfer of Property

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

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

Section 1.83-3(e) of the Regulations provides that for purposes of Section 83, the term "property" includes real and personal property other than either money or an unfunded and unsecured promise to pay money or property in the future. The term also includes a beneficial

interest in assets (including money) which are transferred or set aside from the claims of creditors of the transferor.

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

G. Dominion and Control

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

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

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

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

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

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

DEFERRED COMPENSATION

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

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

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

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

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

A. ERISA Exemption for Top-Hat Plans

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

> [i]t is the view of the Department that in providing relief for "top-hat" plans from the broad remedial provisions of ERISA, Congress recognized that certain individuals, by virtue of their position or compensation level, have the ability to affect or substantially influence, through negotiation or otherwise, the design and operation of their deferred compensation plan, taking into consideration any risks attendant thereto, and, therefore, would not need the substantive rights and protections of Title I [of ERISA].

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

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

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

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

Carrabba at 477.

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

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

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

be a "highly compensated employee" for purposes of the phrase, "select group of management or highly compensated employees."

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

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

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

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

his severance agreement through his attorney and his negotiations with Hobbs, president of Chemworld. He exerted sufficient influence to become the only employee ever to receive retirement benefits from Chemworld. Accordingly, the court concluded that Duggan's severance agreement was maintained for a "select group."

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

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

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

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

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

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

The district court found that the Deferred Compensation Agreement and the Incentive Compensation Plan were subject to ERISA, but, as top-hat plans, were exempt from the substantive vesting requirements of ERISA. The plans included noncompetition provisions which could result in the forfeiture or suspension of benefits, and the district court found that those provisions were permissible since the plans were top-hat plans. The district court said that

because forfeiture clauses are permissible under top-hat plans, "no vesting of rights can occur." Therefore, the court granted the company's motion for summary judgment on the question of whether the release exception for vested rights preserved Healy's benefits under the plans.

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

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

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

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

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

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

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

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

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

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

The deferred compensation plan was financed through contributions made by Nationwide on the agent's behalf to a group annuity. The amount of contribution for an agent was calculated based upon a percentage of the sales and renewal fees earned by the agent. Contributions to an agent's account began when the agent had completed five years of service and continued until the agent was terminated for any reason including, but not limited to, retirement, death, or

disability as long as the agent had reached age 60. The court concluded that, in view of the benefit accrual and distribution features of the deferred compensation plan, the plan provided retirement income to employees and was an employee pension benefit plan under ERISA.

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

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

RECOMMENDATIONS

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

The Staff of the Joint Committee on Taxation appears to be concerned with the effects of nonqualified deferred compensation on shareholders, creditors and the federal treasury. The concerns of the Staff can be addressed without substantially modifying the Internal Revenue Code or the interpretation and application of the doctrines and theories governing the taxation of deferred compensation and without losing the social and economic benefits that employers obtain from being able to provide modestly flexible deferred compensation arrangements for the benefit of a select group of individuals. As discussed earlier, Section 404(a) of the Internal Revenue Code provides that compensation paid under a plan deferring the receipt of compensation will be deductible only if the compensation otherwise satisfies the requirements for reasonable compensation pursuant to Section 162 of the Internal Revenue Code. The potential loss of a significant tax deduction provides, therefore, a significant incentive to employers to provide only "reasonable" compensation. In addition, the boards of directors of employers have fiduciary obligations under the business judgment rule, a feature of the corporation laws of every state, that require them to assure that deferred compensation pay levels

and those for whom such pay levels are established are not abusive to shareholders. If there is a concern about the fairness to shareholders of the amounts of deferred compensation provided to company executives, the avenue for which the concerns may be addressed is not the federal tax laws but the rules and laws governing the obligations and responsibilities of the boards of directors under the business judgment rule and rules adopted and enforced by the Securities and Exchange Commission.

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

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

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

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

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

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

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

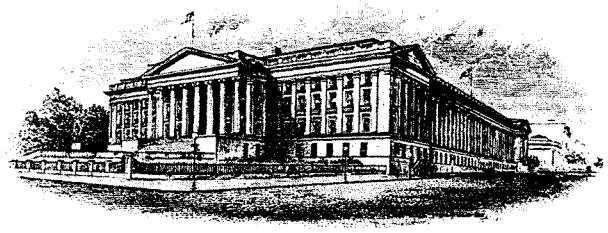
Each of those statutes might be modified or amended to include that transfers of deferred compensation to insiders within a year of the bankruptcy are presumptively avoidable thereby placing the burden of proof on the recipient of the transfer to establish that there was equivalent value and entitlement,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

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

Any other revenue concern of the Staff with respect to an avoidance of current income taxation could be addressed in a manner other than a manner that significantly impacts the economic or social utility of deferred compensation. An approach that may be more acceptable

would be to impose a cap on the deduction at an amount equal to the tax imposed on the individual. So, for example, if the tax rate applicable with respect to the executive was 30%, the deduction for the employer would be determined at no more than that rate. This cap could eliminate any timing issue otherwise applicable and any revenue loss that may otherwise occur at the time that payment is made.

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



TESTIMONY OF
PAMELA F. OLSON
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FOR THE
COMMITTEE ON FINANCE
UNITED STATES SENATE
APRIL 8, 2003

Mr. Chairman, Senator Baucus, and distinguished Members of the Finance Committee, thank you for the opportunity to testify regarding the Administration's legislative and regulatory proposals on executive compensation. The recent report by the staff of the Joint Committee on Taxation, prepared at the request of this Committee, reveals Enron Corporation's excessive and questionable executive compensation practices. The details of the report underscore the importance and timeliness of this hearing.

The practices of Enron make clear that executive pay is about more than just tax policy. Executive pay is an issue of corporate governance and accountability. Many investors' confidence has been adversely affected by reports of increasing executive compensation during times of deteriorating returns. Executive pay is an issue of fiscal responsibility – as the markets worry about the integrity of companies' financial statements. And executive pay is an issue of fairness – the same set of rules governing the taxation of income should apply to all taxpayers. The issues raised by the Enron report deserve the attention of legislators and regulators. We think it is important, however, to distinguish matters of tax policy from matters of corporate governance and accountability. We have specific recommendations for addressing tax policy matters through tax legislation, but we believe recent experience indicates there are risks to using the tax code as a means of influencing decisions about corporate governance and accountability. Consequently, we recommend that such concerns be dealt with directly and not through amendments to the tax code.

In reviewing the report, we noted three general points about Enron's executive compensation. First, several of the executive pay practices at Enron pushed the envelope of current law. The company permitted its executives to defer staggering amounts of income but took measures to insulate them from the risk of non-payment that the law requires as a trade-off for tax deferral. Enron was helped in this effort by out-dated rules on executive compensation – rules that the Treasury Department and the IRS have been statutorily prohibited from updating since 1978. Second, we were pleased to note that several of the pay practices at Enron have been addressed through legislation signed by President Bush last year and by recently-issued Treasury and IRS regulations. Third, the largest category of executive pay at Enron was the massive stock option gains realized by

Enron's executives. Enron's heavy use of stock options, which parallels the use of options by some other large companies, may in fact be the unintended result of legislation from past Congresses and of current financial accounting standards.

The Enron report raises another important issue, one extending beyond executive compensation. The sheer complexity of Enron's tax-motivated transactions made it very difficult for the IRS to find them and then understand what the company was attempting. In many cases, it appears that Enron intended the complexity of the transactions to frustrate detection by the IRS. In other words, Enron was deliberately hiding the ball, and that is cause for concern.

Tax Rules for Executive Compensation

It is important to understand the current tax rules for executive compensation and how those rules factored into Enron's compensation practices. The tax law does not specifically encourage executive compensation arrangements. In contrast to qualified retirement plans and employer-provided health insurance, Congress has never enacted incentives for companies to maintain or enhance executive pay arrangements. In certain cases, Congress has taken the opposite approach by imposing a tax penalty on practices considered inappropriate.

The rules on executive compensation generally have focused on three policy goals: first, to prevent tax avoidance; second, to protect the qualified-plan system; and, third, to promote good corporate governance. A few words about each of these goals are in order before turning in detail to the applicable tax rules.

First, many of the rules on executive compensation aim to prevent tax avoidance. General tax principles allow an executive to defer tax on compensation only if the executive accepts the risk that the compensation may never be paid if the company becomes insolvent or bankrupt. Executives, naturally, do not like this risk and so push for greater security and control in their deferred compensation arrangements. Many of the current rules are intended to prevent tax deferral where the executive has minimized the risk of non-payment or has realized current economic value from deferred amounts. This is an area in which we seek legislation from the Committee.

Second, certain executive compensation rules protect the integrity of the qualified plan system. To ensure the retirement security of millions of American workers and their families, the tax code provides substantial tax incentives for companies to establish and maintain qualified plans. These tax benefits are most valuable to high-paid employees, but they are available to those employees only if the qualified plans give proportional benefits to a broad cross-section of rank-and-file workers. Allowing executive pay plans to provide the same tax benefits that qualified plans can provide would undermine the qualified plan system. That, in turn, would put the retirement security of rank-and-file workers at risk. Thus, the tax code ensures that executive pay arrangements do not inappropriately compete with qualified plans.

Third, certain tax rules for executive compensation are intended to promote good corporate governance and accountability. In certain cases, Congress has determined that particular types of executive compensation arrangements harm shareholders – either because of the type of payment involved or the size of the payment involved. In response, Congress has enacted rules that impose tax penalties unless the company meets certain shareholder-protection standards.

It is useful to begin by considering the tax rules for executive compensation, focusing on how the rules apply to common types of executive pay and the compensation practices at Enron. Instead of setting out comprehensive rules, the tax law addresses executive pay through a combination of general tax principles and particular rules aimed at very specific situations. These principles and rules are found in the tax code, IRS rulings and regulations, and federal court decisions.

I want to stress the role of the Treasury Department and the IRS in executive compensation matters. Our job is to interpret and administer tax rules – in particular, to ensure that companies and executives adhere to the long-standing tax rules about how much control an executive can have over deferred compensation payouts (the "constructive receipt" rules) and how much protection the company can give the executive against non-payment if the company becomes bankrupt or insolvent (the "funding" rules). Enforcing the constructive receipt and funding rules fits within the IRS's role and capabilities. We do not believe that we are well-served by assigning to the IRS the role of enforcing rules intended to protect shareholders' interests.

We recognize that corporate governance and accountability are legitimate policy goals for executive compensation, and we understand that Congress in particular cases may conclude that legislation is needed to promote those goals. Experience indicates, however, that attempting to influence corporate governance and accountability decisions through the tax code is ineffective. Moreover, logic dictates that the issues should be dealt with directly and not through the tax code. So much as possible, the tax code should be neutral in choosing among forms of compensation.

Nonqualified Deferred Compensation – Tax Policy Issues. Nonqualified deferred compensation arrangements – including both executive bonus plans and executive pension plans – constitute one of the most common elements of executive pay. The terms of these arrangements vary widely, but their common objective is to provide tax deferral for a specified period on either an elective or non-elective basis. The compensation compounds during the deferral period at a fixed or variable rate of return, and the executive typically receives distributions of the accumulated amounts at or after retirement (with provisions for distributions under certain other circumstances, as discussed below). Many plans provide the executive with some measure of actual or hypothetical investment control over deferred amounts.

If structured correctly, the tax treatment of a nonqualified deferred compensation arrangement is as follows. The executive does not include the deferred amount in gross income until it is actually paid out to the executive. The company cannot claim a

deduction for the deferred amount until the executive includes it in gross income. During the deferral period, earnings on the deferred amount generally remain taxable to the company. Thus, the law imposes a "tax tension" between the executive and the company because every dollar for which the executive defers income is a dollar for which the company must defer its deduction.

However, that tax tension only works if the executive and the company are both representing their own interests; it does not work if the company structures the pay with the sole aim of maximizing value for the executive without regard to the interests of shareholders. For example, an arrangement under which a company commits substantial assets to an irrevocable trust for the executive's benefit results in the company having less capital to re-invest in its business and may result in lower returns for shareholders – without an offsetting tax deduction for the compensation the company has set aside.

Deferred compensation arrangements must meet certain legal requirements. First, the executive cannot be in "constructive receipt" of any deferred amount. This means that an executive can defer an amount only as long as there is a "substantial limitation or restriction" on the executive's right to receive the amount. The principle of constructive receipt ensures that an executive cannot manipulate the timing of when taxes are due by turning his or her back on income that would be paid right away if the executive simply asked for it. If an executive can choose to receive deferred compensation at any time, the executive is in constructive receipt and is taxed immediately.

The IRS has applied the constructive-receipt doctrine by refusing to approve any decision to defer income and any decision about when and how that income will be paid unless the decision is made in the taxable year before the income is earned. For this reason, deferred compensation plans often provide for deferral elections to be made before the start of the taxable year. The plans often state the time when amounts will be paid out and the form of the distribution. Payout usually is made in a lump sum or in annuity or installment form at retirement or other termination of employment, death, disability, financial hardship, or after a fixed number of years.

Many plans allow an executive to make a subsequent election to defer payouts that are coming due or to change the form of the payout (or both). The plans typically require that the subsequent election be made a fixed number of months (often twelve) before the payout is due. Some plans also allow for accelerated payouts. For example, a plan may provide for an early distribution with a "haircut" – such as a forfeiture of 10 percent – or a suspension from further participation.

The IRS has had difficulty enforcing the constructive-receipt rules in disputes with taxpayers. The federal courts generally have followed an expansive interpretation of these rules, which were first written decades ago. Each court loss for the IRS has made companies and executives bolder in pushing out the line of common practice, with Treasury and the IRS prevented by Congress from updating the rules in response. The treatment by the courts of this issue has been a major factor in the expansion of deferred compensation.

Second, the tax law treats an unfunded promise to pay differently from a funded promise. Thus, the "economic benefit" doctrine and the rules governing transfers of property require that assets related to nonqualified deferred compensation remain subject to the claims of the company's general creditors along with the other general assets of the company. These rules are intended to put the executive at risk of non-payment if the company becomes bankrupt or insolvent. If a company insulates deferred compensation assets from the claims of its creditors – for example, by placing the deferred compensation in a trust or an escrow account for the exclusive benefit of the executive – the executive has a taxable economic benefit and must include the deferred compensation in gross income. Special rules, intended to backstop the qualified plan rules, provide a harsher result for discriminatory trusts by requiring the executive to pay tax currently on earnings as well.

The IRS has allowed very limited funding arrangements – commonly known as "rabbi trusts" – without triggering current tax to executives. Assets held by a rabbi trust are treated as belonging to the company, and the company continues to pay tax on any income they produce. More importantly, assets in a rabbi trust must be reachable by the general creditors of the company in the event of bankruptcy or insolvency. However, certain executive pay arrangements have increasingly stretched the limits on rabbi trusts and deferred compensation funding. In general, these arrangements – which include offshore rabbi trusts and hybrid (rabbi and non-rabbi) arrangements – are meant to keep assets away from creditors without triggering current tax to the executives.

Finally, the cash-equivalence and assignment-of-income doctrines require that an executive's interest in deferred compensation be non-assignable. This ensures that the executive cannot sell, transfer, pledge, or borrow against the deferred compensation and thereby realize economic value from it before it is paid.

The staff of the Joint Committee on Taxation found that Enron, like many large companies, provided very significant deferred compensation to its executives. It appears that Enron's deferred compensation arrangements generally complied with current law. However, Enron's arrangements also demonstrate the limitations of current law. As the company rapidly approached bankruptcy, many Enron executives were able to invoke accelerated distribution clauses. Although those accelerated distributions required a "haircut" – the executives had to forfeit 10 percent of the deferred compensation – the choice between receiving most of their deferred compensation and receiving none of their deferred compensation was surely an easy one. The practical effect of the accelerated distributions was to put these Enron executives in line ahead of the company's general creditors, allowing an end-run around the legal requirement that deferred compensation remain at risk of non-payment.

As discussed in more detail below, current law prevents Treasury and the IRS from restricting haircuts and other accelerated distribution clauses. Because of legislation passed by Congress in 1978, Treasury and IRS only have the authority to make haircut provisions *less restrictive* for executives. This is precisely the opposite of the authority

we need when confronting arrangements that present potential for inappropriate tax avoidance or that undermine the qualified plan system. We strongly recommend that Congress repeal that limitation and give us the authority necessary to address both appropriate and inappropriate deferred compensation arrangements.

Nonqualified Deferred Compensation – Corporate Governance Issues. It is important to recognize that interpretation and administration of the constructive receipt and funding rules fit within the traditional role for Treasury and the IRS while enforcing shareholder protections do not. Practices that pass muster under the constructive receipt and funding rules may still present corporate governance or accountability concerns that Congress should address through legislation. If so, we recommend that Congress legislate directly rather than indirectly by trying to influence corporate governance and accountability decisions through the tax code. The tax code should be neutral. If it is not, it is likely to influence or skew decision-making one way or the other with unfortunate unintended consequences.

Recent history provides examples of what happens when Congress does or does not legislate directly on corporate governance and accountability. Last summer, Congress passed and President Bush signed the Sarbanes-Oxley Act, which includes important new rules about executive compensation. Sarbanes-Oxley enacts one of the President's retirement-security proposals by prohibiting corporate insiders from trading company stock during a "blackout" period of the company's 401(k) or other defined contribution retirement plan; it prohibits public companies from making virtually any loan to executives or directors; and it requires the chief executive officer and the chief financial officer to forfeit incentive and equity-based compensation if the company restates its financial statements. In all these cases, Sarbanes-Oxley directly addresses the problem; it does not attempt to ban or curb a practice indirectly by amending the tax code and then asking the IRS to take on the role of enforcing shareholder protections.

Compare the Sarbanes-Oxley approach with two situations where Congress has used the tax code to address shareholder-protection concerns – the $1 million cap on deductible compensation and the "golden parachute" payments. Both these sets of rules show the unintended consequences that follow from legislating corporate governance through the tax laws.

Section 162(m) provides that a public company cannot deduct compensation in excess of $1 million for any of its top five executives. The provision contains a key exception for certain "performance-based" compensation that has been approved by shareholders after full disclosure. Stock option grants ordinarily fall within this exception. Congress enacted section 162(m) on the rationale that taking away a deduction for "excessive" compensation to top executives would protect investors in public companies by instilling greater discipline in executive pay packages.

But section 162(m) has had the opposite of its intended effect. At many companies, the $1 million "cap" has effectively become a $1 million "floor" for base salary and non-performance bonuses. Additionally, the "performance-based" exception has encouraged

many companies, like Enron, to shift compensation above the $1 million amount into stock options and other forms of compensation tied to the company's stock price. As the Committee is well aware, much of the recent concern about the accuracy of companies' financial statements has focused on whether tying executive pay to the company's stock price gives the executive too much incentive to manipulate earnings statements in order to affect the stock price. Finally, many companies facing the choice between losing the deduction for compensation above $1 million or trimming executive pay simply do not claim the deduction. In those cases, the loss to shareholders simply compounds – the executive still receives the same pay, and the company loses its tax deduction. What was intended as a shield for investors instead becomes a sword against them.

The golden parachute rules provide a similar example. Congress enacted these tax penalties in the mid-1980s to prevent executives from draining value out of companies in connection with corporate takeovers. Section 280G prevents the company from deducting an excess golden parachute payment, and section 4999 imposes a 20 percent excise tax on an executive who receives such a parachute payment. Again, however, the tax penalties intended to protect shareholders have had the opposite effect. In many situations, companies and executives respond to the tax penalties by agreeing that the company will "gross up" the executive – that is, pay for any penalty tax that the executive incurs on a golden parachute payment. The law treats the gross up as a parachute payment, meaning that the cost of making the executive whole spirals upward – and of course, the company cannot deduct the underlying parachute payment or the gross up payment. Thus, the golden parachute penalties have resulted in many companies paying executives *larger* parachute payments and losing their tax deductions – to the detriment of shareholders.

Congress must consider corporate governance and accountability issues when crafting legislation on executive compensation, but we recommend that Congress not use the tax code to legislate on those issues. Experience demonstrates that trying to implement shareholder protections through the tax laws likely will compound the harm to shareholders. Additionally, legislating corporate governance through the tax code puts the IRS in a position of being the primary defender of shareholder interests – a position for which the IRS simply is not well-suited. Shareholder interests are best protected by shareholders themselves and appropriate federal regulatory agencies, such as the SEC. Congress should look to the tax code to promote sound tax policy and, on executive compensation, should enable Treasury and the IRS to administer the long-standing rules concerning constructive receipt and funding of deferred compensation.

Restricted Stock and Stock Options. Restricted stock has long been a component of executive pay packages. Section 83 sets out rules for taxing restricted stock and stock options. An executive must include the fair market value of restricted stock at the time the restricted stock becomes "substantially vested" – that is, when it becomes transferable or not subject to a substantial risk of forfeiture. A special rule allows the executive to make an election to include the restricted stock in gross income prior to its becoming substantially vested. The company's deduction for the restricted stock matches the timing and amount of the executive's income.

In recent years, companies have made extensive use of stock options to compensate executives. An executive is not taxed on the receipt of a stock option (except in the highly unusual case where the option has a "readily ascertainable fair market value" when granted). Instead, the executive is taxed upon exercise of the option. At that time, the executive includes in gross income the "spread" on the option – that is, the difference between the fair market value of the stock and the amount the executive pays to exercise the option (plus any amount the executive paid to acquire the option). The company's deduction for the spread matches the timing and the amount of the executive's income.

A major consideration in the use of stock options for executive pay has been the current accounting rules for options. Under those rules, a company must account for stock-based executive compensation plans under the "fair value" method or the "intrinsic value" method. Under the fair value method (set out in FAS 123), a company expenses an option under Black-Scholes or a binomial model. This creates a charge to earnings at grant or on vesting. Under the intrinsic value method (set out in APB Opinion No. 25) an option granted at fair market value does not have any intrinsic value and results in no charge to earnings. However, a company using the intrinsic value method must disclose in a footnote to its financial statements the effect on earnings, including earnings per share, of using the fair value method to account for option grants.

Most companies, Enron included, have used the intrinsic value method for stock options, thereby avoiding any charge to earnings for this element of executive compensation. It is important to note that the tide may be changing. More companies are beginning to use the fair value method, and FASB currently has this issue under review.

Enron compensated its executives primarily with stock options. According to the Enron report, total compensation for the 200 highest-paid executives was $1.4 billion, and over $1 billion of that amount was attributable to stock options. For the years 1998 to 2000, Enron's deduction for stock-option compensation increased by more than 1,000 percent. Still, it appears from the Enron report that the company treated the option grants and exercises properly under the tax law and that Enron accounted for these options in conformity with FASB accounting rules.

It is important that the Committee's review of executive compensation consider the working of the current rules with regard to stock options and whether these rules caused the concentration of stock options in the Enron executives' pay packages.

Administration's Proposals on Executive Compensation

This Administration has a strong commitment to ensuring that the tax rules apply fairly to everyone. Those who play by the rules rightly expect that all will play by the rules. The law cannot allow executives to end-run existing rules for paying tax on amounts that are currently available to them or that have been insulated from creditors. Unfortunately, Congress in 1978 tied the hands of the Treasury Department and the IRS. The Administration proposes that Congress lift the restrictions on new regulation of executive

compensation and give Treasury and the IRS full authority to address appropriate and inappropriate deferred compensation arrangements.

Section 132 of the Revenue Act of 1978. In 1978, Treasury and the IRS proposed Treasury Regulations section 1.61-16, providing for current inclusion of compensation deferred "at the taxpayer's individual option." The proposed regulation alarmed companies because the scope of the regulation was vague, and it was not clear whether all deferred compensation might be taxed currently. Companies also made strong arguments that they needed deferred compensation as part of their executive pay packages.

In response, Congress enacted section 132 of the Revenue Act of 1978 to prevent finalization of section 1.61-16. Section 132 provides that the taxable year of inclusion of any amount under a private deferred compensation plan "shall be determined in accordance with the principles set forth in regulations, rulings, and judicial decisions relating to deferred compensation which were in effect on February 1, 1978." The broad rule-making moratorium imposed by section 132 currently prohibits Treasury and the IRS from issuing new regulations or other guidance on many aspects of nonqualified deferred compensation arrangements.

Since the enactment of section 132, Treasury and the IRS have been unable to provide new guidance about core elements of deferred compensation arrangements. New guidance is needed to ensure that the tax rules keep pace with the constant changes in deferred compensation practices and to address federal court decisions that have undercut the rules on constructive receipt. The guidance also is needed simply to update IRS ruling guidelines that were issued in 1971 and that, despite minor changes in 1992, are considered out of step with the case law.

Budget Proposal to Repeal Section 132. The Administration's budget for fiscal year 2004 proposes the repeal of section 132 of the Revenue Act of 1978 and a grant of new authority to write regulations on inappropriate deferred compensation arrangements. Last year this Committee reported legislation that would have repealed section 132, and the staff of the Joint Committee on Taxation also recommended repeal of section 132 in the Enron report.

Repeal of section 132 would greatly enhance the ability of Treasury and the IRS to write regulations addressing deferred compensation practices. This enhanced ability is appropriate for Treasury and the IRS to have, because it is a matter of enforcing tax law through the definition of taxable income. In some situations, section 132 directly constrains issuing new rules. In others, repeal of section 132 along with new statutory authority to address inappropriate arrangements would make the rules more likely to survive court challenge. Treasury and the IRS would not implement proposed section 1.61-16 as part of this authority.

The new regulations would address the following topics, among others: benefit distribution elections; initial and subsequent deferral elections; executive control over

deferred amounts; shielding deferred compensation from creditors; and constructive receipt of property. Let me describe these briefly:

- Regarding *benefit distribution elections*, the regulations could address circumstances under which executives control the timing of their benefit payouts to the detriment of general creditors – for example, "haircuts" and other acceleration clauses.

- Regarding *initial and subsequent deferral elections*, the regulations could provide clearer rules to require that an executive's choice to defer income be made before the income is actually available – eliminating the executive's ability to defer tax on amounts under the executive's immediate control; the regulations also could state whether and when subsequent deferral elections are permitted.

- Regarding *executive control over deferred amounts*, the regulations could address questions about how much control an executive may have over deferred amounts – for example, whether and to what extent an executive may control the investment of deferred compensation or "swap" deferred compensation rights for stock options or life insurance arrangements.

- Regarding *shielding deferred compensation from creditors*, the new regulations could address techniques that attempt to shield assets from creditors while making it appear that the assets are reachable by creditors – for example, offshore rabbi trusts, secured trusts that "spring" into existence as a company approaches insolvency, trigger clauses that provide for automatic payouts as a company approaches insolvency, and third-party guarantees of deferred benefits.

- Regarding *constructive receipt of property*, the regulations could address when an executive is taxable on property (such as company stock) that is made available to the executive but is not actually transferred; this would give Treasury and the IRS clearer authority to address the taxation of deeply discounted stock options, resolving uncertainty about how certain old federal court decisions apply to current practices of issuing discounted options in lieu of deferred compensation.

One of the key points of the Administration's legislative proposal is the on-going flexibility that it will provide. Companies and executives regularly restructure executive pay packages, and the tax laws need to keep pace with these changes. The status quo is unacceptable as a matter of tax policy – Treasury and the IRS are actually forbidden from shaping or updating the law to address new practices. Moreover, legislation targeted at specific transactions or practices would be an incomplete response. It may not reach the new transactions or practices companies and executives develop in the future.

Furthermore, it is important that Treasury and the IRS have the authority to determine not only what types of arrangements cross the line but also to say what types of arrangements are permissible. The market pressures for executive compensation are significant, and limiting one particular inappropriate practice inevitably will lead companies and

executives to develop new practices, some troublesome and some not. Effective regulation in this area requires a comprehensive approach and continual updating of the rules to respond to new developments so that companies and executives are guided to appropriate arrangements.

We need also to shape the rules for nonqualified deferred compensation to keep pace with changes in the rules for qualified plans. One of the policy goals of the nonqualified plan rules is to protect the viability and the integrity of the qualified plan system. Because of the important role that qualified plans play in providing retirement income security for millions of American workers and their families, Congress regularly reviews and updates the rules for those plans through new legislation, and Treasury and the IRS regularly issue new regulations and rulings to implement that legislation. In fact, this Committee last year reported legislation, first proposed by the President, to protect the retirement security of workers whose plans invest in employer stock. Just as the Administration urges you to take up the retirement security legislation again this year, so too we urge you to give us the tools needed to make sure that this and future legislation will maintain the balance between qualified and nonqualified plans.

To meet the policy challenges of this dynamic area, we strongly recommend that Congress repeal section 132 of the Revenue Act of 1978 and give Treasury and the IRS lasting and meaningful authority to write proper rules for taxing executive pay. Untying our hands is the only way to ensure that Treasury and the IRS can respond quickly and effectively to developments in executive compensation.

Other Recent Legislative and Regulatory Developments
Certain of the executive compensation practices discussed by the staff of the Joint Committee on Taxation in its report have been addressed either through legislation signed into law by President Bush or through regulations issued by Treasury and the IRS. Additionally, Treasury and the IRS are continually reviewing new transactions to determine whether they are appropriate.

Sarbanes-Oxley Act. The Sarbanes-Oxley Act signed by President Bush last summer addresses outside the tax code certain executive compensation issues. Sarbanes-Oxley prohibits insider trading during "blackout" periods, prohibits almost all loans from public companies to executives and directors, and requires certain executives to forfeit incentive and equity-based compensation if the company restates its financial statements. All these changes would have had a material impact on Enron's executive compensation practices, and we believe they will help curb inappropriate executive pay practices in the future.

Split-Dollar Life Insurance Arrangements. Also last summer, Treasury and the IRS proposed new regulations for taxing split-dollar life insurance arrangements. A split-dollar life insurance arrangement is a contract to allocate the benefits and, in some cases, the costs of a life insurance policy. Under a typical equity split-dollar arrangement, an executive receives an interest in the policy cash value disproportionate to the executive's share of premiums. The new regulations ended many years of uncertainty about how these arrangements are taxed and remove the tax advantage of split-dollar life insurance

arrangements. Under the regulations, an executive will be taxed as receiving below-market loans from the company (if the executive owns the life insurance policy) or as receiving taxable economic benefits from the company (if the company owns the policy). Treasury and the IRS intend to finalize these regulations in the near future.

Other Arrangements. We are aware of other executive pay arrangements that raise tax policy concerns, and in some cases we anticipate publishing regulations or other guidance. For example, some executives who own stock options purport to sell those options to a family limited partnership, a family trust, or another entity in which they or their family members have a direct financial stake. This transaction is intended to defer the gain the executive would otherwise recognize on exercise of the options. We have reviewed these transactions, and we have serious concerns with them. We expect to issue a notice in the near future indicating how and why we intend to challenge them.

Of course, our review of certain transactions would potentially be different if Congress enacted our budget proposal to repeal section 132 of the Revenue Act of 1978. Section 132 ties our hands. To challenge a transaction, we have to conclude that it violates the law as in effect back in 1978. Executive compensation has changed a lot since 1978, and we need to be able to issue new rules and regulations to keep pace with changes in the market.

Finally, once we have identified a type of transaction and have determined that it fails under current law, we are able to list the transaction type and require taxpayers to disclose their participation in it. As with other types of abusive tax avoidance, we believe that listing is an important tool in tax administration and enforcement.

Summary and Closing

I thank the Committee for holding a hearing on this important topic, and I appreciate the opportunity to discuss these critical issues with you. We urge the Committee to do this year what it did last year – report legislation to repeal section 132 of the Revenue Act of 1978 to give Treasury and the IRS new authority to address deferred compensation, as proposed in the Administration's budget. We further urge the Committee to address the corporate governance and accountability issues raised by executive compensation directly rather than through the tax code. Mr. Chairman and Senator Baucus, the Office of Tax Policy would be happy to offer any assistance to you and your staff as you continue your review of this critical issue.

Mr. Chairman, this concludes my formal statement. I would be pleased to answer any questions that you or any other member may wish to ask.

WRITTEN TESTIMONY OF THE STAFF OF THE JOINT COMMITTEE ON TAXATION ON EXECUTIVE COMPENSATION AND COMPANY-OWNED LIFE INSURANCE ARRANGEMENTS OF ENRON CORPORATION AND RELATED ENTITIES

Presented by
Mary M. Schmitt
Acting Chief of Staff of the
JOINT COMMITTEE ON TAXATION

At a Hearing of the
SENATE COMMITTEE ON FINANCE
On April 8, 2003

April 7, 2003
JCX-36-03

CONTENTS

I. INTRODUCTION

My name is Mary Schmitt. I am Acting Chief of Staff of the Joint Committee on Taxation. It is my pleasure to present today the testimony of the staff of the Joint Committee on Taxation (the "Joint Committee staff") concerning the executive compensation and company-owned life insurance arrangements of Enron Corp. and its related entities.[1]

In February 2002, Senators Max Baucus and Charles E. Grassley, then Chairman and Ranking Member of the Senate Committee on Finance ("Senate Finance Committee"), directed the Joint Committee staff to undertake a review of Enron's[2] Federal tax returns, tax information, and any other information deemed relevant by the Joint Committee staff to assist the Senate Finance Committee in evaluating whether the Federal tax laws facilitated any of the events or transactions that preceded Enron's bankruptcy. The Joint Committee staff was also directed to review the compensation arrangements of Enron employees, including tax-qualified retirement plans, nonqualified deferred compensation arrangements, and other arrangements, and to analyze the factors that may have contributed to any loss of benefits and the extent to which losses were experienced by different categories of employees.

In connection with a hearing on the investigation, the Joint Committee staff presented its official Report on the investigation[3] to the Senate Finance Committee on February 13, 2003. This testimony highlights certain aspects of the Report relating to executive compensation and company-owned life insurance. The Report contains more detailed descriptions of Enron's executive compensation and company-owned life insurance arrangements.

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[1] This document may be cited as follows: Joint Committee on Taxation, *Written Testimony of the Staff of the Joint Committee on Taxation on Executive Compensation and Company-Owned Life Insurance Arrangements of Enron Corporation and Related Entities* (JCX-36-03), April 7, 2003.

[2] Except as otherwise indicated, references to "Enron" refer to Enron Corporation and its affiliates, and references to "Enron Corp." refer specifically to the parent company.

[3] Joint Committee on Taxation, *Report of Investigation of Enron Corporation and Related Entities Regarding Federal Tax and Compensation Issues, and Policy Recommendations* (JCS-3-03), February 2003 (the "Report").

II. ENRON'S EXECUTIVE COMPENSATION ARRANGEMENTS

A. Summary Overview of Enron's Executive Compensation Arrangements

Enron's compensation arrangements have received considerable media attention in the aftermath of the Enron bankruptcy. With respect to executive compensation, attention has focused both on the amount of compensation paid to certain executives and on the various forms of compensation used by Enron.[4]

During the period reviewed by the Joint Committee staff, executive compensation at Enron was generally comprised of base salary, annual incentives, and long-term incentives. Certain executives also participated in nonqualified deferred compensation and special compensation arrangements.

Enron's compensation costs for all employees, and especially for executives, increased significantly over the years immediately preceding its bankruptcy. Enron's executives, in particular, were paid substantial amounts. In 2000, total compensation for the 200 highest-compensated employees of Enron was $1.4 billion, an average of $7 million per employee. This consisted of $56.6 million of bonuses, $1.06 billion attributable to stock options, $131.7 million attributable to restricted stock, and $172.6 million of base salary and other income. Incentive compensation was a significant element of Enron's executive compensation arrangements. In 2000, base salary was less than 13 percent of total compensation for the 200 highest-compensated employees.

Notable features of Enron's executive compensation include the following:

- Nonqualified deferred compensation was a major component of executive compensation for Enron. Participants were eligible to defer all or a portion of salary, bonus, and long-term compensation into Enron-sponsored deferral plans. Over $150 million in compensation was deferred by the 200 highest-compensated employees for the years 1998-2001. In late 2001, in the weeks prior to Enron's bankruptcy filing, early distributions totaling more than $53 million were made to certain participants from two of Enron's nonqualified deferred compensation plans.

- Enron used stock-based compensation as a principal form of compensation for executives. Enron's stock-based compensation programs included nonqualified stock options, restricted stock, and phantom stock. Enron's deduction for compensation attributable to the exercise of nonqualified stock options increased by more than 1,000 percent from 1998 to 2000.

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[4] Certain aspects of Enron's tax-qualified retirement plans have also received considerable media attention, particularly the extent to which plan assets were invested in Enron stock. These plans are discussed in detail in the Report.

- In the weeks immediately preceding the bankruptcy, Enron implemented two special bonus programs; one for approximately 60 key traders and one for approximately 500 employees that Enron claimed were critical for maintaining and operating Enron going forward. The combined cost of the programs was approximately $105 million.

- Enron had certain special compensation arrangements for limited groups of people or for specific individuals. One executive received the use of a 1/8 fractional interest in a jet aircraft Hawker 800 as part of his compensation. A very limited number of employees received loans (or lines of credit) from Enron or split-dollar life insurance arrangements. Enron purchased two annuities from Mr. Kenneth L. Lay and his wife as part of a compensation package for 2001. Enron also had a Project Participation Plan for employees in its international business unit under which employees received interests in certain international projects.

B. General Observations with Respect to Enron's Compensation

Enron's stated compensation philosophy was a pay for performance approach; those who were determined to perform well were paid well. Enron implemented this approach with a broad array of compensation arrangements for its executives that included base pay, bonuses, and long-term incentive payments. In 2000, total compensation for the 200 highest-compensated employees of Enron was $1.4 billion dollars ($1.2 billion of which was attributable to stock options and restricted stock). For the same year, Enron reported $979 million of financial statement net earnings.[5]

Enron's approval of compensation packages for its executives rested almost entirely with internal management. Although the Compensation Committee of the Enron Corp. Board of Directors (the "Compensation Committee") formally approved both the total amount of compensation paid to executives and the form of such compensation, the Compensation Committee's approval generally was a rubber stamp of recommendations made by Enron's management. Missing was an objective assessment of the value added by top executives; compensation was typically deemed to be justified if it appeared to be consistent with what other companies paid executives. Targets for compensation were sometimes set, but in practice the total amount paid frequently exceeded the targets. The Compensation Committee went through the motions of satisfying its role as objective evaluator of reasonable pay by commissioning "independent" studies with respect to Enron's compensation arrangements; in some cases, the studies appeared to be designed to justify whatever compensation arrangement management wanted to adopt.

The lack of scrutiny of compensation was particularly prevalent with respect to Enron's top executives, who essentially wrote their own compensation packages. In some cases, although going through the formalities of reviewing arrangements, the Compensation Committee merely accepted what was presented. In other cases, the Compensation Committee either never reviewed certain arrangements for executives, or performed such a cursory review that they were not fully aware of what they were approving. For example, a former chairman of the Compensation Committee could not remember an arrangement under which an Enron executive was awarded a fractional interest in an airplane as a form of compensation.

There was no indication that Enron's Compensation Committee ever rejected a special executive compensation arrangement brought to them. Indeed, the Compensation Committee used studies, sometimes commissioned after the fact, to justify the compensation arrangements for top executives. As a result, Enron's top executives earned enormous amounts of money and even used the company as an unsecured lender. For example, from 1997 through 2001, Mr. Lay borrowed over $106 million from Enron through a special unsecured line of credit with the company.

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[5] This was prior to Enron's November 19, 2001, accounting restatement made public in filings with the Securities and Exchange Commission, which resulted in restated net income of $842 million. A true measure of Enron's net income for the year cannot be determined without a restatement of Enron's financial statements to conform with generally accepted accounting principles.

Enron did not appear to maintain consistent or centralized recordkeeping with respect to compensation arrangements in general and executive compensation in particular. Enron could not provide documentation relating to many of Enron's special compensation arrangements for its top executives. When asked about compensation arrangements in interviews, current and former Enron employees with responsibility for such matters had no knowledge of certain aspects of executives' compensation, particularly in the case of special arrangements. Although Enron represented that it properly reported income with respect to employee compensation arrangements, the lack of recordkeeping made it impossible to verify whether this was true.

Enron's heavy reliance on stock-based compensation, both with respect to executives and with respect to rank and file employees, caused significant financial losses when Enron's stock price collapsed. As part of a philosophy that a large portion of executive compensation should depend on shareholder return, Enron rewarded executives with huge amounts of stock options, restricted stock, and bonuses tied to financial earnings. In addition, a strong company culture encouraging stock ownership by all employees led to high investments in Enron stock made by employees through the Enron Corp. Savings Plan. In the end, when Enron's stock price plummeted, Enron's employees and executives lost millions of dollars in retirement benefits under Enron's qualified plans and nonqualified deferred compensation arrangements and through the loss of value of stock that had been received as compensation for services. Enron's rank and file employees in many cases lost virtually all of their retirement savings because they believed statements made by Enron's top executives up to the very end that Enron was viable and that Enron's stock price would turn around. Although some executives suffered losses that appear stunning in amount, many executives also reaped substantial gains from their compensation arrangements.

C. Enron's Executive Compensation Structure

1. Compensation trends and philosophy

In general

Enron had a pay for performance compensation philosophy; employees who performed well were compensated well. Enron used a variety of forms of compensation in recent years, including cash, stock, stock options, restricted stock, phantom stock, performance units,[6] and participation interests.[7] Enron also offered employees benefits such as participation in qualified retirement plans and in health and life insurance. The amount of compensation that Enron paid to employees, especially executives, increased significantly over the years immediately preceding the bankruptcy.

Tax return data for Enron Corp. and its subsidiaries show how compensation of officers, salaries and wages, and employee benefit program expenses increased over the years immediately preceding the bankruptcy. Table 1, below, shows the deduction taken by Enron Corp. and its subsidiaries for such expenses on its Federal income tax returns for 1998, 1999, and 2000. Enron's total compensation deduction dramatically increased from 1998 to 2000. The increase in compensation expense was, in part, due to the substantial increase in Enron's deduction attributable to the exercise of stock options.

The deduction for compensation of officers increased exponentially. The compensation of officers doubled from 1998 to 1999 and tripled from 1999 to 2000. As shown in Table 1, below, in 2000, the deduction for compensation of officers was almost twice the deduction for salaries and wages.

Table 1.–Enron Compensation Deductions for 1998, 1999, and 2000[8]

Item	1998	1999, as amended	2000
Compensation of officers	$149,901,000	$313,312,000	$952,492,000
Salaries and wages	$499,746,000	$702,725,000	$557,550,000
Pension, profit-sharing, etc., plans	$628,000	$834,000	$20,000
Employee benefit program	$344,676,000	$569,278,000	$1,456,796,000
Total	$994,951,000	$1,586,149,000	$2,966,858,000

[6] Performance units were granted in the 1990's under Enron's Performance Unit Plan. The value of performance units was determined by reference to the ranking of Enron's shareholder return relative to its peer group.

[7] Participation interests were granted in international projects under the Enron International Project Participation Plan.

[8] The Joint Committee staff was not provided information detailing what was specifically included in each category.

Compensation paid to Enron's 200 highest-compensated employees also increased significantly in the years preceding Enron's bankruptcy. Table 2, below, shows information compiled by the IRS, which is based on information provided by Enron, on compensation of the 200 highest-compensated employees for 1998 through 2000. Compensation for this group increased over recent years, particularly, the amount of compensation attributable to stock options. Base salary and other compensation also increased substantially.

Table 2.–Compensation Paid to the 200 Highest-Compensated Employees for 1998-2000

Year	Bonus	Stock Options	Restricted Stock	Base Salary and Other Income	Total
1998	$41,193,000	$61,978,000	$23,966,000	$66,143,000	$193,281,000
1999	$51,195,000	$244,579,000	$21,943,000	$84,145,000	$401,863,000
2000	$56,606,000	$1,063,537,000	$131,701,000	$172,597,000	$1,424,442,000

The range of total compensation paid to the 200 highest-compensated employees of Enron in the years immediately preceding Enron's bankruptcy is shown in Table 3, below.

Table 3.–Range of Per Employee Total Compensation Paid to the 200 Highest-Compensated Employees for 1998-2001

Year	Range of Per Employee Total Compensation Paid to the 200 Highest-Compensated Employees
1998	$152,000 to $20,621,000
1999	$325,000 to $56,541,000
2000	$1,270,000 to $168,741,000
2001	$1,104,000 to $56,274,000

In 2000 and 2001, each one of the 200 highest-compensated employees was paid over $1 million. In 2000, three executives were paid over $100 million, with the top-paid executive receiving $169 million. In 2000, at least 26 executives were paid over $10 million. In 2001, the year of Enron's bankruptcy, at least 15 executives were paid over $10 million. One executive was paid over $56 million.

Enron's Compensation Committee

Enron's Compensation Committee (a Committee comprised of Members of the Board of Directors) was responsible for developing the Enron executive compensation philosophy. The Compensation Committee's stated focus was to ensure a strong link between the success of the shareholder and the rewards of the executive. The Compensation Committee made decisions on a wide variety of compensation issues. While the Compensation Committee was principally involved with executive compensation, the duties of the Compensation Committee were not limited to executive compensation. The Compensation Committee approved all qualified retirement plan documents and amendments. The Compensation Committee also approved medical and dental plans, severance pay plans, and flexible compensation plans. The

Compensation Committee approved all stock plans, bonus plans, and deferral plans and approved grants of stock options and other equity compensation. The Compensation Committee was responsible for authorizing bonus pools and often approved accelerated vesting of options and other equity-based compensation. Selected employment agreements were approved by the Compensation Committee.

While the Compensation Committee had responsibility for a wide range of issues, the members of the Compensation Committee were not deeply involved in most issues. Members of the Compensation Committee interviewed by Joint Committee staff were not fully aware of all of the issues for which they were responsible and often made decisions. For example, even though changes to the nonqualified deferred compensation plans were approved by the Compensation Committee, one former member of the Compensation Committee interviewed by Joint Committee staff did not know whether Enron offered nonqualified deferred compensation. Even though reflected in the minutes, one former member of the Compensation Committee interviewed by Joint Committee staff could not recall whether the Committee approved qualified retirement plans issues, while another Compensation Committee member did not know what a qualified retirement plan was. The members of the Compensation Committee did not scrutinize proposed arrangements, but basically approved whatever compensation arrangements were presented to them by management.

Role of outside consultants

Enron stated intent was to use a market pricing approach to compensation. Enron frequently used outside consultants, principally Towers Perrin, to determine compensation practices in the market place. The Compensation Committee relied on outside consultants in making a variety of decisions. Enron frequently obtained analysis from consultants, particularly Towers Perrin, to ensure that the executive compensation program was within its stated philosophy and goals. Towers Perrin periodically issued opinion letters to Enron regarding its compensation programs in general and on specific compensation issues. General compensation studies were also performed. Studies and opinions provided by Towers Perrin are discussed in further detail in the Report.[9]

From Joint Committee staff interviews with many former members of the Compensation Committee, it appears that many members made decisions relying on the opinions of consultants without fully understanding the underlying issue. For example, former Compensation Committee members interviewed by Joint Committee staff could not explain why Enron purchased two annuities from Mr. Lay and his wife in 2001, but knew that Towers Perrin issued an opinion providing justification for the transaction.

[9] Appendix D of the Report includes studies and opinions provided to Enron by Towers Perrin.

2. Overview of Enron's executive compensation arrangements

Executive compensation at Enron was generally comprised of base salary, annual incentives, and long-term incentives. Base salary levels were targeted at the 50th percentile of the external marketplace, meaning that Enron tried to have its base salary at a level equal to 50 percent of other companies. For total compensation, executives had the opportunity to earn at the 75th percentile or higher level, subject to obtaining performance at the 75th percentile or higher. In addition to the three principal components of executive compensation (base salary, annual incentives and long-term incentives), certain executives also participated in special compensation arrangements, such as nonqualified deferred compensation programs, split-dollar insurance arrangements, and employee loans.

Annual bonuses were a major component of Enron's executive compensation structure. Annual bonuses were targeted at the 75th percentile level compared to the market and could often be larger than base salary for some employees.

In recent years, the long-term incentive program provided for awards of nonqualified stock options and restricted stock. Participation in the long-term incentive plan was available to employees in the vice president job group and above, which generally ranged from approximately 300 to 400 executives. Stock-based compensation was a major component of executive compensation, especially in the years immediately preceding the bankruptcy.

Executives were given the opportunity to participate in nonqualified deferred compensation arrangements. Participants were eligible to defer receipt of all or a portion of salary, bonus and long-term compensation into Enron-sponsored deferral plans. The plans provided an opportunity for executives to choose to delay payment of Federal and State income taxes, and earn tax-deferred return, on deferrals of virtually any form of compensation.

3. Bonuses

In general

There has been much media attention focusing on the magnitude of bonuses paid to Enron executives. In many cases, bonuses were the principal compensation component. Individual executive bonuses paid in 2001, the year of Enron's bankruptcy, were as high as $8 million dollars. In 2001, at least 48 executives received bonuses of $1 million or greater. Table 4, below, shows total bonuses for the 200 highest-compensated employees according to information obtained from the IRS. Enron's bankruptcy filing Exhibit 3b.2 shows that bonuses to 144 insiders (managing directors and above) paid during the year preceding the bankruptcy totaled approximately $97 million.

Enron had two bonus deferral programs, the Bonus Stock Option Program and the Bonus Phantom Stock Deferral Program. The bonus deferral programs gave participants an opportunity to receive stock options and/or phantom stock in lieu of cash bonus payments.

Table 4.–Total Bonuses for the 200 Highest-Compensated Employees

Year	Total Bonuses
1998	$41,193,000
1999	$51,195,000
2000	$56,606,000

Pre-bankruptcy bonuses

In the weeks immediately preceding the bankruptcy, Enron implemented two bonus programs for (1) approximately 60 key traders and (2) approximately 500 employees who Enron claimed were critical for maintaining and operating Enron going forward.[10] As a condition to receiving pre-bankruptcy bonus payments, employees were required to execute an agreement requiring repayment of any amounts received, plus a 25 percent penalty, if the employee voluntarily terminated employment prior to the expiration of 90 days following the receipt of any payment.

According to Enron, approximately 584 employees received payments totaling approximately $105 million. Additional information provided by Enron states that 490 employees received key employee (non-trader) bonuses totaling approximately $50 million, which were paid from general company assets. Trader bonuses were paid to 67 employees totaling approximately $46 million, which were made from a grantor trust established to fund 2001 performance bonuses. In addition, 27 Canadian employees received bonuses totaling $8 million, which were paid by Enron Canada Corp.[11] Pre-bankruptcy payments ranged from $2,500 to $8 million per employee.

4. Special compensation arrangements

Enron had certain special compensation arrangements for limited groups of people or for specific individuals. For example, one executive received the use of a 1/8 fractional interest in a jet aircraft Hawker 800 as part of his compensation. A few employees received loans from Enron and had split dollar life insurance policies. Certain executives were allowed to exchange interests in plans for large cash payments or stock options and restricted stock grants.

One of the most notable special compensation arrangements was the purchase by Enron of two annuities from Mr. Lay and his wife as a part of his compensation package for 2001. Under the transaction, Enron purchased the annuity contracts from Mr. and Mrs. Lay for $5 million each (a total of $10 million) and also agreed to reconvey the annuity contracts to Mr. Lay if he remained employed with Enron through December 31, 2005. If Mr. Lay were to leave Enron prior to that date, reconveyance still would take place on the occurrence of one of four events: (1) retirement with the consent of the Board; (2) disability; (3) involuntary termination

[10] Appendix D of the Report includes a list of employees who received pre-bankruptcy bonus payments.

[11] These payments appear to have been made in connection with the trader bonus payments.

(other than a termination for cause); or (4) termination for "good reason." Towers Perrin issued a letter regarding the benefits of the transaction. It is unclear whether the contracts have been or will be reconveyed to Mr. Lay.[12] For more detail, see Part Four, III,C.4, of the Report.

Enron Development Corporation, which was later renamed Enron International, used a Project Participation Plan to grant awards to international developers and other employees working on international projects. Under the Project Participation Plan, employees were granted participation interests in particular international projects. Payments with respect to a project were triggered upon the occurrence of certain plan payment dates. Awards for top developers could be as high as $7 million for single projects.

[12] The Joint Committee staff was informed by counsel for former Compensation Committee members that the issue of whether Mr. Lay was entitled to receive the annuity contracts given the terms of his departure was under review by Enron and various legal counsel. Enron stated it was unable to give the Joint Committee staff any further information regarding the status of the annuity contracts and whether they had been or would be reconveyed to Mr. Lay. In response to Joint Committee staff written questions regarding the annuity contracts, Mr. Lay's counsel, Piper Rudnic, responded that "We are not in a position to give a legal opinion about the current status of the annuity contracts." They also stated their understanding that the characterization of Mr. Lay's termination for purposes of severance benefits was still under review.

D. Discussion of Specific Issues

1. Nonqualified deferred compensation

Introduction and background

"Nonqualified deferred compensation" refers to compensation that is deferred other than through a tax-qualified retirement plan or similar arrangement. Nonqualified deferred compensation is a common form of compensation for executives. Nonqualified deferred compensation may be provided through a number of mechanisms. For example, an employer may have a qualified deferred compensation arrangement covering a specified group of executives or may provide for deferral for executives only as provided in individual employment contracts. In contrast to tax-qualified retirement plans, nonqualified deferred compensation arrangements are subject to few restrictions. Nonqualified deferred compensation arrangements are attractive to employees because they offer the ability to defer in effect unlimited amounts of compensation. Employers often make such arrangements available to executives in order to meet the desire of executives for tax deferral. In some cases deferred compensation may also be used by an employer to achieve certain objectives, such as providing a retention incentive.

In contrast to nonqualified deferred compensation arrangements, tax qualified retirement plans are subject to a variety of rules under the Federal tax laws and the Employee Retirement Income Security Act ("ERISA"), including limits on the amount that can be deferred, a variety of employee protections, and nondiscrimination rules that are designed to ensure that the plan covers a broad range of employees, not just highly compensated employees. In exchange for complying with these restrictions, tax-qualified retirement plans receive favorable tax benefits. Employees do not include qualified retirement plan benefits in income until received, even though the plan is funded and the participant is vested in his or her benefit. Employers receive a current deduction, within limits, for contributions to tax-qualified retirement plans, even though the income inclusion on the part of the employee is deferred. Qualified retirement plan assets are required to be held in trust for the exclusive benefit of plan participants and beneficiaries.

Nonqualified deferred compensation arrangements are not subject to the requirements applicable to tax-qualified retirement benefits, and the rules for the timing of the employer's deduction and the employee's income inclusion differ. For example, there is no statutory limit on the amount of compensation that can be deferred under a nonqualified deferred compensation arrangement. However, under a nonqualified deferred compensation arrangement, the employer is not entitled to a deduction until the employee includes the compensation in income. Thus, in theory, there is a tension between the interests of the employer in a current deduction and the employee in obtaining deferral of taxes. In practice, in many cases this tension is illusory and does little to impact the amount of compensation that is deferred. As described below, in Enron's case, the possibility of a forgone deduction appeared to have little, if any, effect on the amount of deferred compensation.

Nonqualified deferred compensation arrangements are also not subject to the nondiscrimination rules applicable to tax-qualified retirement plans. Rather, in order to avoid being subject to ERISA's requirements, nonqualified deferred compensation arrangements must

be limited to a "select group of management or highly compensated employees".[13] This means that nonqualified deferred compensation arrangements do not cover a broad range of employees.

Unlike tax-qualified retirement plans, there is no single set of rules governing the tax treatment of nonqualified deferred compensation. The determination of when amounts deferred under a nonqualified deferred compensation arrangement are includible in the gross income of the individual earning the compensation depends on the facts and circumstances of the arrangement. A variety of tax principles and Code provisions may be relevant in making this determination.[14]

In general, the time for income inclusion of nonqualified deferred compensation depends on whether the arrangement is unfunded or funded. An arrangement is considered funded if there is a transfer of property under section 83. If the arrangement is not considered funded for tax purposes, amounts deferred are includible in income when actively or constructively received. In general, in order for an amount not to be constructively received, there must be a substantial limitation on the individual's right to receive the amount. If compensation has been deferred under a funded arrangement, then income is includible for the year in which the individual's rights are transferable or not subject to a substantial risk of forfeiture under the rules for section 83.

Over time, arrangements have developed in an effort to provide employees with greater security for nonqualified deferred compensation and greater control over amounts deferred, while still providing the desired deferral of income. One such arrangement, designed to provide greater security for the employer, is a "rabbi trust."

A "rabbi trust" is a trust or other fund established by an employer to hold assets from which nonqualified deferred compensation payments may be made. The trust or fund is generally irrevocable and does not permit the employer to use the assets for purposes other than to provide nonqualified deferred compensation, except that the terms of the trust or fund provide that the assets are subject to the claims of the employer's general creditors in the case of insolvency or bankruptcy. Terms providing that the assets are subject to the claims of creditors of the employer in the case of insolvency or bankruptcy have been the basis for the conclusion that the creation of a rabbi trust does not cause the related nonqualified deferred compensation

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[13] *See, e.g.*, ERISA section 201(2). Nonqualified deferred compensation arrangements exempt from ERISA are commonly referred to as "top-hat plans". There is no precise definition of the term "select group of management or highly compensated employees," however, the term "highly compensated employees" as used in ERISA is not synonymous with such term as used in the Code.

[14] These include the doctrine of constructive receipt, the economic benefit doctrine, the provisions of section 83 relating generally to transfers of property in connection with the performance of services, and provisions relating specifically to nonexempt employee trusts (sec. 402(b)) and nonqualified annuities (sec. 403(c)).

arrangement to be funded for income tax purposes.[15] As a result, no amount is included in income by reason of the rabbi trust; generally income inclusion occurs as payments are made from the trust.

The IRS has issued guidance setting forth model rabbi trust provisions.[16] Revenue Procedure 92-64 provides a safe harbor for taxpayers who adopt and maintain grantor trusts in connection with unfunded deferred compensation arrangements. The model trust language requires that the trust provide that all assets of the trust are subject to the claims of the general creditors of the company in the event of the company's insolvency or bankruptcy.

In addition to arrangements to increase security, a variety of practices have developed to provide employees with greater control over deferred amounts. These include providing greater flexibility in distributions, greater flexibility in timing of elections with respect to initial deferrals and payments, and the ability to specify how earnings will be credited to deferred amounts. For example, one practice is to provide that distributions from a nonqualified deferred compensation arrangement may be made at any time, subject to the discretion of the committee or other body with authority over the plan and also subject to a forfeiture of some portion of the amount to be distributed, such as 10 percent. Such forfeiture provisions are often referred to as a "haircut."

While many common practices, when viewed in isolation, may appear to be within the limits of present law, when examined in connection with other plan provisions and features, appear to provide executives with an excessive level of security and control. As discussed below, Enron used a number of these practices in its nonqualified deferred compensation arrangements.

The development of questionable and aggressive practices regarding nonqualified deferred compensation is, at least in part, due to the moratorium on Treasury guidance addressing certain nonqualified deferred compensation arrangements. Section 132 of the Revenue Act of 1978[17] provides that the taxable year of inclusion in gross income of any amount covered by a private deferred compensation plan is determined in accordance with the principles set forth in regulations, rulings, and judicial decisions relating to deferred compensation that

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[15] This conclusion was first provided in a 1980 private ruling issued by the IRS with respect to an arrangement covering a rabbi; hence the popular name "rabbi trust." Priv. Ltr. Rul. 8113107 (Dec. 31, 1980).

[16] Rev. Proc. 92-64, 1992-2 C.B. 422, *modified in part by* Notice 2000-56, 2000-2 C.B. 393.

[17] Section 132 of the Revenue Act of 1978 was enacted in response to proposed Treasury regulation 1.61-16, which provided that if a payment of an amount of a taxpayer's compensation is, at the taxpayer's option, deferred to a taxable year later than that in which such amount would have been payable but for the taxpayer's exercise of such option, the amount is treated as received by the taxpayer in such earlier taxable year. Prop. Treas. Reg. 1.61-16, 43 Fed. Reg. 4638 (1978).

were in effect on February 1, 1978. Thus, the Treasury Department has been restricted in issuing new deferred compensation guidance for over 25 years.

Enron's deferred compensation programs in general

Nonqualified deferred compensation was a major component of executive compensation for Enron. Through Enron's nonqualified deferred compensation programs, executives were able to defer more than $150 million in compensation from 1998 through 2001. Approximate amounts deferred under all deferred compensation plans for the 200 highest-compensated Enron employees for the years 1998-2001 are shown in the following table.

Table 5.–Amounts Deferred by the 200 Highest-Compensated Employees 1998-2001

Year	Amounts Deferred Under All Deferred Compensation Plans for the 200 Highest-Compensated (millions of dollars)
1998	$13.3
1999	19.7
2000	67.0[18]
2001	54.4

Many executives participated in Enron's deferral programs. In recent years, Enron had two nonqualified deferred compensation plans: the Enron Corp. 1994 Deferral Plan (the "1994 Deferral Plan)" and the 1998 Enron Expat Services, Inc. Deferral Plan (the "Expat Deferral Plan"). The plans had almost identical terms and features except that the Expat Deferral Plan was used for expatriates who were ineligible to participate in the 1994 Deferral Plan because they were employed by Enron Expat Services Inc. In addition, a rabbi trust was established in connection with the 1994 Deferral Plan, but no such trust was established in connection with the Expat Deferral Plan. Enron also had older deferral plans that were predecessors to the current plans.

Information provided by Enron shows that for the years 1999-2001, there were approximately 340 participants in the 1994 Deferral Plan and approximately 55 total participants in the Expat Deferral Plan. Under the deferral plans, participants could defer up to 35 percent of base salary, up to 100 percent of annual bonus payments, and up to 100 percent of select long-term incentive payments.

Specific features of Enron's deferred compensation plans

In general

In the process of reviewing Enron's deferred compensation arrangements, the Joint Committee staff identified a variety of features that allowed the executives to maintain security and control over the amounts deferred. These features are similar to those reportedly used by other employers. While the 1994 Deferral Plan and the Expat Deferral Plan were designed to

[18] Of the $67 million, $32 million was deferred by Mr. Lay.

impose restrictions or limitations on the participant's control of amounts deferred, such restrictions or limitations could be seen as illusory. While these plan provisions may not result in constructive receipt under present law, there is an issue as to whether the mere existence of such features should result in the application of the constructive receipt doctrine. When viewed collectively, the existence of the opportunities for accelerated distributions, participant-directed investment, and changes in participant elections lend credence to the argument that the doctrine of constructive receipt should apply.

Accelerated distributions

Normally, distributions of nonqualified deferred compensation were paid to Enron executives upon retirement, death, disability, or termination of employment. Participants were also allowed to receive special purpose deferrals while remaining active employed.[19] In addition, participants could request accelerated distributions from the 1994 Deferral Plan and the Expat Deferral Plan. Such distributions were subject to the consent of the "committee" provided for by the terms of the plan. Upon an accelerated distribution, participants were required to forfeit 10 percent of the elected distribution amount and also would not be eligible to participate in the plan for at least 36 months. The plans were presumably designed with these restrictions to avoid constructive receipt. This provision allowed employees to avoid current taxation while maintaining the ability to request distribution of deferrals at any time.

Under present law, a requirement of surrender or forfeiture of a valuable right is a sufficient restriction to preclude constructive receipt of income. The IRS has not explicitly authorized the use of forfeiture provisions (i.e., "haircuts") in nonqualified deferred compensation plans. Many nonqualified deferred compensation plans utilize a 10-percent forfeiture limitation (like that used by Enron) designed to prevent constructive receipt, based on the 10-percent early withdrawal tax applicable to distributions from qualified retirement plans and IRAs.[20] The Joint Committee staff understands that some employers utilize haircuts of less than 10 percent.

In the weeks preceding Enron's bankruptcy, participants began to request accelerated distributions of amounts deferred under Enron's deferral plan. As a practical matter, the 10-percent forfeiture provision and restriction on future deferrals did not appear to impose much of a deterrent for participants in requesting distributions. In total, 211 participants requested accelerated distributions.[21] Greg Whalley, the newly appointed sole member of the 1994 Deferral Plan Committee, had discretion whether or not to approve accelerated distribution requests from participants in the 1994 Deferral Plan. The Report outlines the process that Mr. Whalley stated that he used in making the determination of whether requests for early

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[19] Special purpose deferrals could be received as soon as three years following the deferral in a lump sum or up to five annual installments and were intended to assist with anticipated expenses.

[20] Sec. 72(f).

[21] Appendix D of the Report includes a chart of all accelerated distribution requests.

distributions should be approved. Under the process, the extent to which requests were granted depended upon the financial position of Enron at the time. In total, accelerated distributions totaling over $53 million were made to approximately 127 individuals from October 30, 2001, through November 29, 2001.[22]

Participant-directed investment

Under the 1994 Deferral Plan and the Expat Deferral Plan, participants could choose to have their deferrals treated as if they had been invested in either of two types of investment accounts -- the Phantom Stock Account or the Flexible Deferral Account. Deferrals treated as invested in the Phantom Stock Account were treated as if the participant purchased shares of Enron Corp. common stock at the closing price on the date of deferral. Participants electing deferrals to be treated as invested in the Flexible Deferral Account were allowed to select investment funds, which in recent years mirrored those of the Enron Corp. Savings Plan, for the crediting of earnings to their account balances. For 2001, participants could allocate deferrals among 17 investment choices that mirrored funds available in the Enron Corp. Savings Plan. Daily changes in election choices within the Flexible Deferral Account were allowed. This allowed participants to direct how earnings on amounts deferred should be credited.

Subsequent elections

Distributions from the Enron deferral plans could be made upon the participant's retirement, disability, death or termination of employment.[23] Participants could elect to receive payments in a lump sum or in up to 15 annual installments. Participants in the 1994 Deferral Plan were allowed to change payout elections at any time subsequent to the initial deferral. Elections were effective one year after being received by Enron.

Allowing participants to make subsequent changes to payout elections gives them control over the amounts deferred. Nevertheless, courts have generally been lenient in applying the constructive receipt doctrine with respect to subsequent elections.

Rabbi trust

Enron established an irrevocable rabbi trust in connection with the 1994 Deferral Plan. Upon the establishment of the trust, 100 trust-owned life insurance ("TOLI") policies were purchased on the lives of 100 participants in the 1994 Deferral Plan. According to Enron, the assets of the trust were not intended to be sufficient to pay entirely for the nonqualified deferred compensation obligations under the 1994 Deferral Plan.[24] Distributions to participants were not

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[22] In the weeks preceding the bankruptcy, participants also made requests for hardship distributions. There were no hardship requests granted in 2001.

[23] As previously discussed, special purpose deferrals were also allowed.

[24] According to Enron, only initially did Enron direct investments in the rabbi trust to generally correspond with participant elections.

made from the trust, but were made from the general assets of Enron. According to Enron, as of October 28, 2002, the cash surrender value of the remaining insurance policies was $25 million.

It appears that Enron may have intended the rabbi trust used in connection with the 1994 Deferral Plan to comply with the safe harbor requirements of Revenue Procedure 92-64.[25] It was certainly intended that the trust not result in current income taxation. Even if the trust were a valid rabbi trust when evaluated solely on the basis of the trust document, there is an issue as to whether other provisions under the 1994 Deferral Plan would cause the trust to be considered funded for tax purposes.

In the case of a rabbi trust, trust terms providing that the assets are subject to the claims of creditors of the employer in the case of bankruptcy or insolvency have been the basis for the conclusion that the creation of a rabbi trust does not cause the related nonqualified deferred compensation arrangement to be funded for income tax purposes. In the case of Enron, even though the trust document provided that the assets of the trust were subject to the claims of creditors, because participants had the ability to obtain accelerated distributions, there is an argument that the rights of such employees were effectively greater than the rights of creditors, making the trust funded for tax purposes. If, in fact, the arrangement was not subject to the claims of creditors, the arrangement should be considered funded, and income inclusion should have occurred to the participants when there was no substantial risk of forfeiture.

Deferral of stock option gains and restricted stock

Enron's deferral plans allowed for deferral of income attributable to stock options and restricted stock. Under the deferral of stock option gains program, participants could make an advance written election to defer the receipt of shares of Enron Corp. common stock from the exercise of a stock option granted under a stock plan sponsored by Enron, when such exercise was made by means of a stock swap using shares owned by the participant. Under the deferral of restricted stock program, participants could make an advance written election to defer the receipt of shares of Enron Corp. common stock to be released according to a grant of restricted shares under a stock plan sponsored by Enron Corp.

Although these types of programs may be commonly used, there are questions whether they should result in effective income deferral. There is no authority clearly addressing these deferral programs. The programs do not fit within the IRS ruling guidelines on the application of constructive receipt to nonqualified deferred compensation.[26] The favorable tax treatment is achieved by allowing employees to exchange a future right to receive property for an unfunded promise to pay. The Joint Committee staff believes that allowing individuals to control the timing of income inclusion in this way should not be allowed.

The deferral of stock option gains program can be viewed as a manipulation of the rules for deferred compensation and stock-for-stock exercise, which were not intended to be

[25] Rev. Proc. 92-64, 1992-2 C.B. 422, *modified in part by* Notice 2000-56, 2000-2 C.B. 393.

[26] Rev. Proc. 71-19, 1971-1 C.B. 698; Rev. Proc. 92-65, 1992-33 I.R.B. 16.

combined, thus resulting in an unintended and inappropriate result for Federal income tax purposes. In the deferral of stock option gains, the election to defer could be made even after the options were vested. The fact that the favorable tax result on the deferral of stock option gains can only be achieved through a stock-for-stock exercise, rather than a cash exercise, suggests that there is a manipulation of rules in order to achieve the desired tax result.

Discussion and recommendations

In general

The experience with Enron demonstrates that the theoretical tension between an employer's interest in a current tax deduction and an employee's interest in deferring tax has little, if any, effect on the amount of compensation deferred by executives. In Enron's case, because of net operating loss carryovers, denial of the deduction did not have a significant impact on its current tax liability. Despite any possible effect on its tax deduction, Enron's deferred compensation arrangements allowed executives to defer millions of dollars in compensation that would otherwise be currently includible in income. The amount of compensation deferred by Enron's 200 highest-compensated employees increased significantly in the years prior to bankruptcy.

While there are a number of reasons why nonqualified deferred compensation arrangements are adopted, a primary factor is the desire of executives to defer payment of income tax. For example, a stated purpose of the 1994 Deferral Plan and Expat Deferral Plan was to allow executives to reduce current compensation and thereby reduce their current taxable income and earn returns on a tax-favored basis. Without the tax benefit of deferral, it is unlikely that nonqualified deferred compensation arrangements would exist, and certainly would not exist to the extent they do under present law.

Enron's nonqualified deferred compensation arrangements contained a variety of features that serve to blur the distinction between nonqualified deferred compensation and qualified plans. Enron's nonqualified deferred compensation plans included features that to some extent provided the advantages of a qualified plan, such as security for and access to benefits without current income inclusion, despite not meeting the qualified plan requirements. Because nonqualified arrangements have features like qualified plans, there may be less incentive for employers to adopt broad-based qualified retirement plans. If executives are able to fulfill their retirement needs through the use of nonqualified plans, for some employers there would be no incentive to offer qualified retirement plans to rank and file employees.

As previously discussed, there are no precise rules governing many aspects of nonqualified deferred compensation arrangements. As a result, taxpayers may design deferred compensation arrangements based on varying interpretations of authority that may not be strictly applicable to the situation in question. Under present law, a variety of practices have developed with respect to deferred compensation arrangements which are intended to achieve the desired tax deferral, while at the same time attempting to provide some sense of security to executives as well as some degree of flexibility regarding time of payment and other plan features. Many of the practices with respect to nonqualified deferred compensation have developed over time. However, since 1978, the IRS has been precluded from issuing guidance addressing many of

these issues. Thus, the IRS is at a disadvantage in responding to the growth and development of these arrangements. The IRS is unable to adequately address common deferral arrangements that are viewed by many as pushing the limits under present law.

While deferred compensation arrangements vary greatly, many of the plan features used by Enron are not uncommon. A recent article shows that the practice of providing security for amounts deferred is not uncommon.[27] Even though certain aspects of Enron's deferral plans may be within common practices, some issues may be raised with respect to whether they meet the requirements necessary to obtain the desired tax deferral. In addition, even if the present-law rules are satisfied, certain of the arrangements Enron maintained raise broader questions of whether they fall within the spirit of the present-law rules or whether they should, as a policy matter, result in tax deferral.

Specific recommendations

The Joint Committee staff believes that some changes to the present-law rules regarding the taxation of nonqualified deferred compensation are appropriate. The Joint Committee staff believes that such compensation should be includible in income no later than the time it is earned unless there is a substantial risk of forfeiture of the rights to the compensation. This rule would tax the income at a more appropriate time than under present-law rules in which, for example, an unfunded promise to pay, even if vested, is not currently taxable.

Because of the difficulty of identifying the precisely correct time to tax nonqualified deferred compensation and the potential hardship to the employee, one possible way to revise current law is to continue existing treatment of the employee but to make sure any income deferral is accompanied by a consequence to the employer that is commensurate with the benefit obtained by the employee. The consequence might arise, for example, regardless of the tax-loss status of the employer. Such an approach, however, would represent a significant change in the law.

In the alternative, specific rules should be provided to limit the circumstances under which compensation will continue to receive deferred treatment in the future. Rules should be developed to require current income inclusion in the case of plan features that give taxpayers inappropriate control over amounts deferred. The Joint Committee staff believes that the existence of plan provisions that allow accelerated distributions, participant-directed investment, or subsequent elections should result in current income inclusion. These provisions give participants control over amounts deferred. The Joint Committee staff also believes that consideration should be given to whether rabbi trusts are appropriate for deferred compensation, or whether additional requirements should be imposed with respect to such trusts. In addition, the Joint Committee staff believes that the use of programs such as Enron's deferral of stock options gains and restricted stock programs should not be allowed.

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[27] *See* Theo Francis & Ellen E. Schultz, *As Workers Face Pension Cuts, Executives Get Rescued*, WALL ST. J., April 3, 2003, at C1.

The ability of Treasury to issue guidance on deferred compensation should not be restricted. The Joint Committee staff recommends the repeal of section 132 of the Revenue Act of 1978.[28] The restriction imposed by section 132 of the Revenue Act of 1978 has prevented Treasury from issuing more guidance on nonqualified deferred compensation and may have contributed to aggressive interpretations of present law. The existence of the moratorium on Treasury guidance puts Treasury in a disadvantaged position because it cannot respond adequately to forms of deferred compensation not contemplated prior to 1978. This has a chilling effect on the ability of Treasury to enforce the law in a consistent and effective way. Restricting Treasury guidance to the rules in effect more 25 years ago paralyzes Treasury to address current common practices that may be inconsistent with the law.

The Joint Committee staff believes that annual reporting of deferred amounts should be required to provide the IRS greater information regarding such arrangements.

2. Stock-based compensation

Enron used stock-based compensation as a principal form of compensation for executives. Management believed that executive compensation should be tied to company performance. There was a stock ownership requirement for certain executives, the stated purpose of which was to align the interests of executives and stockholders. A stated focus of the Compensation Committee was ensuring that there was a strong link between the success of the shareholder and the rewards of the executive. The Compensation Committee believed that a great deal of executive compensation should be dependent on company performance.

The Enron culture also promoted Enron stock ownership by employees. For example, Joint Committee staff was told that there was a monitor in the lobby of the Enron headquarters in Houston so that the performance of Enron stock could be viewed by all who entered the building. Even up to the months immediately preceding the bankruptcy, employees were encouraged that the company was in strong financial shape. Stock-based compensation was used for all employees in a variety of forms, including as an investment in the Enron Savings Plan and Enron Employee Stock Ownership Plan, in addition to the all-employee stock option programs. Stock was used as a form of compensation for nonemployee directors.

Enron utilized various types of programs to provide its employees with compensation tied to the equity or long-term performance of the company. During the 1990s, Enron had two principal stock plans: the 1991 Stock Plan and the 1994 Stock Plan. In addition, the 1999 Stock Plan was used as a funding mechanism for the issuance of common stock in connection with special circumstances. The stock plans generally allowed awards to be made in stock options, restricted stock, phantom stock units, and in some cases, stock appreciation rights.[29]

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[28] The Joint Committee staff does not intend the repeal of section 132 to include the finalization of Proposed Treasury Regulation section 1.61-16, which section 132 was enacted to prevent.

[29] In addition to stock option grants under Enron's stock plans, Enron periodically made stock option grants to all employees to allow all employees to become shareholders of Enron.

In recent years, Enron used stock options and restricted stock as the long-term component of executive compensation. Stock-based compensation, and stock options in particular, was the principal form of compensation for many executives. The amount of compensation generated from such arrangements increased dramatically in the years immediately preceding the bankruptcy, particularly in 2000.

Table 6, below, shows Enron's deduction attributable to stock options for 1998 through 2000 on Enron's corporate tax returns.

Table 6.–Enron Deduction Attributable to Stock Options (1998-2000)

Year	Amount of Deduction
1998	$125,343,000
1999	$585,000 as filed $367,798,000 as amended
2000	$1,549,748,000

Table 7, below, shows the amount of compensation attributable to stock options for the 200 highest-compensated employees for 1998, 1999, and 2000.

Table 7.–Compensation Attributable to Stock Options for the 200 Highest-Compensated Enron Employees (1998-2000)

Year	Amount of Compensation
1998	$61,978,000
1999	$244,579,000
2000	$1,063,567,000

Table 8, below, shows the compensation generated from the release, i.e., vesting, of restricted stock for the top-200 most highly paid Enron employees for 1998-2000.

Table 8.–Compensation Attributable to the Vesting of Restricted Stock for Top-200 Most Highly Paid Enron Employees (1998-2000)

Year	Amount of Compensation
1998	$23,966,000
1999	$21,943,000
2000	$131,701,000

From a Federal tax perspective, Enron structured its stock-based compensation arrangements with an eye toward tax planning, sometimes from the point of view of Enron, sometimes from the point of view of the executive.

These grants included the All-Employee Stock Option Program, Project 50, and EnronOptions-Your Stock Option Program. There was an all-employee stock option grant as recently as August 2001.

For example, Enron used nonqualified stock options, but did not use qualified stock options (i.e., incentive stock options and options granted under an employee stock purchase plan). The tax treatment of these two types of options differs for both the employer and the employee. In the case of a nonqualified option, the difference between the option price and the fair market value of the stock (i.e., the "spread") is generally includible in income as compensation at the time the employee exercises the option. A corresponding compensation expense deduction equal to the amount of ordinary income included in the gross income of the employee is allowable to the employer. In the case of a qualified option, no income is includible in the gross income of the employee on either the grant or exercise of the option.[30] No compensation expense deduction is allowable to the employer with respect to the grant or exercise of a qualified stock option.

The difference in the employer's deduction for qualified and nonqualified options is one factor in determining what type of option to grant. In the case of qualified options, the employer forgoes a deduction entirely. In the case of nonqualified options, compared to the payment of current compensation, the employer's deduction is deferred until the option is exercised. The use of nonqualified stock options resulted in tax deductions for Enron that would not have been available if Enron had used qualified stock options. There may be other reasons Enron did not use qualified options, including the restrictions placed on those options under applicable Code requirements.

Enron also made use of techniques that benefited the executives from a tax perspective.[31] For example, the use of stock-for-stock exercises provided a more favorable tax result for the executive than would have resulted if the executive sold Enron stock and used the cash proceeds to exercise options. In addition, the stock option transfer program, which allowed the gifting of stock options to family members and certain other persons, was clearly an estate planning device and was described to employees as such. However, both of these programs appeared to operate in accordance with published IRS rulings. In these cases, Enron appeared to do little more than take advantage of tax planning opportunities provided by clear IRS authority.

The use of stock options by Enron brings renewed attention to discussions regarding the proper treatment of stock options for accounting purposes, and the difference between the treatment of options for tax and accounting purposes. Under APB 25, which Enron followed, no compensation cost is generally required to be recorded in financial statements for stock options issued to employees if the exercise price is equivalent to or greater than the market price on the grant date. FAS 123, the "preferred," but optional, approach, would require stock option costs to

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[30] If a statutory holding period requirement is satisfied with respect to stock acquired through the exercise of a qualified stock option, the spread, and any additional appreciation, will be taxed as capital gain upon disposition of such stock.

[31] The materials provided in response to the Joint Committee staff's general request for information regarding Enron compensation arrangements included documents describing a tax shelter technique purporting to defer inclusion of income upon the exercise of an employee's stock options. It is not clear whether or not any Enron executives entered into a transaction of this type. Appendix D of the Report includes these materials.

be taken into account when options are granted, based on a determination of the value of the option.

Even if the FAS 123 approach is made mandatory, as currently being considered, because of the differences between accounting rules and tax rules, the amount shown on financial statements as a cost attributable to stock options, can be substantially less than a company's tax deduction for stock options. Accounting rules and tax rules have somewhat different purposes, and it may be appropriate for different rules to apply in order to achieve the differing purposes. Nevertheless, the sheer magnitude of the amount of corporate deductions and executive income generated by the exercise of stock options in some cases, such as Enron's, may appropriately focus attention on whether proxy disclosure rules and accounting rules are sufficient to properly inform shareholders.

While some argue that linking shareholder and executive success is beneficial for shareholders, conflicts may arise. Linking compensation of executives to the performance of the company can result in executives taking measures to increase short-term earnings instead of focusing on longer-term interests. Enron's heavy reliance on stock-based compensation, both with respect to executives and with respect to rank and file employees, caused significant financial loss when Enron's stock price collapsed. Although some executives suffered losses that appear stunning in amount, many executives also reaped substantial gains from their compensation arrangements.

3. Employee loans

Enron did not have a general policy or program relating to executive loans. However, from time to time Enron extended loans to various executives. These loans were individually designed arrangements, and varied considerably. Most prominent among the loans was a noncollateralized, interest-bearing line of credit extended to Mr. Lay. The line of credit was originally set at $4 million and was later increased to $7.5 million. The aggregate amount withdrawn pursuant to this line of credit from 1997 through 2001 was over $106 million. In 2001 alone, Mr. Lay engaged in a series of 25 transactions involving withdrawals under the line of credit. The total amount of withdrawals for 2001 was $77.525 million (of which all but $7.5 million was repaid). During 1997 through 2001, Mr. Lay repaid principal amounts of $99.3 million. Over $94 million of this amount was repaid with 2.1 million shares of Enron stock. Mr. Lay's counsel told the Joint Committee staff that in 2001 Mr. Lay drew down on the Enron line of credit and then repaid it with stock principally because he needed funds to avoid or, if unavoidable, to pay margin calls on secured lines of credit Mr. Lay had established with certain banks and brokerage firms. These lines of credit were secured primarily by Enron stock, the price of which was falling.

The Joint Committee staff also reviewed loans to nine other persons, including loans to Mr. Skilling. These loans ranged in amount from $200,000 to $4 million, and generally accrued interest at the applicable Federal rate. In two cases, loan agreements provided that the loan would be forgiven if the executive stayed with Enron for a certain period of time. Other loans did not have a provision regarding forgiveness, but were forgiven by Enron. In such cases, the amount forgiven was treated as compensation to the executives.

Certain of the loan arrangements, particularly those that provided that the loan would be forgiven if the executive worked for Enron for a certain period of time, raise questions as to whether the arrangements were in fact the payment of compensation rather than a real loan. The loan transactions raise corporate governance issues of whether corporate funds were in essence being used for personal purposes.

The Sarbanes-Oxley Act contains a prohibition on executive loans. If this prohibition had been in effect in prior years, it is likely that the loans reviewed by the Joint Committee staff in this case would not have been made. Thus, the Joint Committee staff is not recommending further legislative changes at this time.

4. Split-dollar life insurance arrangements

Introduction

The term "split-dollar life insurance" refers to splitting the cost and benefits of a life insurance contract. The cost of premiums for the contract often is split between two parties. One party typically pays the bulk of the premiums, and is repaid in the future from amounts received under the contract. The other party often pays a small portion of the premiums, but has the right to designate the recipient of the bulk of the benefits under the contract. This type of arrangement transfers value from one party to the other party.

Split-dollar life insurance arrangements have been used for several purposes. A principal use has been by employers to provide low-cost life insurance benefits or to provide funds for other compensatory benefits (such as nonqualified deferred compensation) for employees on a tax-favored basis.

Enron's split dollar life insurance arrangements

Enron entered into split-dollar life insurance arrangements with three of its top management: Mr. Lay (two arrangements, for $30 million and $11.9 million); Mr. Skilling ($8 million), and John Clifford Baxter ($5 million). The specific details of these split-dollar arrangements are discussed in the Report.

Another split-dollar life insurance agreement with Mr. Lay for $12.75 million of life insurance coverage was later approved by the Compensation Committee of the Board of Directors on May 3, 1999, at Mr. Lay's request. Although Enron purchased the life insurance contract in 2000, Enron and Mr. Lay did not enter into the split-dollar arrangement.

Discussion and recommendation

Enron's split-dollar life insurance arrangements with Mr. Lay, Mr. Skilling, and Mr. Baxter were entered into between 1994 and 2000, before the issuance of the series of recent IRS guidance starting with Notice 2001-10 in January, 2001. Under the limited guidance issued by the IRS prior to Notice 2001-10,[32] the cost of current term insurance protection would have been

[32] In the 1960s, the IRS published rulings providing that the amount includible in an employee's income under a split-dollar insurance arrangement is the cost of current term

includible in income of the owner of the life insurance contract (less the amount paid by the owner). The value of the current term insurance protection was determined by reference to a table (P.S. 58) based on the age of the insured. This guidance would not affect the tax treatment of an employer that enters into a split-dollar arrangement; thus, Enron would not be permitted to deduct the premiums.[33]

In January 2001, the IRS issued Notice 2001-10.[34] It provided interim guidance for the tax treatment of split-dollar life insurance, including types of split-dollar life insurance arrangements between an employer and employee in which the employee has an interest in the cash value of the contract (equity split-dollar arrangements) that were not addressed by the limited earlier guidance. The Notice provided that split-dollar arrangements would be subject to tax under either a loan approach or an economic benefit approach. Notice 2001-10 provided a new table, Table 2001, to replace the P.S. 58 table for valuing the cost of current life insurance protection.

A year after Notice 2001-10 was issued, it was revoked by Notice 2002-8.[35] Notice 2002-8, however, provides interim guidance applying the general concepts of the earlier Notice, and provides that Table 2001 generally applies for valuation purposes for arrangements entered into after January 28, 2002 (the date Notice 2002-8 was issued).

The IRS issued proposed regulations on split-dollar life insurance arrangements on July 5, 2002.[36] The proposed regulations provide guidance on the income, employment, and gift tax treatment of split-dollar life insurance arrangements. Somewhat like the earlier notices, the proposed regulations generally provide two mutually exclusive regimes for taxing split-dollar arrangements, one taking an economic benefit approach,[37] and the other applying loan treatment.[38]

Under the economic benefit approach of the proposed regulations, the value of economic benefits under the life insurance contract is treated as being transferred from the contract owner

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insurance protection (less the amount, if any, paid by the employee). Any policyholder dividends paid to, or benefiting, the employee are also includible in income. Rev. Rul. 64-328, 1964-2 C.B. 11, and Rev. Rul. 66-110, 1966-1 C.B. 12.

[33] Sec. 264; *see* the Report at note 2146.

[34] 2001-5 I.R.B. 459.

[35] 2002-4 I.R.B. 398.

[36] REG-164754-0, July 5, 2002. Regulations are proposed under Code sections 61, 83, 301, 1402, 7872, 3121, 3231, 3306, and 3401.

[37] Sec. 61.

[38] Sec. 7872 (or secs. 1271-1275, if the loan is not below-market).

to the nonowner (reduced by any consideration paid by the nonowner to the owner). The tax consequence of the transfer depends on the relationship of the owner and nonowner;[39] in the employment context, the transfer is regarded as compensation for services.

Under the loan approach of the proposed regulations, the owner and nonowner are treated as borrower and lender, respectively, if the nonowner (e.g., employer) paying premiums is reasonably expected to be repaid from the contract's cash value or death benefits. If the loan does not provide sufficient interest, then interest is imputed under the rules of section 7872. In general, such interest is not deductible by the borrower, but is includible in the income of the deemed lender (generally, the employee) in the arrangement.

Until the issuance of Notice 2001-10 in 2001, the IRS had issued very little guidance on split-dollar life insurance since the 1960s. During this period, the use of split-dollar life insurance became more widespread, and variations on the product proliferated. In the absence of guidance, some taxpayers may have taken a variety of positions as to the includibility in income of benefits under the arrangements, and as to the timing or amount of items that are includible. From a tax policy perspective, taxpayers' failure to include in income the appropriate value of an economic benefit received by an employee from an employer indicates a need for guidance as to the proper tax treatment of split-dollar life insurance arrangements.

Under the recent interim guidance published by the IRS relating to split-dollar life insurance arrangements, the economic benefit received in a split-dollar life insurance arrangement is treated more like other economic benefits received by employees. This recent interim guidance specifies the tax treatment in greater detail than previously in an area in which practices that may not accurately measure income had become increasingly common.

Requiring taxpayers to include in income the economic value of the benefit received in a split-dollar life insurance arrangement (or to treat the arrangement as a loan, if that treatment reflects the nature of the transaction) is consistent with the goal of the income tax system to accurately measure income. The Notices and proposed regulations generally serve the tax policy goal of improving accurate income measurement in the case of split-dollar life insurance arrangements. The Joint Committee staff recommends that the pending guidance relating to split-dollar life insurance should be finalized.

5. Limitation on deduction of certain executive compensation in excess of $1 million

Present law

Present law generally allows a deduction for ordinary and necessary business expenses, including a reasonable allowance for salaries and other compensation for personal services actually rendered. However, compensation in excess of $1 million paid by a publicly held company to the company's "covered employees" generally is not deductible.[40] Covered

[39] For example, depending on the relationship, the arrangement may be a payment of compensation, dividend distribution under section 301, gift under the gift tax rules, or other transfer. Prop. Treas. Reg. sec. 1.61-22(d)(1).

[40] Sec. 162(m).

employees are the chief executive officer and the four other most highly compensated employees of the company as reported in the company's proxy statement.

Subject to certain exceptions, the deduction limitation applies to all otherwise deductible compensation of a covered employee for a taxable year, regardless of the form in which the compensation is paid and regardless of when the compensation was earned. The deduction limitation applies when the deduction would otherwise be taken. For example, in the case of a nonqualified stock option, the deduction is normally taken in the year in which the option is exercised, even though the option was granted with respect to services performed in a prior year.

Certain types of compensation are not subject to the deduction limitation. With respect to compensation paid to Enron executives, the most relevant exception is for performance-based compensation. In general, performance-based compensation is compensation payable solely on account of the attainment of one or more performance goals with and respect to which certain requirements are satisfied, including a shareholder approval requirement.

Discussion and recommendation

Based on the review of Enron's compensation arrangements, the Joint Committee staff found that the $1 million limitation on the deductibility of certain executive compensation did not appear to have had a substantial impact on either the amount of compensation paid by Enron or the structure of its compensation arrangements.

Table 9, below, shows total compensation, performance-based compensation, additional deductible compensation, and nondeductible compensation for 1998 through 2000.

Table 9–Application of $1 Million Deduction Limitation for 1998-2000
(Millions of Dollars)

Year	(1) Total Compensation of Covered Employees	(2) Performance-Based Compensation	(3) Additional Deductible Compensation**	(4) Nondeductible Compensation
1998	48.5	20.9	4.0	23.6
1999	124.2	111.6	4.2	8.4
2000	260.9	241.0	3.5	16.5
Total 1998-2000*	433.6	373.5	11.7	48.5

* Details may not add to totals due to rounding.
**Additional deductible compensation is the amount of total compensation, minus performance-based compensation, not in excess of $1 million.

The existence of the $1 million deduction limitation does not appear to have had any effect on the total compensation provided to Enron executives. Based on information provided

by Enron to the IRS, as shown in Table 9, above, total compensation for the top-five executives for 1998-2000 was $433.6 million.[41]

Enron intended certain of its compensation arrangements to qualify as performance-based for purposes of the deduction limitation,[42] and treated substantial amounts of compensation as meeting this requirement. Based on information provided by Enron to the IRS, as shown in Table 9 above, performance-based compensation for 1999 and 2000 was comparable, 90 percent and 92 percent, respectively of total compensation. In those years, seven percent and six percent, respectively, of total compensation of covered employees was not deductible. In the case of certain executives, the amount of performance-based compensation was so great compared to total compensation that less than $1 million of compensation was potentially subject to the deduction cap.

For 1998, however, performance-based compensation was only 43 percent of total compensation of covered employees, and 49 percent of the total compensation of covered employees was not deductible because of the $1 million deduction limit. This is due in large part to the compensation provided to two covered employees. The nondeductible compensation for those two employees was 82 percent of the total nondeductible compensation of all five covered employees. Seventy-six percent of the total compensation for those two employees was not deductible.

Although Enron treated substantial amounts of compensation as performance-based, the $1 million deduction limitation does not appear to have had a significant impact on the overall structure of Enron's compensation arrangements. The arrangements that Enron considered to provide performance-based compensation were generally utilized prior to the enactment of the deduction limitation. Enron made certain modifications to its compensation arrangements in order to meet the Code's definition of performance-based compensation; however, these modifications were generally limited to relatively minor changes needed to meet the requirements rather than changes to the overall structure of its compensation arrangements. For example, in the case of bonuses, the Compensation Committee was advised by its outside consultants to establish a high enough "soft" target that could be approved by the shareholders so that whatever level of bonuses Enron ultimately paid would be within the target and thus would not fail to be performance based. It is possible that certain arrangements might not have been submitted for shareholder approval had this not been required in order to meet the requirements for performance-based compensation.

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[41] Enron also paid compensation in excess of $1 million to many employees not subject to the deduction limitation. The information regarding the top-200 most highly compensated employees provided by Enron to the Joint Committee staff indicates that 46 employees, 93 employees, and all 200 top-paid employees received compensation in excess of $1 million in 1998, 1999, 2000, and 2001, respectively.

[42] Enron submitted three plans for shareholder approval in order to meet the requirements of the exception for performance-based compensation: the 1991 Stock Plan, the Performance Unite Plan, and the Annual Incentive Plan.

The Compensation Committee was required to take certain actions in order for compensation to qualify as performance-based. A review of the Compensation Committee minutes indicates that the deduction limitation was discussed from time to time, and the role of the Compensation Committee with respect to approval of performance targets was mentioned. In addition, the annual report of the Compensation Committee in proxy statements discussed the deduction limitation. While the deduction limitation was discussed in Compensation Committee meetings, it appears that more time was spent on broader compensation issues, such as overall compensation targets. One former member of the Compensation Committee interviewed by the Joint Committee staff indicated he had no knowledge of the deduction limitation and did not remember it ever being discussed. This may be an indication that the limitation was not a significant concern for Enron.

The existence of the $1 million deduction limitation did not prevent Enron from paying nondeductible compensation. From 1998 through 2001, $48.5 million of nondeductible compensation was paid to covered employees.

Another aspect of the deduction limitation that can be observed from the review of Enron is the discrepancy between the operation of the limitation, which is based on generally applicable tax rules, and compensation as reported in Federal proxy statements. Proxy statements include a summary compensation table for covered employees (referred to as "named officers" under the securities laws) as well as other information regarding executive compensation. Because of timing differences and other factors, compensation as reported for proxy purposes can vary significantly from compensation subject to the $1 million deduction limitation. The difference in the treatment may cause confusion for persons who are attempting to determine the amount of nondeductible compensation from publicly available sources; it is not possible to make this determination based on proxy information.

The determination of whether a corporation has properly applied the $1 million dollar deduction can involve a time consuming, labor intensive process. In Enron's case, the IRS review of the application of the $1 million deduction involves extensive factual review and determinations, including a review of terms of numerous plans and individual employment contracts, examining materials submitted to shareholders, and the need to reconcile a number of inconsistencies in information.

The Joint Committee staff believes that, in Enron's case, the $1 million deduction limitation was ineffective at accomplishing its purpose. The Enron experience raises serious doubts about the effectiveness of the $1 million deduction limitation. If this experience is widespread among public companies, the Congress should consider repealing the rule. The concerns reflected in the limitation can be better addressed though laws other than the Federal tax laws.

The $1 million deduction limitation reflects corporate governance issues regarding excessive compensation, rather than issues of tax policy.[43] It is often difficult for tax laws to

[43] H.R. Rep. No. 103-111, at 646 (1993).

have the desired effect on corporate behavior.[44] Taxpayers may simply choose to incur the adverse tax consequences rather than change their behavior. In Enron's case, due to the existence of net operating losses, the denial of the deduction may not have been an issue.

In Enron's case, the $1 million deduction limitation appeared to have little, if any, effect on the overall level of compensation paid to Enron executives or the structure of Enron's compensation arrangements. To the extent that performance-based compensation is viewed as being a preferable form of compensation, some may argue that the $1 million limitation was effective in the Enron case, because such a large part of compensation was structured to be performance-based. However, as noted above, the deduction limitation did not appear to be a motivating factor in the structure of Enron's compensation and the arrangements that it treated as performance-based (or similar arrangements) generally predated the enacted of the limitation. In addition, some may question whether the compensation was truly performance based, particularly given Enron's financial decline; to the extent the limitation affected Enron's compensation arrangements, it may have merely placed more emphasis on the desire to increase reported earnings.

[44] Another example of tax laws that are aimed at corporate governance issues are the golden parachute rules that limit the compensation that may be paid to certain employees due to the change of control of a company. Sec. 280G. Failure to comply with these rules results in a denial of the deduction to the company and the imposition of a 20 percent excise tax, payable by the employee. Sec. 4999. Commentators generally observe that the golden parachute rules have done little to affect the amount of compensation payable upon a change of control. Rather, the rules are often thought of as providing a road map as to how to structure compensation arrangements. It is not uncommon for employment agreements to provide that, in the event the employee is subject to the excise tax, the tax will be paid by the company, with a gross up to reflect the income tax payable as a result of the employer's payment of the tax.

III. COMPANY-OWNED AND TRUST-OWNED LIFE INSURANCE

Enron implemented company-owned life insurance ("COLI") and trust-owned life insurance ("TOLI") programs. COLI generally has been the subject of considerable publicity due to its Federal income tax and financial accounting benefits,[45] and Congress has sought to limit its use as a tax arbitrage mechanism in Federal tax legislation since the 1940's.

Enron's COLI and TOLI transactions

During the 1980's and early 1990's, Enron bought approximately 1,000 life insurance contracts covering employees. Approximately $178 million had been borrowed under these life insurance contracts at the end of 1994, after which Enron stopped purchasing life insurance contracts covering employees. Approximately half of Enron's life insurance contracts covering employees (including a group of 201 contracts purchased June 1, 1986) were purchased before June 20, 1986, the effective date of 1986 legislation limiting the tax deduction for interest on debt under a life insurance contract. A 1999 summary by Clark-Bardes showed that interest rates charged on loans under some of the contracts -- those issued by Massachussetts Mutual and Great West -- ranged from 6.75 percent to 11.75 percent during the period 1983 - 1999. As the cash surrender value of the contracts increased, Enron continued to borrow under the contracts. The summary states, "Enron's policy blocks retain 100% loan interest deductibility under current legislation; this deductibility is a commodity that is no longer available in the insurance marketplace." By late 2001, the amount borrowed under Enron's life insurance contracts had grown to approximately $432 million.

Portland General Electric, an Enron subsidiary acquired in 1997, also owned life insurance contracts covering its employees. As of 1999, Portland General Electric had approximately $79 million worth of such life insurance contracts, and its affiliates owned approximately $59 million worth. Policies covering a total of 2,315 Portland General Electric employees were purchased between 1996 and 1999.

Following Enron's bankruptcy filing, Enron surrendered its life insurance contracts during 2002. Portland General Electric's life insurance contracts were in the process of being surrendered as of early 2003.

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[45] *See, e.g.*, Francis, *Bill Seeks Disclosure on Insuring Employees*, Wall St. J., Feb. 5, 2003; Francis, *Insurance Disclosure of S&Ls May Change*, Wall St. J., Jan. 27, 2003; Gettlin, *Tax-Free Earnings: A Life-And-Death Issue*, National J., Oct 26, 2002, at 3140; Clark, *Better off dead?*, U.S. News & World Report, May 6, 2002, at 32; Schultz and Francis, *The Economy: Senator to Target Tax Boon to Firms Insuring Workers*, Wall St. J., May 3, 2002; Francis and Schultz, *Big Banks Quietly Pile Up 'Janitors' Insurance,'* Wall St. J., May 2, 2002; Francis and Schultz, *Many Banks Boost Earnings with 'Janitors' Life Insurance,'* Wall St. J., April 26, 2002; Francis and Schultz, *Why Secret Insurance on Employees Pays Off*, Wall St. J., April 25, 2002; Schultz and Francis, *Why Are Workers in Dark? Most States Don't Force Firms To Disclose 'Janitors' Insurance,' But Congress May Change That*, Wall St. J., April 24, 2002; Schultz and Francis, *Valued Employees: Worker Dies, Firm Profits*, Wall St. J., April 19, 2002.

Discussion

Tax arbitrage

No Federal income tax generally is imposed on a policyholder with respect to the earnings under a life insurance contract[46] ("inside buildup").[47] Further, an exclusion from Federal income tax is provided for amounts received under a life insurance contract paid by reason of the death of the insured.[48] Because of the nontaxation of inside buildup, life insurance contracts provide an opportunity for tax arbitrage.

Borrowing by a business with respect to a life insurance contract is attractive because the earnings under the policy (i.e., inside buildup) increase tax-free. The loans permit the borrower to have the current use of income that has not been taxed. If the business borrows directly under the policy it owns, interest paid by the borrower is credited to the policy; the effect is equivalent to paying interest to itself. The amount of the loan reduces the death benefit when the insured person dies, if the loan has not yet been repaid; however, this is not a disadvantage to the borrower if another person (such as an employee's spouse) is the recipient of the death benefit. A further advantage of borrowing with respect to a life insurance policy arises to the extent the interest on the policy loan is deductible. Although 1996 legislation limited the interest deduction on debt under a life insurance, annuity or endowment contract, and 1997 legislation imposed a pro rata interest deduction limitation on debt allocable to unborrowed policy cash values of a life insurance, annuity or endowment contract, tax arbitrage opportunities related to the nontaxation of inside buildup remain under exceptions to the 1997 legislation.

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[46] By contrast to the treatment of life insurance contracts, if an annuity contract is held by a corporation or by any other person that is not a natural person, the income on the contract is treated as ordinary income accrued by the contract owner and is subject to current taxation. The contract is not treated as an annuity contract (sec. 72(u)).

[47] This favorable tax treatment is available only if a life insurance contract meets certain requirements designed to limit the investment character of the contract (sec. 7702). Distributions from a life insurance contract (other than a modified endowment contract) that are made prior to the death of the insured generally are includible in income, to the extent that the amounts distributed exceed the taxpayer's basis in the contract; such distributions generally are treated first as a tax-free recovery of basis, and then as income (sec. 72(e)). In the case of a modified endowment contract, however, in general, distributions are treated as income first, loans are treated as distributions (i.e., income rather than basis recovery first), and an additional 10 percent tax is imposed on the income portion of distributions made before age 59-1/2 and in certain other circumstances (secs. 72(e) and (v)). A modified endowment contract is a life insurance contract that does not meet a statutory "7-pay" test, i.e., generally is funded more rapidly than seven annual level premiums (sec. 7702A).

[48] Sec. 101(a).

COLI legislation

Provisions of tax legislation designed to limit the tax arbitrage of deducting interest on borrowings with respect to a life insurance contract date to the 1940's.[49] The deductibility of interest on borrowings that relate to life insurance contracts has been limited most recently by Federal tax legislation in 1986, 1996, and 1997.

In 1986, deductible interest on borrowings under life insurance contracts was capped at debt of $50,000 per contract, to combat the use of life insurance loans as an "unlimited tax shelter."[50] This provision was effective for contracts purchased on or after June 20, 1986. Life insurance contracts purchased before that date were grandfathered; the $50,000 cap did not apply to interest on debt borrowed under such contracts.

A pattern then developed of businesses insuring the lives of thousands of their employees to increase the amount of interest to deduct on borrowings under the contracts.[51] In 1996, a broader limitation on deductibility of interest on debt under a life insurance contract was enacted, generally replacing the $50,000 cap. That rule provided that no deduction is allowed for interest paid or accrued on any indebtedness with respect to one or more life insurance, annuity or endowment contracts owned by the taxpayer, and covering the life of any individual who is or has been (1) an officer or employee of, or (2) financially interested in, any trade or business currently or formerly carried on by the taxpayer.[52] A key person insurance exception was provided. The 1996 legislation applied generally to interest paid or accrued after October 13, 1995, with a phase-in rule. However, the grandfather rule for pre-June 20, 1986, contracts was preserved, with a new interest rate cap based on a Moody's rate.[53]

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[49] Section 129 of the Revenue Act of 1942 (Pub. L. No. 753, 77th Cong., 56 Stat. 798) added Internal Revenue Code section 24(a)(6), which provided that no deduction was allowed for "any amount paid or accrued on indebtedness incurred or continued to purchase a single premium life insurance or endowment contract. For the purposes of this paragraph, if substantially all the premiums on a life insurance or endowment contract are paid within a period of four years from the date on which such contract is purchased, such contract shall be considered a single premium life insurance or endowment contract."

[50] Joint Committee on Taxation, *General Explanation of the Tax Reform Act of 1986* (JCS-10-87), May 4, 1987, at 579. *See* Tax Reform Act of 1986, Pub. L. No. 99-514, sec. 1003, 100 Stat. 2388 (1986).

[51] *See* Lee Sheppard, "'Janitors' Insurance as a Tax Shelter," *Tax Notes*, Sept. 25, 1995, p. 1526.

[52] Joint Committee on Taxation, *General Explanation of Tax Legislation Enacted in the 104th Congress* (JCS-12-96), Dec. 18, 1996, p. 365. See Health Insurance Portability and Accountability Act of 1996, Pub. L. No. 104-191, sec. 510, 110 Stat. 2090 (1996).

[53] Sec. 264(e)(2).

The interest deduction limitation was further expanded in 1997 when Congress became aware of the practice of businesses insuring the lives of customers or debtors (for example, financial institutions insuring the lives of mortgage borrowers while borrowing under the life insurance policies, or maintaining other debt, and deducting the interest thereon).[54] The 1997 legislation provided that no deduction is allowed for interest paid or accrued on any debt with respect to a life insurance, annuity or endowment contract covering the life of any individual. It also provided that, for taxpayers other than natural persons, no deduction is allowed for the portion of the taxpayer's interest expense that is allocable to unborrowed policy cash values of a life insurance, annuity or endowment contract. An exception is provided under this proration rule for contracts that cover an individual who is a 20-percent owner, officer, director or employee of the taxpayer's trade or business.[55] The pro rata interest deduction limitation applied generally to contracts issued after June 8, 1997. Thus, the phase-in rule under the effective date of the 1996 legislation, and the grandfather rule under the 1986 and 1996 legislation for contracts purchased on or before June 20, 1986, were not affected.

Judicial decisions relating to COLI

Interest deductions under COLI arrangements have also been limited by recent case law applying general principles of tax law, including the sham transaction doctrine. These cases generally cover taxable years of taxpayers before the recent 1996 and 1997 legislation took effect. These principles of tax law continue to apply after enactment of the specific interest deduction limitation rules.

The case of *Winn-Dixie Stores, Inc. v. Commissioner*[56] involved the application of the sham transaction doctrine. In 1993, Winn-Dixie entered into a COLI program on the lives of its 36,000 employees. Under the program, Winn-Dixie purchased whole-life insurance policies and was the sole beneficiary. Winn-Dixie borrowed periodically against the policies' account value at interest rates that averaged 11 percent. The 11-percent average interest rate, when coupled with the administrative fees, outweighed the net cash surrender value and benefits paid on the policy. Thus, although Winn-Dixie lost money on the program each year, the tax deductibility of the interest and fees yielded a benefit of several billion dollars over 60 years. In 1997, Winn-Dixie terminated its participation in the COLI program following the enactment of tax law changes in 1996 that limited the deductibility of interest on COLI policy loans. On audit, the IRS

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[54] *See* "Fannie Mae Designing a Program to Link Life Insurance, Loans," *Washington Post*, Feb. 8, 1997, p. E3; "Fannie Mae Considers Whether to Bestow Mortgage Insurance," *Wall St. Journal*, April 22, 1997, at C1.

[55] This proration rule applies to policies issues after June 8, 1997. See Taxpayer Relief Act of 1997, Pub. L. No. 105-34, sec. 1084, 111 Stat. 951 (1997), and see Joint Committee on Taxation, *General Explanation of Tax Legislation Enacted in 1997* (JCS-23-97), Dec. 17, 1997, p. 272.

[56] *Winn-Dixie,* 113 T.C. 254 (1999), *aff'd* 254 F.3d 1313 (11th Cir. 2001), *cert. denied*, April 15, 2002.

disallowed the deductions for interest and administrative fees that Winn-Dixie claimed on its 1993 tax return with respect to its COLI program and COLI policy loans.

On petition to the Tax Court, Winn-Dixie argued that the deductions relating to its COLI program were proper because: (1) the COLI program satisfied the business purpose and economic substance prongs of the sham transaction doctrine and (2) in any case, the sham transaction doctrine was inapplicable because Congress explicitly authorized the deductions in connection with the COLI program. However, the Tax Court sustained the IRS disallowance of the COLI-related deductions claimed by Winn-Dixie, concluding that the COLI program (including the associated policy loans) was a sham.

Other recent cases have also upheld the disallowance by the IRS of deductions for interest relating to COLI programs. In *Internal Revenue Service v. CM Holdings, Inc.*,[57] Camelot Music had purchased COLI policies in 1990 covering the lives of 1,430 employees. Camelot borrowed under the policies to pay the first three annual premiums and sought to deduct the interest on the borrowings. Camelot subsequently filed a petition under chapter 11 of the Bankruptcy Code, and the IRS filed proofs of claim based on disallowance of the interest deductions. The District Court held that the interest deductions should be disallowed, and also concluded that the application of accuracy-related penalties was appropriate. The court stated that there were two rationales for the interest deduction disallowance. First, the interest deductions were part of a transaction that was in part a factual sham and therefore did not meet the "4-out-of-7" exception to the interest deduction disallowance rule of Code section 264(a)(3). In addition, the COLI plan lacked economic substance and business purpose, and was a sham in substance.[58] On appeal, the Third Circuit affirmed, "based on the . . . reasoning, that the COLI policies lacked economic substance and therefore were economic shams."[59] The Appellate Court also affirmed the assessment of penalties.

In *American Electric Power, Inc. v. U.S.*,[60] the District Court concluded that interest deductions on policy loans under a COLI program covering the lives of over 20,000 employees should be disallowed. The court concluded that the "plan as a whole was a sham in substance,"[61] as well as concluding that first-year policy loans, and the first-year and fourth-through seventh-year loading dividends and corresponding portions of the premiums, were factual shams. The court stated that it had "independently reached many of the same conclusions as the [District]

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[57] *Internal Revenue Service v. CM Holdings, Inc.*, 254 B.R. 578 (D. Del. 2000).

[58] *Id.* at 583, 654.

[59] *IRS v. CM Holdings, Inc. (In Re: CM Holdings, Inc.)*, 301 F.3d 96 (3d Cir. 2002), at 96.

[60] *American Electric Power, Inc. v. U.S.*, 136 F.Supp. 2d 762 (S. D. Ohio 2001).

[61] *Id.* at 795.

court in *C.M. Holdings*," and that the policies in that case were in all relevant respects identical to those involved in this case.[62]

In another recent District Court case, however, *Dow Chemical Company v. U.S.*,[63] involving two groups of COLI policies (one group of policies covering 4,051 employees and the other covering 17,061 employees), the court held that the IRS improperly disallowed Dow's deductions for interest and expenses in connection with the COLI plans. Although the court held that partial withdrawals under the policies to pay premiums in the fourth through seventh years "were not real and constituted shams in fact,"[64] the court determined that "the policy loans were real transactions consistent with commercial norms, and therefore were not factual shams."[65] The court concluded that Dow's COLI plans were "imbued with economic substance."[66]

Enron's grandfathered contracts

Enron's COLI and TOLI arrangements were leveraged, showing approximately $432 million of debt on $512 million of life insurance coverage by November, 2001. The purchase of these contracts predated the 1996 and 1997 legislation limiting interest deductions under life insurance contracts and imposing a pro rata reduction on interest deductions in the case of taxpayers that have life insurance contracts but do not borrow directly under the contracts.

The grandfather rule under the 1986 COLI legislation would apply to those contracts Enron purchased on or before June 20, 1986. Under this grandfather rule, neither the 1986 $50,000 per-contract cap on debt, nor the broader 1996 rule disallowing interest on debt under a life insurance contract, applied to contracts Enron purchased on or before June 20, 1986 (although for interest incurred after the 1996 legislation, those contracts were subject to an interest rate cap based on a Moody's rate relating to corporate bond yields).

This grandfather rule continues in effect, allowing the continued deduction of interest on debt under contracts that were purchased on or before June 20, 1986. As years pass from the 1986 date, the value of this tax treatment increases with the growth of the cash surrender value of the grandfathered contracts (assuming they are not treated as materially changed or otherwise ceasing to be pre-June 20, 1986, contracts). This result could be viewed as inconsistent with Congress' repeated legislation limiting interest deductions with respect to life insurance contracts.

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[62] *Id.* at 769.

[63] Case No. 00-10331-BC, E. D. Mich., Mar. 31, 2003. The court stated that many of the issues in the case were "thoroughly litigated" in the *Winn-Dixie, CM Holdings*, and *American Electric Power* cases, *supra*. *Dow Chemical* at 3. The court in *Dow Chemical* reached different conclusions on many of the issues, however.

[64] *Id.* at 139.

[65] *Id.* at 138.

[66] *Id.*

Recommendations

The Joint Committee staff recommends termination of the grandfather rule for pre-June 20, 1986, COLI contracts. Even though Enron did not purchase any additional life insurance contracts after 1994, Enron's debt and deductible interest under life insurance contracts continued to increase throughout the 1980s and 1990s (along with the cash surrender value of the contracts). This result is inconsistent with the legislative limitations imposed by Congress in 1986, 1996, and 1997 on interest associated with the tax-free inside buildup of life insurance contracts. If the 1986 grandfather rule was intended to provide transition relief to businesses that had purchased life insurance contracts before the 1986 date, sufficient time has passed that a redeployment of such businesses' assets could have been possible. The grandfather rule can no longer serve any reasonable need for transition relief.

Although the COLI transactions in which Enron engaged suggest repeal of the grandfather rule for such contracts, there may be other issues relating to COLI that arise from other corporations' practices with respect to ownership of life insurance. Tax arbitrage opportunities that arise in such contexts may suggest other legislative responses.

IV. CONCLUSIONS

Some of the issues examined by the Joint Committee staff with respect to Enron's compensation arrangements raise nontax issues, such as issues of corporate governance, which would be better addressed outside of the tax laws. With respect to tax-related issues, as discussed above, the Joint Committee staff finds it appropriate to make the following recommendations:

- Changes should be made to the rules relating to nonqualified deferred compensation arrangements to curb current practices that allow for the deferral of tax on compensation income while providing executives with inappropriate levels of security, control, and flexibility with respect to deferred compensation. These changes include providing that certain plan features result in current taxation, including the ability to obtain accelerated distributions, direct investments, and make subsequent elections. In addition, the Joint Committee staff believes that the use of programs such as Enron's deferral of stock options gains and restricted stock programs should not be allowed. The ability of the Treasury to issue guidance with respect to deferred compensation should not be restricted. Reporting of deferred compensation amounts should also be required;

- Guidance relating to split-dollar life insurance should be finalized;

- Congress should consider whether the limitation on the deduction for compensation in excess of $1 million should be repealed; and

- With respect to company-owned life insurance, the Joint Committee staff recommends termination of the grandfather rule with respect to interest deductions that is applicable to pre-June 20, 1986, contracts.

The Joint Committee staff notes that there were executive compensation provisions included in the National Employee Savings and Trust Equity Guarantee Act ("NESTEG"), approved by the Finance Committee on July 11, 2002. The provisions included:

- Section 501 of the bill, which repealed the limitation on Treasury guidance regarding nonqualified deferred compensation;

- Section 502 of the bill, which taxed deferred compensation provided through offshore trusts;

- Section 503 of the bill, which treated certain loans as compensation; and

- Section 504 of the bill, which required wage withholding at the top marginal rate for supplemental wages in excess of $1 million.

The Joint Committee staff recommendation to repeal section 132 of the Revenue Act of 1978 was included in section 501 of the bill. In addition, section 502 of the bill provides current taxation of deferred compensation provided through offshore trusts. The Joint Committee staff

supports this provision, but notes that it would have no direct effect on Enron, as the Joint Committee staff found no evidence that Enron provided assets through an offshore trust. As announced by Senator Grassley, section 503 of the bill, which would treat certain loans as compensation has been mooted by the Sarbanes-Oxley Act. In addition to the executive compensation provisions included in NESTEG, additional steps beyond those contained in NESTEG should be taken to curb the use of certain executive compensation arrangements.

COMMUNICATIONS

Policy Notes

Shaping the World of Corporate Benefits Policy

NONQUALIFIED DEFERRED COMPENSATION: AN IMPORTANT SOURCE OF RETIREMENT INCOME

(PREPARED BY THE GROOM LAW GROUP FOR THE AMERICAN BENEFITS COUNCIL)

a written statement submitted
to the Senate Finance Committee hearing

Enron: Joint Committee on Taxation Investigative Report - Compensation - Related Issues

April 8, 2003

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Nonqualified deferred compensation plans provide a valuable source of retirement income for many thousands of U.S. employees. These plans benefit not only senior corporate officers, but also many mid-level managers, salespersons, and other professional staff.

Nonqualified plans have been thoroughly scrutinized by Congress and the media in recent months. Although some abuses may have developed in this area that need to be addressed, recent legislative proposals would needlessly curtail many beneficial and non-abusive nonqualified deferred compensation plans.

We provide below some general background on the differences between qualified and nonqualified plans, and the key rules that apply to nonqualified plans. We explain how nonqualified plans play a meaningful role in the retirement and compensation programs of U.S. companies, and how these plans help fill the gaps in retirement income caused by various Internal Revenue Code (the "Code") limitations. We explain that unlike "tax shelters" nonqualified plans have substantial economic and legal consequences for employers and employees. Finally, we address some of the non-abusive plan features that Congress and the media have recently scrutinized.

"Qualified" and "Nonqualified" Plans

It is difficult to know exactly what types of arrangements are intended to be covered when the term "nonqualified deferred compensation plan" is used. Generally, any employer-sponsored retirement plan or arrangement that does not meet the requirements for a "qualified retirement plan" under § 401(a) of the Code can be described as a "nonqualified deferred compensation plan" or a "nonqualified plan." For purposes of this discussion, only nonqualified plans sponsored by for-profit employers will be considered.

Employers Prefer to Provide Qualified Plan Benefits

Favorable federal income tax rules apply to an employer maintaining a "qualified" retirement plan. The employer may deduct amounts as they are contributed to the plan's trust and the earnings on the trust assets are not taxed. By contrast, an employer may not deduct amounts set aside to meet its obligations under a nonqualified plan until plan benefits are paid to, and taxable to, employees. Further, the employer must pay tax on the earnings generated by any such amounts set aside. Given these tax advantages, an employer would strongly prefer to provide retirement benefits to its employees through its qualified plan(s), rather than a nonqualified plan.

Employees Prefer to Receive Qualified Plan Benefits

Employees would also strongly prefer to have their retirement benefits provided for in a qualified plan, because (1) an employer is not required to set aside any assets to fund a nonqualified plan, and (2) any amounts it does set aside must remain subject to the claims of its creditors. Thus, if an employer goes bankrupt, employees are very likely to lose a significant portion, or all, of their nonqualified plan benefits. By contrast, employers are required to fund benefits earned under a qualified plan by contributing assets to a trust. If the employer becomes insolvent, its creditors may not reach these assets, as they must be held by the trustee for the "exclusive benefit of plan participants." In addition, benefits under qualified plans (but not nonqualified plans) generally are exempt from the employee's own creditors in bankruptcy.

The federal income tax treatment of an employee is also more favorable under a qualified plan. Generally, benefits earned under both qualified and nonqualified plans are taxed only upon distribution to an employee. However, the taxation of certain distributions from a qualified plan will be deferred if the employee "rolls over" the distribution into an IRA or another qualified plan. Distributions from a

nonqualified plan may not be rolled over, and thus, are subject to immediate taxation. In addition, except for 401(k) contributions, there are no social security taxes on contributions or benefits under qualified plans.

Thus, there are a host of reasons why both employers and employees prefer to have retirement benefits provided under a qualified plan rather than a nonqualified plan. However, as explained below, the Code contains numerous limits on contributions and benefits under qualified plans. These limits are intended to cap the so-called "tax subsidy" provided by the government and to promote substantial coverage of rank and file employees. However, the limits are so restrictive and complex that they act as a disincentive to the maintenance of qualified plans by employers and result in large gaps in retirement savings and preparedness for many thousands of employees. Therefore, retirement benefits which are in excess of these limits must be provided under a nonqualified plan.

See the attached Appendix A for a brief comparison of qualified and nonqualified plans.

Brief History of Nonqualified Plans

Nonqualified deferred compensation plans and arrangements have existed for more than 50 years. In their earliest and simplest form, these plans generally involved an advance agreement between an employer and an employee that an amount to be earned in a given year would be paid to the employee in a subsequent year, generally upon retirement or termination of employment. If the agreement was structured properly in accordance with all Code requirements, the employee would not pay tax on the deferred amount until it was paid to him. The employee hoped to be in a lower income tax bracket when payment was received, and thus, pay less taxes on the deferred amount. While nonqualified plans now take many forms, this same basic structure and tax treatment still applies. The governing tax principles have been based essentially on general constructive receipt principles discussed later in this paper.

ERISA Accommodates Nonqualified Plans

When the Employee Retirement Income Security Act ("ERISA") was enacted in 1974, nonqualified plans were common enough and so well accepted that Congress created exceptions to most of ERISA's substantive requirements for them (although ERISA's enforcement provisions do apply). As discussed below, the primary exception applies to a so-called "top hat plan." A top hat plan is one that is "unfunded and is maintained by an employer primarily for the purpose of providing deferred compensation for a select group of management or highly compensated employees." Another exception applies to "excess benefit plans," i.e., nonqualified plans that provide benefits in excess of the Code section 415 limits for qualified plans.

Limits Placed on Qualified Plan Benefits

Beginning with the enactment of ERISA, Congress has periodically added limitations to the Code to restrict the benefits that may be provided under qualified plans.[1] For example:

- In 1974, the Code was amended to limit the annual amount that could be contributed to an employee's account under a defined contribution plan, and the annual amount of benefits that could be paid to an employee from a defined benefit plan. Code § 415.

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[1] Many of these changes were made to raise revenue-- in some cases, to help offset the cost of unrelated revenue-losing provisions.

- In 1986, the Code was amended to cut the annual amount of employee pre-tax contributions to a 401(k) plan from $30,000 (the then current Code § 415 limit) to $7,000. Code § 402(g).

- In 1986, the "ADP" nondiscrimination testing requirements were tightened, and "ACP" nondiscrimination testing requirements were added to the Code to further limit the amounts that highly compensated employees could contribute, and the employer matching contributions they could receive, under a 401(k) plan. Code § § 401(k) and 401(m).

- In 1986, and again in 1993, the Code was amended to limit the amount of compensation which could be considered in calculating the amount of a participant's benefit. The reduction in the compensation limit to $150,000 in 1993 resulted in a major increase in the employees affected. Code § 401(a)(17).

These Code limits have repeatedly reduced the amount of benefits that highly paid employees would otherwise receive under the normal provisions of a qualified plan.[2] In addition, due to budget constraints, Congress has periodically frozen or rolled back inflation increases in the qualified plan limits. In recent years, these limits have impacted larger and larger numbers of employees. Employers increasingly have had to offer middle and senior level managers, salespersons, and non-management professional staff benefits under nonqualified plans to make up for the reduced benefits that may be paid from qualified plans.

Types of Nonqualified Plans

While traditional deferred compensation plans are still widely used, nonqualified plans now take various forms. Two of the more common types of nonqualified plans, "mirror" 401(k) plans and "SERPs," provide benefits that would otherwise be provided under qualified plans if the limits under the Code did not exist. These plans are described in more detail below.

Supplemental or "Mirror" 401(k) Plans

These defined contribution plans allow an employee to defer amounts he would have been able to defer under his employer's qualified 401(k) plan but for the limits under the Code. Deferred amounts are credited to a bookkeeping account the employer maintains for the employee. The employer may also credit the employee's account with the amount of matching contributions he would have received under the 401(k) plan had his contributions not been limited by the Code. The account balance is credited with interest or earnings until paid to the employee. In many cases, an employee will be able to choose the investment vehicle(s) used to measure earnings credited to his bookkeeping account, and the vehicles will often be very similar or identical to those available under the employer's 401(k) plan. These elections do not, however, control the actual investment of any amounts set aside by the employer to meet its nonqualified plan obligations. In fact, the employer is not required to set aside any assets to meet its nonqualified plan obligations, and any assets that are set aside remain subject to the claims of the employer's creditors.

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[2] Increases in some of these limits under the Economic Growth and Tax Relief Reconciliation Act of 2001 ("EGTRRA") have provided some incremental relief for employers and employees, but these changes have not been made permanent.

Supplemental Pension Plans or "SERPs"

These defined benefit plans typically provide an employee with benefits he would have received under his employer's qualified defined benefit pension plan but for limits under the Code.

These and other types of nonqualified plans are structured to meet certain requirements under the Code and ERISA. We outline those requirements below and discuss briefly how certain common nonqualified plan features have been designed to fit within these rules.

Code Rules

The Code requirements a nonqualified plan needs to meet are less complex than those imposed on qualified retirement plans. The two primary sets of rules under the Code that apply to nonqualified plans are the constructive receipt and economic benefit rules.

Constructive Receipt Rules and Employee Elections

Under the constructive receipt rules, a taxpayer may be subject to taxation on an amount prior to actually receiving it. These rules apply when an amount has been set aside and a taxpayer may draw upon it without substantial limitations or restrictions. Accordingly, a nonqualified plan must place substantial restrictions on an employee's ability to receive his plan benefits. Thus, an employee may not simply demand an immediate payment of his nonqualified plan benefits.

A few examples of how substantial restrictions are placed on an employee's ability to receive nonqualified plan distributions follow:

- If a plan permits an employee to elect the time and method for the post-employment distribution of his plan benefits, the election must be made well in advance of the employee's termination of employment.
- Any "subsequent election" to change an originally scheduled date to commence the payment of benefits or the method of payment must be made sufficiently in advance of the originally scheduled distribution date.
- A "hardship" distribution will typically only be allowed if the employee suffers an "unforeseeable emergency" for reasons beyond his control and which result in severe financial hardship (as currently permitted under published IRS authority).
- If a plan does permit an employee to elect an immediate distribution of his plan benefits, typically an employee making such an election will forfeit a substantial portion (often 10%) of his benefit under the plan, and may not earn additional benefits for some period of time (a so-called "haircut" distribution).

Qualified plans are not subject to the constructive receipt rules. So employees may elect the time and method for distribution of their qualified plan benefits after they have terminated employment and have a better sense of their retirement income needs. Less stringent rules also apply to the ability to change payment elections and to elect in-service distributions in certain types of defined contribution plans. This flexibility is yet another reason why employees would prefer to have their benefits payable from a qualified plan.

Economic Benefit Rules and Rabbi Trusts

An employee may also be taxable on the value of his nonqualified plan benefits under "economic benefit" principles. These rules would apply if an employer sets aside funds outside the reach of its creditors to meet its obligations to the employee under such a plan. In order to avoid this result, an employer will normally keep any assets earmarked for payment of plan benefits either in its own accounts or in a so-called "rabbi trust." In either case, the assets will remain available to meet the claims of the employer's creditors in the event of its insolvency.

A "rabbi trust" is typically established with a financial institution serving as trustee. Because the assets of such a trust remain subject to the claims of an employer's creditors, a rabbi trust does not protect an employee from the risk of his employer becoming insolvent and unable to meet its obligations under the plan. However, if an independent financial institution holds these assets in trust and the trust agreement has appropriate provisions, the trust may provide the employee with some protection from a change in the control of his employer, or from the employer otherwise having a change of heart and attempting to avoid making payments due under the plan.

Some employers irrevocably set aside assets in a "secular trust" to meet their nonqualified plan obligations. Because the assets of a secular trust are not subject to the claims of an employer's creditors, the "economic benefit" rules apply, and an employee will be taxable on the value of his vested interest in the trust assets. For this reason, secular trusts are rarely used in practice.

ERISA Rules – "Top Hat Plans"

Employer-sponsored plans that provide employees with deferred compensation benefits generally are subject to ERISA's requirements. However, so-called "top hat" retirement plans are exempt from almost all of the substantive rules of ERISA. In order to qualify as a top hat plan, a plan must be (1) unfunded, and (2) "maintained by an employer primarily for the purpose of providing deferred compensation for a select group of management or highly compensated employees." The top hat exception generally recognizes that federal law should not dictate a plan's terms or funding with respect to employees at these levels of the company. Nonqualified plans are typically designed to fit within this exemption.

Basically, a plan will be considered "unfunded" for this purpose if the employer has not set aside assets outside the reach of its creditors to meet its obligations under the plan (similar to the economic benefit rules discussed above). Because the assets of a rabbi trust are subject to the claims of an employer's creditors, plans with rabbi trusts are considered "unfunded."

Whether a plan meets the "select group" requirement is a more difficult question. In most of the cases on the subject, courts have focused on specific objective measures, such as the percentage of the workforce covered by the plan and the average salary of the covered employees compared to the average for the workforce, to determine whether a plan covers a select group. The Department of Labor indicated in 1990 that, in its view, participation in such plans should be limited to individuals with the ability to "influence" the terms of the plan.

Key Aspects of Nonqualified Plans

Several key aspects of nonqualified plans deserve closer inspection than that given them in recent months. Specifically, we explain below why:

- nonqualified plans are an important source of retirement income for a large number of employees;
- these plans have economic substance and are properly disclosed;
- certain devices used by a small percentage of nonqualified plans are potentially abusive; and
- recent legislative proposals would go much farther than is necessary to address potentially abusive practices and would needlessly curtail many common and non-abusive practices.

Plans Meet Retirement Income Shortfalls

Due to the many Code limitations described above, the retirement benefits many executives, salespersons, and management employees receive from qualified plans will represent a considerably smaller percentage of their final pay than that received by rank-and-file employees. The same is true of the social security benefits these employees will receive in retirement. Nonqualified plans help fill these gaps in retirement income, so that these employees can receive a percentage of final pay in retirement more comparable to that received by a rank-and-file employee.

It is important to keep in mind also that many employers that used to offer both a qualified defined benefit pension plan and a 401(k) plan now offer only a 401(k) plan. Thus, many employees are covered under only one qualified plan, which may or may not provide significant retirement income.

Plans Benefit Numerous Employees

The number of employees covered by nonqualified plans has grown significantly in recent years. Any employee earning over $90,000 is now considered a "highly compensated employee" for qualified plan purposes, and thus the employee's benefits may be reduced based on some of the Code limits described above. Thus, many middle managers and salespersons in this income range rely on nonqualified plans to supplement their qualified plan benefits. Often, these employees are the ones most severely affected by Code limitations (e.g., the ADP test). Notably, a recent survey on nonqualified plan coverage found that persons with incomes below $100,000 were eligible to participate in approximately 50% of the nonqualified plans.

Plans Have Economic Substance

Unlike many tax shelters and other arrangements some companies have entered into in recent years, nonqualified plans have substantial economic and legal consequences for employers and employees beyond their tax treatment. An employee who participates in such a plan foregoes current cash compensation, in return for his employer's unfunded, unsecured promise to pay deferred amounts in the future. The employee bears the risk that the employer will become insolvent and unable to pay these benefits. The employee also bears the risk of his own insolvency.

An employer sponsoring a nonqualified plan retains the use of the cash that it would have paid to the employees absent the nonqualified plan. However, the employer generally is still subject to tax on the income generated by this amount, even if the amount is placed in a rabbi trust. Moreover, the employer can not deduct these amounts until they are actually paid to the employee.

In many cases, an employer may use cash it would have paid to the employees to make capital investments in the business or hire new workers. Particularly in the case of small employers, nonqualified plans may be integral to the ability of the employer to grow and create new jobs.

Plans and Liabilities Are Publicly Disclosed

Unlike some corporate liabilities which have drawn attention in recent corporate scandals, an employer's liabilities under a nonqualified plan are included on its financial statements. Similarly, any assets set aside to fund these liabilities, including amounts placed in a rabbi trust, are included as assets of the employer on its financial statements.

Public companies also file electronic copies of their nonqualified plans with the SEC as exhibits to their periodic Form 10-K and Form 10-Q filings. Thus, the nonqualified plans of public companies are available for inspection through the SEC's web site. Additional information about the amount of benefits under certain nonqualified plans maintained by a public company will be provided in the company's annual proxy statement (also available for inspection on the SEC's web site).

Potential Abuses and Legislation

Recent legislative proposals and media attention has focused on potentially abusive nonqualified plan practices. Specifically, concerns have been raised about devices intended to prevent an employer's creditors from accessing assets set aside by the employer to meet its nonqualified plan obligations. These devices include the use of off-shore rabbi trusts and early payment triggering devices. A triggering device could provide, for example, that when an employer's finances deteriorate to a certain pre-determined level, the assets set aside would be paid out to plan participants or be moved to a secular trust. The vast majority of nonqualified plans do not utilize these types of devices.

Recent legislative proposals in the nonqualified plan area would go significantly beyond these potentially abusive devices. These proposals would subject an employee to federal income taxes on deferred amounts (or invite the IRS to issue regulations doing the same) merely because amounts were set aside in a rabbi trust or the nonqualified plan contained certain distribution elections.

As explained above, placing assets in a rabbi trust does not remove the assets from the reach of an employer's creditors. At most, a rabbi trust provides employees with limited protection against non-payment in the event of a change in control of their employer or a change of heart by current management. And, again as explained above, most nonqualified plans place substantial restrictions on an employee's ability to elect a distribution of his plan benefits.

It is worth noting that the IRS routinely issues private letter rulings to employers on their nonqualified plans and related rabbi trusts. These rulings are issued pursuant to two IRS revenue procedures on the subject (one of which includes a "model" rabbi trust) and provide assurance that the plans and related trusts achieve the desired tax treatment. Routine IRS approval of these plans stands in marked contrast to the IRS's recent attacks on certain abusive executive compensation arrangements as tax shelters.

Joint Committee on Taxation's Enron Report

Recently, the Joint Committee on Taxation ("JCT") issued a report which described certain aspects of Enron Corporation's nonqualified plans and made recommendations for extensive changes in the tax laws for such plans.[3] The report recommended restrictions on rabbi trusts and prohibitions on the use of "haircuts" and other provisions for the acceleration of payment. The report also recommended prohibiting subsequent payment elections and participant-directed investments in nonqualified plans.

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[3] Joint Committee on Taxation, *Report of Investigation of Enron Corporation and Related Entities Regarding Federal Tax and Compensation Issues, and Policy Recommendations* (JCS-3-03), February 2003.

As noted above, assets held in a rabbi trust must remain subject to the claims of an employer's creditors, and rabbi trusts do not protect employees from the risk of his employer becoming insolvent and unable to meet its obligations under the plan.

"Subsequent elections" are often permitted under nonqualified plans to provide employees with limited flexibility in their retirement planning. Longstanding case law makes clear that such an election does not result in constructive receipt of deferred amounts, provided the election is made sufficiently in advance of the originally scheduled distribution date.

Employees in some nonqualified plans, particularly mirror 401(k) plans, may be permitted to designate the investments used to measure earnings credited to their bookkeeping accounts. In recent private rulings, the IRS has determined that the ability to make such elections does not result in constructive receipt. These elections do not control the actual investment of any amounts an employer sets aside to meet its nonqualified plan obligations, and they have no impact on the ability of an employer's creditors to access any such amounts. Thus, it is difficult to understand why the ability to select the earnings crediting vehicle should result in constructive receipt or economic benefit issues.

Conclusions

Nonqualified plans are an important part of the retirement income and compensation programs of many employers. They help employees -- including many below the executive ranks -- to achieve their retirement income goals. These plans are not concealed, abusive perquisites reserved for a handful of top executives. Any legislation in the nonqualified plan area should target only potentially abusive practices, such as the use of inappropriate off-shore rabbi trusts or insolvency triggering devices. Legislation should not limit the ability of employers and employees to establish non-abusive deferred compensation arrangements consistent with longstanding tax principles.

Appendix A
Comparison of Qualified and Nonqualified Plans

Tax (or Other) Effect	Qualified Plans	Nonqualified Plans
Employer Deduction	Deduction at time of contribution to trust.	Deduction deferred until employee is taxed.
Tax on Investments	Tax on earnings of assets deferred until amounts are distributed to employee.	Employer currently taxed on earnings of any assets (unless earnings are tax-exempt).
Tax on Employee's Benefits	Tax deferred until amounts distributed to employee. Tax-free rollovers to IRAs and qualified plans allowed.	If properly structured, employee is not taxed until actual receipt. Rollovers are not allowed.
Limits on Contributions/Benefits	Section 415 limits (DC and DB); $200,000 compensation limit; 401(k) deferral limit ($12,000 for 2003); nondiscrimination rules (e.g., ADP and ACP).	Only as imposed by employer.
Payment Flexibility	Constructive receipt rules do not apply; thus, great flexibility.	Constructive receipt rules apply; thus, employee's access to funds subject to substantial restrictions.
Claims of Employer's Bankruptcy Creditors to Assets Set Aside	Amounts must be placed in trust; employer's creditors have no claim to assets.	Employer's creditors have claims to assets, even if held in a "rabbi trust."
Claims of Employee's Bankruptcy Creditors	Protected from claims	Not protected from claims
Social Security Taxes	No (except for 401(k) contributions)	Subject to limited extent

Comments by the American Council of Life Insurers for the Hearing in the Senate Finance Committee Titled: "Enron: Joint Committee on Taxation Investigative Report - Compensation - Related Issues" on April 8, 2003

As part of the report prepared by the Joint Committee on Taxation addressing the Enron Corporation, (JCS-3-03), there was a discussion of the tax treatment related to certain life insurance contracts owned by Enron. These contracts were issued prior to June 1986 and were covered by a "grandfather" provision in the Enron report. There was a suggestion that this grandfather provision may have been a transition rule and thus, should be repealed. It is the position of the American Council of Life Insurers that this suggestion should be rejected based on the reasons described herein.

In essence, this grandfather is an effective date provision and any proposal to retroactively change an effective date will undermine the fundamental confidence taxpayers must have in the actions Congress takes. If Congress changes the effective date years after its enactment, how can any taxpayer remain assured about the future of any other change in law that includes a grandfather?

In 1986, Congress undertook broad and dramatic tax reforms resulting in the Tax Reform Act of 1986. As is often the case when Congress enacts a modification of an existing statute, the amendment changing the tax treatment of certain life insurance contracts explicitly did not seek to retroactively apply this change. To do so would have unfairly penalized taxpayers who had carefully arranged their affairs so as to be in compliance with the law prior to its amendment. .

As part of the Tax Reform Act of 1986 (P.L. 99-514), Congress dramatically changed the tax treatment of interest deductions for interest incurred in relation to loans from life insurance contracts. Along with this change, Congress specifically "grandfathered" existing contracts such that they were unaffected by the new statute. In other words, Congress specifically intended that contracts issued prior to June 20, 1986 would be forever unaffected by the new restrictions.

The provisions of the grandfather are specified in the conference report on the Tax Reform Act of 1986 [H.Rpt. 99-841, pages II-340 & II-341] and are explained further in the "Blue Book" prepared by the Joint Committee on Taxation, which is intended as a guide explaining the provisions of the Tax Reform Act of 1986. [JCS-10-87, "General Explanation of the Tax Reform Act of 1986, pages 578-580]

During Congressional debate of the Tax Reform Act of 1986, there were a series of colloquies, some specifically addressing the grandfather provision and under what situations a change relating to the policy would cause the policy to have lost its protection [Cong. Rec. H8361 (September 25, 1986)]; [Cong. Rec. S13956 (September 27, 1986)]; & [Cong. Rec. E3391 (October 2, 1986)]. None of these dialogues raised any implication that at some time in the future, the grandfather provision should be modified or removed.

Despite the clear intent of Congress in 1986 that life insurance contracts issued prior to June 20, 1986 were not to be affected by any subsequent changes in tax law, the JCT now recommends modification of this 17-year-old provision; however there is no legal rationale or evidence to support the JCT's presumption that the effective date of 1986 legislation was somehow intended as "transition" relief to give businesses sufficient time to redeploy their assets

Overtime, Congress has proven that it knows the difference between an effective date provision and a transition rule. This is shown by contrasting the 1986 grandfather with a subsequent change in tax law affecting life insurance contracts. In 1996, the loan deduction provisions were again amended. (Section 501 HIPAA). In this change, there was no grandfather provision for existing contracts. There was a transition rule that affected existing contracts, permitting them to retain certain deductions from the date of passage for the next three years. The distinction between a transition rule, as in 1996, and a grandfather, as in 1986, is clearly set forth.

With respect to the 1986 grandfather, in 1996, Congress again reaffirmed that the new limitations did not generally apply to contracts purchased on or before June 20, 1986. In 1996, Congress knew that the grandfather enacted in 1986 was intended to limit the effect of statutory changes. [JCS-12-96, "General Explanation of Tax Legislation Enacted in the 104th Congress, pages 366-367.]

Lastly, in 1997, Congress again looked at interest deductions relating to life insurance contracts when it limited the ability of policyholders who insured officers, directors, non-employees, and 20-percent of owners who owned cash value policies to take deductions for unrelated borrowing. The JCT description of this provision, in discussing the scope of the new provisions, indicates that there is an effect of contracts, "except as otherwise provided under present law with respect to key persons and pre-1986 contracts." [JCS-23-96, "General Explanation of Tax Legislation Enacted in 1997.]

NATIONAL ASSOCIATION OF
INSURANCE AND FINANCIAL ADVISORS

STATEMENT OF

ALBERT J. SCHIFF
PRESIDENT
ASSOCIATION FOR ADVANCED LIFE UNDERWRITING

AND

RICHARD A. KOOB
PRESIDENT
NATIONAL ASSOCIATION OF INSURANCE AND FINANCIAL ADVISORS

SUBMITTED TO THE
SENATE FINANCE COMMITTEE
APRIL 22, 2003

FOR THE RECORD OF
ITS APRIL 8, 2003 HEARING ON
ENRON: JOINT COMMITTEE ON TAXATION
INVESTIGATION ON COMPENSATION-RELATED ISSUES

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This statement sets forth the views of the Association for Advanced Life Underwriting (AALU) and the National Association of Insurance and Financial Advisors (NAIFA) in connection with the Senate Finance Committee's April 8, 2003, hearing on Enron: Joint Committee on Taxation Investigation on Compensation-Related Issues.

AALU is a nationwide organization of life insurance agents, many of whom are engaged in complex areas of life insurance such as business continuation planning, estate planning, retirement planning, deferred compensation and employee benefit planning. AALU represents approximately 2,000 life and health insurance agents and financial advisors nationwide.

NAIFA, (formerly the National Association of Life Underwriters), is a federation of nearly 850 state and local associations representing 320,000 insurance and financial advisors and their employees. Originally founded in 1890, NAIFA is the nation's oldest and largest life insurance trade association.

The Joint Committee on Taxation ("JCT") staff has recommended repeal of the 1986 grandfather rule permitting the continued deduction of interest on policy loans with respect to life insurance policies purchased before June 21, 1986. AALU and NAIFA believe that repeal of this grandfather rule would be unwarranted and directly contrary to the legislative intent of Congress expressed in 1986 and again in 1996.

Nothing in the JCT staff's report on its Enron investigation suggests (nor could it) that Enron acted inconsistently with Congressional intent in borrowing against pre-June 21, 1986 life insurance policies. If Enron did not abuse current law with respect to its policy borrowings, those borrowings should not be a rationale for reconsidering a grandfather rule included in legislation nearly two decades ago. The sins of Enron did not extend to its life insurance policy borrowings and certainly do not serve as justification for enacting punitive tax increases on law-abiding corporations.

1986 Grandfather Rule Was Not a "Transition Rule"

In the Tax Reform Act of 1986, Congress generally restricted the deduction for interest on life insurance policy loans to the first $50,000 of indebtedness on a policy. However, this limitation, by statute, applied only to policies purchased after June 20, 1986. In 1996, when Congress revisited the issue of corporate-owned life insurance, it specifically reconfirmed the grandfather rule for pre-June 21, 1986 policies.[1]

The JCT staff raises a question in the Enron Report of whether the relief for policies purchased before the effective date was intended to be permanent or a "transition rule":

> If the 1986 grandfather rule was intended to provide transition relief to businesses that had purchased life insurance contracts before the 1986 date, sufficient time has passed that a redeployment of such businesses' assets could have been

[1] While reconfirming the general grandfather, Congress did decide in 1996 to adopt market-focused limits on the interest rates that could be used for borrowings against those grandfathered policies.

> possible. The grandfather rule can no longer serve any reasonable need for transition relief.[2]

In fact, the legislative record nowhere indicates that the 1986 grandfather rule was intended to be a temporary transition rule. Instead, the effective date was intended and drafted as a permanent (i.e., life of the policy) grandfather for policies purchased prior to the effective date. Congress often adopts such permanent grandfather rules when it determines to change the law but believes it would be unfair to deny the benefits of prior law to taxpayers that relied on that law in making business decisions (e.g., the purchase of a life insurance policy).

Tax-writing committee members are well aware of the distinction between a permanent grandfather rule and a temporary transition rule, and could have adopted the latter in 1986 if that had been their intention. As an example of a transition rule (labeled as such), note the general 3-year phase-out of interest deductions on life insurance policy borrowings adopted as part of the Health Insurance Portability and Accountability Act ("HIPAA") of 1996,[3] which was intended to end perceived abuses regarding broad-based leveraged corporate-owned life insurance:

> (2) TRANSITION RULE FOR EXISTING INDEBTEDNESS.—
> (A) IN GENERAL.— In the case of—
> (i) indebtedness incurred before January 1, 1996, or
> (ii) indebtedness incurred before January 1, 1997 with respect to any contract entered into in 1994 or 1995,
> the amendments made by this section shall not apply to qualified interest paid or accrued on such indebtedness after October 13, 1995, and before January 1, 1999.

In connection with this transition rule, Congress in the 1996 Act also went out of its way to reconfirm the 1986 grandfather rule. Ten years after adoption of the original 1986 grandfather, Congress believed that grandfather continued to have merit and specifically protected pre-June 21, 1986, policies from the new 1996 rule denying interest deductions for life insurance policy loans. Reaffirmation of this grandfather rule stands in sharp contrast to the above "transition" relief Congress provided at the same time for other life insurance policies.

Taxpayers with pre-June 21, 1986, life insurance policies relied on pre-1986 law in purchasing those policies. They relied no less on the grandfather rule enacted 17 years ago to continue to maintain borrowings against life insurance policies.

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[2] JCT Staff Enron Report at I-303.
[3] HIPAA section 501(c)(2) (excerpt).

Repeal of the Grandfather Would Create Significant Hardship

If the 1986 grandfather rule were eliminated now, taxpayers would be left with several bad alternatives:

(i) They could suffer a significant tax increase because of the loss of interest deductions;

(ii) They could sell other assets to raise funds to pay off the life insurance policy loans. However, this could cause the companies to sell assets they otherwise considered necessary to their business operations. In addition, asset sales could result in additional tax from built-in gains.

(iii) They could replace the life insurance policy borrowings with other, interest-deductible borrowings. These replacement borrowings would have adverse financial statement consequences by increasing the companies' reported leverage and would restrict the companies' abilities to make further borrowings for business operations; or

(iv) They could surrender sufficient portions of the life insurance policies to satisfy the indebtedness. However, this would cause immediate taxation of accrued inside buildup of the life insurance policies.

Leveraged Corporate-Owned Life Insurance Must Satisfy Stringent Case Law Standards

The case law has made it clear that leveraged corporate-owned life insurance arrangements, including grandfathered pre-June 21, 1986 policies, cannot be mere tax-savings devices. In addition to satisfying clear statutory requirements for deductibility of interest on life insurance policy loans, taxpayers must demonstrate that these life insurance arrangements satisfy common-law tests requiring them to have "economic substance."

Grandfathered Policies Do Not Provide a Perpetual Avenue for Borrowing

Contrary to what we understand some have suggested, the benefits of being able to deduct interest on borrowings against pre-June 21, 1986, life insurance policies will not go on forever.

The individuals insured under these policies will die with the passage of time. These policies are, by definition, at least 17 years old, with the result that most insureds (who were typically company executives at the time they were insured) are now in their 60's or 70's. Once the insureds die, the policies will terminate. All loans against policies on deceased insureds are satisfied out of the death benefits payable under the policies, with the remainder being paid to the policy beneficiaries.

The inevitability of death cannot be circumvented by substituting a new insured on an existing policy. Such a change would cause the policy to be treated as a newly issued policy for purposes of the grandfather rule. According to the JCT's General Explanation of the Tax Reform Act of 1986:

> A life insurance contract, other than one received in exchange for a life insurance contract issued by the same insurer, received after June 20, 1986, in exchange for an existing contract is considered to have been purchased after June 20, 1986. In the case of a policy purchased before June 21, 1986, minor administrative changes in the policy after June 20, 1986, such as changes in the address of the insurer, the officers of the insurer, or the address of the insured, do not cause the policy to be treated as purchased after June 20, 1986.[4]

While there was some discussion during the Senate debate on the 1986 Tax Reform Act to the effect that a substitution of insureds would not be treated as the purchase of a new policy after June 20, 1986[5], this assertion was rapidly contradicted by House Ways and Means Committee Chairman Dan Rostenkowski who stated:

> I am particularly concerned, among other issues, by statements which seem to validate the ability to substitute insureds under a policy and qualify under the grandfather provisions. This issue was never discussed, and therefore never agreed to, by the conferees.[6]

Moreover, even if it were possible to argue that there could be a substitution of insureds while preserving the pre-June 21, 1986, policy grandfather, such a substitution would result in a taxable exchange of the life insurance policy, with the result that all of the accrued inside buildup (considerable for policies that are now at least 17 years old) would become immediately taxable.

Conclusion

Despite the question raised by the JCT staff, the 1986 grandfather rule was intended and drafted as permanent relief, rather than as a "transition" rule. No justification has been asserted by the JCT staff for repealing this 1986 grandfather. Basic principles of equity dictate that Congress not eliminate a grandfather rule that has been in place for nearly two decades.

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[4] JCT Staff General Explanation of the Tax Reform Act of 1986 at 580.
[5] September 27, 1986, colloquy between Senators Dole and Packwood appearing at S13956-7 in the Congressional Record.
[6] October 2, 1986, statement by Rep. Dan Rostenkowski appearing at page E3391 in the Congressional Record.

COMMENTS OF THE BUSINESS ROUNDTABLE
to the
Senate Finance Committee
Hearing on Enron and Executive Compensation
Tuesday, April 8, 2003

The Business Roundtable is pleased to submit the following comments to the Senate Finance Committee on the legislative proposals regarding nonqualified deferred compensation plans that are being considered in response to problems at Enron Corporation. These comments examine the impact of the wide-reaching proposed restrictions would have on the many employees who participate in these plans.

The Business Roundtable is an association of chief executive officers of leading corporations with a combined workforce of more than 10 million employees in the United States and $3.7 trillion in annual revenues. Our members are committed to restoring investor and employee confidence in corporate America. As part of that goal, we recognize and applaud Congressional efforts to curb abusive compensation practices. However, we strongly counsel against adopting sweeping changes that would harm a significant number of deferred compensation programs that comply with the requirements of the Internal Revenue Code and with good corporate governance.

While tax-qualified retirement plans provide employees an opportunity to save for retirement, the dollar limits on contributions to such plans by both employees and employers often result in contributions that are lower than necessary to meet the future financial needs of employees and their families. Many middle-level managers do not qualify to contribute to an individual retirement account on a pre-tax basis; nonqualified plans offer such individuals an opportunity to increase retirement security, and provide needed funds in the case of the employee's disability. Given the current debate over the solvency of the Social Security system, concerns about the retirement income adequacy of an ever-growing segment of the U.S. population, and the crisis of inadequate retiree medical coverage, nonqualified deferred compensation plans allow a wide range of employees to save additional amounts for retirement.

The Business Roundtable understands that the Committee may find it appropriate to develop targeted restrictions designed to address specific abuses, but it urges the Committee to ensure that any such restrictions are properly targeted and applied prospectively. Many of the proposals under current consideration would preclude compensation practices long recognized as legitimate and adopted by many, if not most, U.S. employers. If not carefully crafted, concepts like those set forth in the Pension Protection and Expansion Act of 2003 (S. 9), the American Competitiveness and Corporate Accountability Act of 2002 (H.R. 5095, as introduced in the 107th Congress), or the report issued by the staff of the Joint Committee on Taxation on Enron could considerably and inappropriately restrict the availability of nonqualified deferred compensation plans and unfairly penalize innocent employees who have elected to defer compensation under nonqualified programs. In particular, the BRT is concerned that the proposals would: (1) require all employees to make irrevocable decisions as to the timing and form of ultimate distribution when they make an initial deferral; (2) preclude any in-service distributions, even if the employee becomes disabled or suffers an unforeseen hardship; (3) preclude any deferral of income stemming from stock option exercise or restricted stock awards; (4) preclude any choice of earnings measures; and (5) potentially apply these changes retroactively. In order to explain how these restrictions would impact common existing employee plans, The Business Roundtable offers the following comments and suggestions.

A. Retain flexibility with respect to elections under nonqualified deferred compensation plans

It is unreasonable to restrict all flexibility with respect to the timing and form of retirement distributions by requiring employees to make irrevocable decisions when they make an initial deferral. Such a restriction would force employees to determine, irrevocably, all aspects of the deferral and distribution of a specified portion of their compensation as much as 20-30 years prior to retirement. Recognizing changing retirement income needs, Congress permits employees to make elections with respect to benefits provided by tax-qualified plans at any time prior to the commencement of benefits. Although, consistent with the general doctrine of constructive receipt, it is appropriate to impose some limitations on when participants may make an election, the mere fact that benefits are paid under a non-qualified plan should not lead the Committee to demand binding final elections as much as 20-30 years prior to retirement. It would be more reasonable to demand that such election be made or confirmed six–twelve months prior to the distribution.

Moreover, concerns about multiple elections should not preclude an employee from making this final election closer to retirement. While The Business Roundtable recognizes the need to preclude annual changes that undermine constructive receipt/assignment of income principles, it would be unreasonable to preclude an employee from changing or confirming an initial election closer to actual retirement. Again, while it may be appropriate to require that such election be made at least six to twelve months prior to the actual distribution, it would not be appropriate to preclude all such elections.

B. Permit distributions in the event of disability or unforeseen financial hardship

It is inappropriate to preclude distributions from nonqualified deferred compensation plans in the event of employee disability or hardship. These arrangements have long provided for disability and hardship distributions and no evidence of abuse with respect to these provisions has been documented, even at Enron. Where an employee becomes disabled, or faces severe and unanticipated financial need, it would be unreasonable to deny complete access to previously deferred compensation. However, it may be reasonable to impose an objective standard of disability or financial need. As the Congress has found in attempting to define distribution rules applicable to qualified plans, IRAs and Roth IRAs, if distribution options are too restrictive, employees fail to save in the first place, based on a fear that such funds might be needed in the event of a future personal crisis.

1. Permit disability distributions

For many years, the Internal Revenue Service has permitted nonqualified deferred compensation plans to make distributions upon a participant's disability. Revenue Procedure 92-65, 1992-2 C.B. 428, sets forth the circumstances under which the Service will issue an advance ruling (a "private letter ruling") on a nonqualified deferred compensation plan. In Section 3.01(b) of the Revenue Procedure, the Service required that a nonqualified plan define the time and method for payment of deferred compensation for each event (such as termination of employment, regular retirement, disability retirement or death) that entitles a participant to receive benefits. Thus, distributions upon an employee's disability are clearly permitted under current law. The Service has also issued many favorable private letter rulings regarding nonqualified plans that permitted

distributions upon the participant's disability. See, e.g., Priv. Ltr. Ruls. 199915028 (April 16, 1999) and 199906008 (February 12, 1999).

2. Permit distributions in the event of unforeseen hardship

As with disability distributions, the Service has long permitted nonqualified plans to make distributions to a participant in the event of the participant's hardship. Section 3.01(c) of Rev. Proc. 92-65 provides:

> The plan may provide for payment of benefits in the case of an "unforeseeable emergency." "Unforeseeable emergency" must be defined in the plan as an unanticipated emergency that is caused by an event beyond the control of the participant or beneficiary and that would result in severe financial hardship to the individual if early withdrawal were not permitted. The plan must further provide that any early withdrawal approved by the employer is limited to the amount necessary to meet the emergency. Language similar to that described in section 1.457-2(h)(4) and (5) of the Income Tax Regulations may be used.

Similarly, the Service has issued many favorable private letter rulings defining acceptable hardship provisions and, in the context of section 401(k) and 457 plans, regulations setting forth definitional and operational standards. In practice, many nonqualified deferred compensation plans (like many 401(k) plans) do include provisions permitting hardship distributions. In fact, while not technically subject to the section 401(k) rules, many nonqualified deferred compensation plans adopt similar standards in defining hardship.

There has been no evidence of abuse of the hardship provisions, even at Enron. This is quite understandable if you consider the risks relating to any abuse. Most nonqualified deferred compensation plans cover a group of employees. Plans are quite restrictive in considering applications for hardship distribution because the potentially adverse tax consequences fall not only upon the individual seeking the distribution, but also upon all other participants. There is no question that any participant who receives a hardship distribution would be in actual receipt of the funds, and thus, be taxed on the amount of the distribution. At issue is whether all remaining participants should also be taxed under the doctrine of constructive receipt. If a plan grants any request for a hardship distribution, regardless of circumstances, then the Service could assert that any participant could receive his or her account at any time, in which case, all participants would be considered to be in constructive receipt of all deferred amounts. To preclude tainting the entire plan and all participants therein, employers impose, both in form and operation, significant restrictions on such distributions.

It should also be noted that, in practice, it is often participants with lower compensation who require additional funds in the event of financial hardship. Top-paid executives often have greater disposable income and greater insurance protection than middle managers, and thus, do not need, and may not qualify for, hardship withdrawals. It is more likely that eliminating the right to receive a hardship distribution would impact mid-level managers than senior executives.

C. Permit the deferral of stock option gains or restricted stock

The Business Roundtable believes that stock options and restricted stock, like salary and bonuses, constitute forms of compensation. As we noted in our Principles of Corporate

Governance (May 2002), "an appropriate compensation package for management includes a carefully determined mix of...incentives." Similarly, the Conference Board's Commission on Public Trust and Private Enterprise, in their study of executive compensation, recognized the importance of performance-based compensation. Accordingly, if employees are permitted to defer compensation, subject to reasonable constraints defined by the Congress, it is inappropriate to limit the types of compensation that may be deferred. Deferrals of stock option gains or restricted stock compensation should be permitted under whatever guidelines are established and made applicable to all other forms of compensation.

D. Permit flexibility with respect to choice of earnings measurements

The Business Roundtable believes that it is unreasonable to deny employees who otherwise properly defer compensation the ability to select the measure of earnings to be credited to such deferrals. This feature has long been recognized as legitimate, and has been adopted by many, if not most, US employers. The right to select the earnings measure does not mean the participant has the right to require the employer to invest deferred amounts in that manner. In fact, many employers do not set aside funds for future distribution, but instead make such distributions out of the current operating assets of the company. The earnings measure is just that, a measure to adjust the amounts ultimately due to the employee under the deferral agreement with the employer. The earnings measure has no impact on the timing or form of the payment of deferred compensation. Limiting this right would not curb perceived abuses regarding employees' control over deferred amounts.

To draw a simple analogy, financial institutions currently offer certificates of deposit with floating interest rates – the depositor can elect a higher rate during a stated window period. No one would argue that the depositor has control over the bank, or should be taxed currently on the earnings. This is also the case in nonqualified arrangements.

E. Ensure that any changes are applied prospectively

The Business Roundtable urges Congress to apply any changes to deferred compensation plans prospectively. Nonqualified deferred compensation plans are sponsored by many, if not most, major US employers. Hundreds of thousands of employees, including many mid-level managers, have deferred compensation with the legitimate expectation that such amounts would not be taxed until distribution. These plans were established in compliance with existing case law and guidance from the Service. It would be patently unfair to apply any new restrictions retroactively to existing deferrals.

Furthermore, deferred compensation arrangements are contractual arrangements between employers and employees. Employees agree to defer receipt of future compensation in return for receiving an agreed-upon earnings measure on such deferrals. Employers gain the use of such funds for normal operating uses. Any changes that are required to nonqualified arrangements as a result of proposed legislation will require a change to that contractual arrangement. Employers cannot take unilateral action to revise deferred compensation programs. Thus, it is critical that employers and employees be given sufficient time to renegotiate existing nonqualified deferred arrangements to reflect any new restrictions.

Thank you for the opportunity to present our views on this vital issue.

TESTIMONY OF

LPA, THE HR POLICY ASSOCIATION

TESTIMONY SUBMITTED TO THE COMMITTEE ON FINANCE UNITED STATES SENATE

HEARING ON THE JOINT COMMITTEE ON TAXATION'S INVESTIGATIVE REPORT ON ENRON: EXECUTIVE COMPENSATION ISSUES

WASHINGTON, DC
APRIL 8, 2003
(03-46)

The HR Policy Association

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Mr. Chairman, and Members of the Committee:

In the aftermath of the corporate scandals involving companies such as Enron, Tyco, WorldCom and Global Crossing, Congress has paid increased attention to executive compensation issues. The most extensive review to date has been the Joint Tax Committee's comprehensive report on Enron's tax shelters and executive compensation arrangements. LPA, the HR Policy Association, commends the Committee for the extensive investigation and analyses it performed with respect to Enron's approach to compensation. From a human resources perspective, the report provides an in-depth review of Enron's compensation plans for employees and executives. While not indicative of typical practices at large companies, the report's findings of fact will be instructive to companies, policymakers and students for years to come.

Although the Joint Tax Committee report provides useful facts with respect to Enron's executive compensation practices, and in particular its use of nonqualified deferred compensation plans, we believe that the recommendations the Committee made as a result of the company's failings went too far. We respectfully request that the Finance Committee consider the following:

- the report recommended statutory changes based on the circumstances surrounding Enron, which it viewed as a paradigm for most corporations, even though Enron's practices are not representative of those in most large companies;
- the report disclosed several lapses in corporate governance on the compensation committee, but its recommendations focused exclusively on changes to tax law, which have nothing to do with corporate governance;
- the report misperceived the primary reason for nonqualified deferred compensation arrangements as being tax avoidance when, in reality, such arrangements are most often a vehicle to provide additional retirement savings for executives whose participation in qualified plans is limited by current legal restrictions;
- the report claimed that the existence of nonqualified deferred compensation arrangements provides companies an incentive to eliminate qualified retirement plans for all employees, even though to our knowledge this did not occur at Enron nor at any other company;
- the report recommended eliminating all accelerated distributions under nonqualified deferred compensation plans, even though there are circumstances, such as emergencies or hardship, in which accelerated distributions are necessary and appropriate;
- the report found that certain Enron executives withdrew deferred amounts prior to bankruptcy and thus recommended the elimination of rabbi trusts and plan provisions that require the employees to forfeit 10 percent of their deferred amounts in order to withdraw such amounts early; yet, federal law permits a bankruptcy trustee to reclaim payments made to corporate insiders within a year;

- the report recommended the elimination of deferrals of stock option gains and restricted stock, even though companies that use these devices regularly require employees to keep these deferrals in company equity, thus promoting alignment with shareholder interests.

This testimony provides some context to the Joint Tax Committee's recommendations, and provides LPA's response to many of the committee's recommendations with respect to nonqualified deferred compensation.

LPA, the HR Policy Association, is a public policy advocacy organization representing senior human resource executives of more than 200 leading employers doing business in the United States. LPA provides in-depth information, analysis, and opinion regarding current situations and emerging trends in employment policy among its member companies, policy makers, and the general public. Collectively, LPA members employ over 19 million people worldwide and over 12 percent of the U.S. private sector workforce. LPA has a keen interest in ensuring that its members can recruit and retain top executive talent to provide leadership for their companies who face highly challenging business conditions. For this reason, the association seeks to maintain the flexibility of executive compensation while ensuring compliance with the law, and promoting transparency without adding excessive paperwork.

Impact of Contribution Limits on Nonqualified Deferred Compensation

A nonqualified deferred compensation plan is typically used to provide supplemental retirement benefits to an executive whose level of income restricts the amount that he or she may save under qualified (tax-favored) benefits arrangements. Just like traditional pensions and 401(k) plans, a nonqualified deferred compensation plan is a deferred arrangement—one designed to provide compensation to an executive at some point in the future, such as during retirement, after the executive's job is terminated (*e.g.*, in the event of a hostile takeover), or in the event of death or disability.

Unlike traditional pension or 401(k) plans, deferred compensation plans are considered nonqualified because they do not qualify for the special tax advantages that pension plans, 401(k) plans, and similar plans receive under the tax code. Because executives are paid substantial salaries, their contributions to tax qualified plans normally exceed the contribution limits set by tax law for such plans. Currently, contributions to 401(k) plans are limited to $11,000 annually, and employer contributions to pension plans may take into account the first $200,000 of income annually. In order to provide approximate parity (*i.e.*, the same ratio) of benefits to salary that rank-and file employees enjoy, companies establish nonqualified deferred plans that enable the executive to defer additional amounts that typically will be used for retirement purposes. These are often called "mirror plans," because they are designed to mirror existing qualified plans, except that the participating executives must pay taxes on them.

Nonqualified Deferred Plans Carry Risk

Unlike qualified plans, which have funds dedicated to them and are insured and protected to some extent, nonqualified plans carry a risk. By law, the company may not dedicate specific funds to nonqualified plans, and the assets must be accessible by general

creditors. Thus, an executive may not receive the amounts deferred if the company refuses to pay them or if the company enters bankruptcy. Considered this way, nonqualified deferred compensation is performance-based pay, because a good share of deferred compensation often is retained in company equity. It is also pay at risk, because if the company, the industry, or the stock market generally does not perform well, executives can lose substantial amounts of money, either because the value has dropped or because the company cannot afford to pay. Indeed, the Enron report itself noted, "In connection with Enron's financial problems, many executives lost a considerable amount of compensation that had been deferred."

Tax Treatment of Nonqualified Deferred Compensation

The tax code sets general parameters for nonqualified deferred compensation plans. In general, deferred compensation is not taxable until the executive is, for all practical purposes, guaranteed receipt of the funds. As a practical matter, deferred compensation is only valuable as a savings tool if the recipients are not required to pay tax on the compensation in the year it is deferred. Otherwise, executives would be better off financially to receive the compensation immediately, pay taxes on it, and invest it. However, to make the deferral nontaxable, there must be some risk that the executive will not receive the funds.

Whether a nonqualified deferred compensation plan is immediately taxable to the executive is determined by whether the plan is considered funded. A funded plan is one in which the company has dedicated funds to an account or trust for a specific executive (or set of executives), and the executive (or set of executives) has access to the funds. The tax code treats a funded plan as if the company had paid the money directly to the executives. If a plan is funded, the amounts transferred to the account or trust are treated as a transfer of property and taxed to the executive as ordinary income the year of the transfer. In tax parlance, the executive has control over the funds and thus is taxed as if he or she has constructively received them. Consistent with the "matching principle" in the tax code, the company would receive a deduction for compensation when the executive recognizes income under a deferred plan.

By contrast, there is no immediate taxation for nonqualified deferred plans if the company does not directly pay the executive or place funds in a dedicated account or trust.

Some company plans permit executives to withdraw unfunded amounts before retirement or upon another pre-arranged event or on a preset timetable. This is called an early distribution. Plans with early distribution provisions are permissible, provided that there is a penalty, such as a 10 percent "haircut," for withdrawing the deferred amounts early. The penalty is considered a substantial limitation on withdrawal that acts as a disincentive to withdrawal, and thus, the funds are treated as not constructively received. The funds *are taxable* to the executive as soon as they are withdrawn, and the company is allowed a compensation deduction.

In addition, funded plans that carry a substantial risk of forfeiture are not taxable. A substantial risk of forfeiture exists if the individual has yet to perform substantial services for the company at the time the deferral is elected or if there is an event that could cause the individual to lose the deferred amounts. For example, many companies have funded

deferred executive compensation through rabbi trusts, which provide that the amounts in the trust are subject to general creditors in insolvency or bankruptcy. Placing funds into a trust whose terms required that the funds could be paid only to certain executives would normally "fund" the arrangement. However, by making the assets subject to the general creditors in insolvency or bankruptcy, the trust is subject to a substantial risk of forfeiture and not taxable until the executives actually receive the funds.

Report Makes Recommendations Based on Management Practices at Enron—an Atypical Corporation

The Joint Tax Committee report provided important insights into financial accounting and compensation practices at Enron Corporation. However, Enron does not represent the way large corporations are typically managed and, for that reason, the report should not be used as the basis for sweeping reform legislation on executive compensation.

At the same time, the report detailed shocking facts with respect to Enron's compensation committee, yet it never referenced these facts in its recommendations. Specifically, the report states that some compensation committee members were not well versed in the basic issues that they were tasked with overseeing. One member did not know whether Enron offered nonqualified deferred compensation, another did not know whether the compensation committee approved qualified plans, while a third did not know what a qualified plan was. Often, executive sessions during which the committee discussed compensation for top officers were not reflected in the compensation committee minutes. All of these facts help demonstrate that the Enron executive compensation committee was little more than a rubber stamp for management.

Clearly, the substantial focus placed on good corporate governance in the aftermath of Sarbanes-Oxley, and the SEC's demand for stricter corporate governance standards by the stock exchanges will help cure lax practices, such as those mentioned in the report. However, the report never referenced the need for good corporate governance in ensuring sound executive compensation practices.

Report Selectively Highlights Key Points of Nonqualified Deferred Compensation

Beyond corporate governance matters, the section of the report on nonqualified deferred compensation appeared to be crafted to provide a rationale to further restrict such compensation, rather than to cure the corporate governance defects that led to many, if not most of Enron's woes. This is evident from the discussion of the reason companies offer and executives seek nonqualified plans, as well as the current treatment of such plans under tax law. These issues are discussed below.

Tax Avoidance Is Not Predominant Motivation for Seeking Deferred Compensation. The Joint Tax Committee repeatedly infers that executives defer compensation predominantly to avoid immediate income taxation. However, as mentioned above, companies provide, and executives seek, nonqualified deferred plans because current law limits the amounts that they may contribute to qualified plans. In fact, the amount of annual compensation that qualified plans could take into account has steadily been ratcheted down over time. Qualified plans are more advantageous to the company, because the company may take an immediate tax deduction for contributions to the plan. They are also more advantageous to the executive, who receives the greater security of a

plan that provides dedicated funds. If given the opportunity, executives would prefer to participate fully in qualified plans. However, because tax law limits their participation in such plans, executives take the opportunity to defer income for retirement through nonqualified plans, to mirror the percentage deferred by other employees.

Moreover, the tax consequences of deferred compensation plans are effectively a wash, just like other forms of compensation. On the margin, when an executive recognizes deferred compensation, he or she pays income taxes on the amount, and the company recognizes a compensation deduction in the same amount. Moreover, by permitting deferred amounts—whether in company equity or some other form—to grow, the executive ultimately pays more in taxes than if the income were received and recognized immediately.

Existence of Nonqualified Deferred Plans Will Not Reduce or Eliminate Qualified Plans. In several places, the Joint Tax Committee opines that the existence of nonqualified deferred compensation plans will cause executives to discontinue qualified plans for employees, even though this never happened at Enron or any other prominent company. The Committee's view is based on the misguided notion that, if executives have flexibility under nonqualified deferred plans, there is no reason to sponsor qualified plans. Yet, deferred compensation arrangements have not undermined qualified plans for two reasons. First, every company has a need to recruit and retain talented employees throughout the company, not just at its highest levels. No company in today's world can attract that talent without competitive qualified plans. Second, even to those at the highest levels, qualified plans provide an extra measure of security that nonqualified plans do not, thus attracting the participation of executives to the extent they are permitted. As the Committee acknowledges, those executives who had deferred compensation in nonqualified plans lost a significant amount of money when the company's stock dropped, and it entered bankruptcy.

Bankruptcy Law Permits Recoupment of Payments to Insiders Up to a Year Before Bankruptcy Filed. Without saying it directly, the Joint Tax Committee argued that in Enron's case, the company circumvented the doctrine of constructive receipt by making payments out of its rabbi trust to executives within two months of bankruptcy. Under a rabbi trust, the company sets aside deferred compensation in a trust for executives, but the amounts must be available to creditors in the event of insolvency or bankruptcy. The Committee argued that by making the payments to executives so close to the bankruptcy filing, the executives were in a better position than creditors, and thus all deferred compensation in the trust should have been immediately taxable. The Committee failed to acknowledge that bankruptcy law allows a bankruptcy trustee to recoup transfers made to insiders of a corporation, including executives, within one year from bankruptcy. Given that the assets in Enron's rabbi trust were set up to be accessible to general creditors, the payments made to certain executives shortly before bankruptcy was filed should be recoverable.

Report Inconsistent on Tax Treatment of Nonqualified Deferred Compensation. The Joint Tax Committee Report noted with an understandable level of shock the dramatic increase in compensation expense that Enron reported for executives on its tax returns between 1999 and 2000. Yet, the report discounted the deterrent effect that nonqualified

arrangements can have on a company because the company's compensation deduction is delayed until the executive actually receives, or gains control over, the funds.

When discussing the tax effects of Enron's nonqualified deferred compensation arrangements, the committee argued that the compensation deduction realized by the company when executives received deferred compensation was inconsequential because the company reduced or eliminated taxes through other, albeit questionable, transactions. Ignoring for the moment that Enron's situation is unique (if not an aberration), the report's argument with respect to the compensation deduction for deferred compensation is inconsistent: If compensation expense for executives is significant, it should not matter whether the compensation is comprised of current year salary or deferred amounts from prior years that are paid and recognized as a compensation expense in the current year. Deferred compensation is treated similarly to other compensation: when the executive has effective control over the compensation, the executive recognizes income and the company receives a compensation deduction in the same amount.

Accelerated Distributions, Subsequent Elections, and Directed Investments Do Not Undermine Constructive Receipt. The Joint Tax Committee recommended that all distributions under deferred compensation agreements other than at the termination of employment (including retirement and death) should be prohibited. The Committee also recommended that the ability of employees to change the timing and form of the distribution should be prohibited, as should the ability of participants to direct where the amounts are invested. The committee opposed each of these features under the argument that they permitted the employee to control the deferred amounts, making it appear as if the only purpose of the deferral was to avoid taxes. In reality, the employees have a minimal amount of control over the amounts until they are received.

Accelerated Distributions. Currently, accelerated payouts can only be made from a deferred compensation plan if there is a "substantial risk of forfeiture,' such as a 10 percent penalty (or haircut). The Committee cites the accelerated distribution to executives before Enron filed bankruptcy as evidence that the 10 percent haircut is not a sufficient deterrent. However, the report noted that until the company entered financial difficulties, it had no formal procedure for processing accelerated distributions. Such distributions were rarely, if ever, used prior to the company's financial difficulties. The report also failed to mention the provisions of bankruptcy law that allow the bankruptcy trustee to recoup payments to corporate insiders made within a year of filing bankruptcy. Given that the withdrawals in Enron's case were made roughly two months before the bankruptcy filing, the trustee should be able to recoup these payments.

Subsequent Elections. The report also comments that the Enron deferred compensation plan permitted executives to make subsequent elections as to when they were to receive the income and the form that the income would be expected to take. It recommends that because the ability to make subsequent elections indicates that the executives have control over the deferred funds, such elections should result in immediate taxation. However, current law permits such elections to the extent that they are made sufficiently in advance of the receipt of income. Even with subsequent elections, executives still must wait a period of time before obtaining deferred amounts. Thus, the deferrals did not work like a separate bank account in which withdrawals could be made at any time. In tax parlance, there is still a substantial limitation on withdrawal,

significantly limiting control over the funds, and the practice should be allowed to continue.

Directed Investments. The Enron report notes that executives who participated in the deferred compensation program had the ability to direct where their deferred funds were invested. In reality, participants could in fact direct where their earnings would be credited among a chosen mix of investment funds, much the way that corporate 401(k) plans work. The difference being, however, that their deferred investments were subject to the claims of general creditors, as discussed above.

Deferrals of Stock Option Gains and Restricted Stock Are No Different Than Other Deferrals. The Enron report viewed the deferral of stock option gains and restricted stock "as a manipulation of the rules for deferred compensation and stock-for-stock exercise." Yet, most companies that permit deferral of stock option gains or restricted stock require employees to keep their deferred amounts in company equity. This reinforces both the pay-for-performance and pay at risk concepts discussed above. It also helps to align the interests of the executives with the shareholders by contributing toward greater executive stock ownership.

Moreover, when the deferred amounts are liquidated at the end of employment, the executive must pay income taxes on the amounts, and the company receives a compensation deduction. The report focused exclusively on the potential that the transaction could result in tax avoidance. However, if the stock appreciates, the deferral will result in greater taxes at an ordinary income rate. Looked at this way, it is hard to see how the government's interest is impaired.

Conclusion

In conclusion, we believe that the Enron problem was based upon serious flaws in its corporate governance structure, not the mechanics of its nonqualified deferred compensation plans. Enron's unique facts simply do not make the case for sweeping reforms of the tax laws governing deferred compensation. We strongly encourage the Committee, before considering any changes in these laws, take a much closer look at typical deferred compensation arrangements and recognize the legitimate role they play in compensating top executives.

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