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.

III. Specific Recommendations and Rebuttals

Constructive Receipt Rules of Code §61

The Joint Committee attributes the growth of abuses of executive deferred compensation plans to the lack of regulatory guidance by the IRS, and thus recommends the repeal of Congress' moratorium. Certainly for the Service to issue new guidance in this area, the moratorium must be repealed. But that alone is **not** sufficient. Congress imposed the moratorium back in 1978 because it believed the Service had overstepped its regulatory authority. Thus Congress froze the constructive receipt rules to those regulations, rulings and case law in existence as of 1978. Since the Service's regulations and rulings were at odds with the then existing case law, the repeal of the moratorium will not correct that ambiguity. Congress needs to provide specific legislative guidance for both the Service *and* the courts to follow. Focusing on the specific terms of the executive deferred compensation plans, the Joint Committee recommends that Congress retool the scope of constructive receipt (under Code §61) in three distinct situations -- the use of participant-directed investment control; the right to accelerate distributions; and the right to make subsequent elections as to timing of benefits.

In ascertaining appropriate constructive receipt rules for Code §61, this Committee should refer to the Service's seminal ruling, Rev. Rul. 60-31. In that ruling, deferred compensation is to be subject to immediate taxation if it "is credited to his account, set apart for him, or otherwise made available so that he may draw upon it any time." Such rule does not avoid tax for the executive, but merely delays the taxation for the executive until receipt of benefits.

The employer continues to be subject to tax on such deferrals, awaiting a deduction when the executive takes the benefit into income. The purpose of the constructive receipt rule is to impose current tax on the executive if he/she has an *unfettered control* in determining *when* income will be taxable.

Participated-directed investment control: The Joint Committee equates a participant's control over investments as *control* for constructive receipt purposes under Code §61 and calls for such a feature to be eliminated for all such executive deferred compensation plans. Such observation misses two important issues -- first, the constructive receipt rules of Code §61 address the participant's control over the *timing* of the receipt of the benefit, not control over the *amount or earnings* of the benefit -- and second, if the underlying employee benefit plan is a defined contribution plan, such plan permits the employer to shift the investment risk to the participant (in contrast with a defined benefit plan in which the employer assumes the investment risk).

In the past, the application of the constructive receipt doctrine has not depended on whether the underlying plan was a defined benefit or defined contribution plan. Shifting investment risk to the participant is exactly what a defined contribution plan does. Eliminating such risk for executive deferred compensation plans actually would force employers to guarantee rates of investment on such deferrals, thereby affording even greater protection to the executives. Under the Enron's executive deferred compensation plans, such participant-directed control resulted in drastically reduced values by the end of 2001 as the directed investment had been Enron stock. As these plans are not qualified plans, actual accounts are not even established, let alone invested in the hypothetical investment. The investment choices are merely a means of calculating a return on the deferrals. Thus, the attached proposed legislation does **not** trigger constructive receipt in the executive deferred compensation plan which permits participant-directed investments.

Haircut provisions: The Joint Committee recommends that the use of a haircut provision within an executive compensation plan should trigger constructive receipt. Under the current constructive receipt rules, the right to receive deferrals which are subject to a substantial risk of forfeiture does not result in immediate taxation. Certainly, imposing a financial penalty equal to a percentage of the executive benefits can constitute a substantial risk of forfeiture -- we can debate as to whether 5%, 10% or 15% is substantial, but once we quantify the penalty, such amount certainly results in a forfeiture of benefits. Nonqualified executive plans typically impose a 10% penalty.

In regards to the use of the haircut provision by the Enron executives, $53 million in withdrawals were exercised two months prior to bankruptcy. However, other executives and managers were continuing to make elective deferrals of $54 million during 2001 -- this suggests to me that certain insiders privy to the financial information were taking advantage of the haircut, whereas other executives and managers thought the company was financially healthy which is why they continued to make deferrals even in the year of bankruptcy.

Once Congress decides on an appropriate financial penalty, there is nothing inherently wrong with haircut provisions, especially as applied to *elective* deferrals. However, if Congress is concerned that insiders may exercise their withdrawal right in order to defraud creditors, then the use of haircut provisions should be restricted to them. My February proposed legislation would have prohibited the use of haircut provisions by any officer, director or 10% owner. Upon more refinement, the exercise of the haircut should not be a *per se* violation; instead availability of inside information in exercising the haircut should be prohibited. The attached proposed legislation would require insiders to wait 12 months before exercising a haircut provisions, thereby preventing them from taking advantage of any inside information. Such 12-month period also reinforces the bankruptcy rules. Thus, the proposed legislation would permit haircut provisions for non-insiders but restrict their use for insiders.

Subsequent elections: The Joint Committee recommends the Service's approach regarding subsequent elections (*i.e.,* that subsequent elections should trigger constructive receipt as the participant has control over the timing of his/her distribution). Case law has not affirmed the Service's approach but instead permits subsequent elections provided they are made prior to the tax year of the expected distribution. Given that these plans involve long periods of deferrals, subsequent elections regarding timing and form (*e.g.,* installment vs. lump sum) 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 and 24 months in advance for insiders. The additional 12-month requirement for insiders is to provide further protection for the employer's creditors.

Economic Benefit Theory of Code §83

The Joint Committee also addresses the use of rabbi trusts as security arrangements for executive deferred compensation plans. Under the economic benefit doctrine of Code §83, if the participant has any rights to employer assets that are *greater than* those of general creditors, the underlying benefits become "funded" and if vested, then taxable to the participant. The Joint Committee presumes that the use of a haircut provision within the underlying deferred compensation plan afforded the participants with greater rights to the employer's assets as the assets were available upon demand, subject to a financial penalty. However, *none* of the $53 million withdrawn under Enron's haircut distributions came from Enron's rabbi trusts. I believe the question of haircut provisions should be resolved under the constructive receipt rules of Code §§61 and 451 and once resolved have no bearing on the economic benefit rules of Code §83.

In Rev. Proc. 92-64, the Service has approved the use of rabbi trusts in order to protect executives against a subsequent change of control or change of heart by management. Such events are clearly outside the control of the executive and thus are legitimate reasons to provide protection for executives. It appears that the terms of the Enron's rabbi trusts complied with IRS' directives. But there have been abuses with the use 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 should result in taxation under Code §83. Also moving the rabbi trust assets offshore may afford greater security for executives and thus should result in taxation under Code §83.

Reporting and Disclosure Requirements
The Joint Committee acknowledges that the Department of Labor regulations require only an initial plan filing, noting that there is no required reporting of nonqualified deferred compensation benefits. Such result can be easily remedied by directing the Department of Labor to subject executive deferred compensation plans to reporting and disclosure requirements that are similar to those applicable to qualified plans (*e.g.*, Form 5500).

To provide greater access to information for investors, distributions made pursuant to a haircut provisions may also be required to be reported to the Department of Labor. This will serve as a public watchdog for these provisions, similar to the insider trading rules. If more specific information is needed, the Department of Labor already has the necessary administrative powers to demand more specificity and information. As the attached proposed legislation limits accelerated distributions for insiders and imposes a minimum of 24 months for subsequent elections, the insiders' decisions regarding the timing of plan benefits will be more aligned with the continued financial health of the employer.

IV. Conclusion

Congress should use its current momentum in the wake of these corporate scandals to shed meaningful light on the practices used by some nonqualified executive deferred compensation plans. But saddling the IRS with the task of defining the rules without any meaningful legislative guidance neither corrects the problem in the near future, nor assists the Service in future litigation. I recommend that the Senate Finance Committee specially amend §§61 and 83 of the Internal Revenue Code in order to provide immediate and concrete guidance for these plans and any related security arrangements. In addition, the Secretary of Labor should be directed to remove the regulatory exemption from ERISA's reporting and disclosure rules for these plans and apply time-tested rules that govern qualified plans. I look forward to working with you and your staff to implement these needed changes. Thank you for this opportunity.

Respectfully submitted,

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Attachment

Proposal
Section 132 of the Revenue Act of 1978 (Public Law 95-600) is repealed.
The amendment by this section shall apply to taxable years after the date of the enactment of this Act.

Proposal to Change Code Section 61:

Within the context of Section 61, it is proposed that Congress add new subsections (subsection (c) and (d)) to Section 61 which specifically exempts from current taxation deferrals under nonqualified executive compensation plans that satisfy the requirements of that subsection. The subsection is not intended to alter the current constructive receipt rules applicable to individual employment arrangements that are not regarded as nonqualified plans for purposes of section 61.

Section 61 of the Internal Revenue Code of 1986 (relating to gross income) is amended by adding the following new subsections:

"(c) Inclusion of Deferred Income under an Unfunded Nonqualified Deferred Compensation Plan -- In the case of a participant in an eligible nonqualified deferred compensation plan, any amount of compensation deferred under the plan, and any income attributable to such amounts, shall be includible in gross income under this section in the taxable year in which such compensation or other income is distributed to the participant or beneficiary.

(1) Eligible Nonqualified Deferred Compensation Plan Defined. -- For purposes of this section, the term "eligible nonqualified deferred compensation plan" means a plan established and maintained by a plan sponsor providing for the deferral of compensation for services, other than under a plan qualified under section 401(a), a section 403(a) annuity plan, a tax-deferred annuity under section 403(b), a simplified employee pension under section 408(k), and eligible deferred compensation plans under section 457, --

(A) in which only employees or independent contractors (individuals or entities) who perform service for the plan sponsor may be participants,

(B) for plans permitting participants to elect to have deferrals of any compensation for services be made under such plan, such election must be made before the beginning of the participant's tax year in which the services are performed, except that an election may be made within 30 days of being eligible to participate in the plan or within 30 days of the plan=s effective date,

(C) which meets the distribution requirements of subparagraph (2), and

(D) for plans permitting participants or beneficiaries to elect among alternate forms of distribution payments, such election must be made at least 12 months in advance of the first distribution payment.

(2) Distribution Requirements. --

(A) In General. -- For purposes of subparagraph (1)(C), a plan meets the distribution requirements of this subsection if --

(i) under the plan, amounts deferred, and any income attributable to, will not be made available to participants or beneficiaries earlier than --

(I) severance from employment, death, disability, retirement, attainment of a specified age according to the terms of the plan, or change of control (as defined by Section 83(c)(4)(B)(i)),

(II) a specified date or completion of a fixed number of years as elected by the participant or beneficiary according to the terms of the plan, which may be subsequently altered by the participant or beneficiary according to the terms of the plan at least 12 months in advance of such date,

(III) upon an unforeseeable emergency (determined in a manner consistent with the Secretary's regulations under section 457), or

(IV) at any time as requested by the participant according to the terms of the plan, provided such distribution is subject to a financial penalty of at least 10%,

(ii) for purposes of applying subparagraph (i) to any participant or beneficiary who is an "insider" within the meaning of subparagraph (iii) below, "24 months" shall be substituted for "12 months" in subparagraph (i)(II), and "12 months after being" shall be substituted for "at any time as" in subparagraph (i)(IV), and

(iii) an "insider" is someone who is a director, officer or 10% principal owner of the public plan sponsor subject to section 16 of the Securities Exchange Act of 1934 (or would be subject to section 16 if the plan sponsor was public).

(B) Notwithstanding subparagraph (A), amounts contributed by the plan sponsor on behalf of the participant under the plan which are not subject to a participant's distribution election nor the result of matching deferrals by the plan sponsor, including any income attributable to such amounts, may be paid in accordance with the terms of the plan at an earlier date than those described in subparagraph (i) above provided such amounts remain subject to a substantial risk of forfeiture (as that term is defined by section 83(c)) during the period of deferral until the actual time of receipt."

The amendment made by these sections shall apply to taxable years beginning after the date of the enactment of this Act.

Proposal to Change Code Section 83:

Section 83(c) of the Internal Revenue Code of 1986 (relating to special rules for property transferred in connection with performance of services) is amended by adding the following new paragraph:

"(4) Use of Security Arrangements. --

(A) In General. In determining whether there is a transfer of property for purposes of subsection (a), if assets --

(i) are designated or otherwise available to protect a participant or beneficiary in the event of a change of control or change of intent by the plan sponsor with respect to benefits under a nonqualified deferred compensation plan (as defined by section 61(b)), such assets shall not be treated as property provided --

(I) the rights of the participant or beneficiary to such amounts shall be those of a general unsecured creditor of the plan sponsor,

(II) such assets remain solely the property of the plan sponsor and are available to satisfy the claims of its creditors at all times until distribution under the terms of the plan,

(III) the trustee of any assets held in trust be an independent third party with granted corporate trustee powers under state law, and

(IV) except as authorized by the Secretary by regulation, the indicia of ownership of such assets must be held inside the jurisdiction of the courts of the United States.

(B) For purposes of subparagraph (A) --

(i) the term "change of control" means the purchase or other acquisition of more than 20% of the total outstanding stock or total voting stock of stockholder-owned plan sponsor or more than 20% of the capital or profit interest in a non-stockholder-owned plan sponsor (as described by the Secretary by regulation), and

(ii) The term "change of intent" means either

(I) the plan sponsor's refusal to pay benefits under the terms of the nonqualified deferred compensation plan other than for reasons of bankruptcy or insolvency, or

(II) the plan sponsor's attempt to amend or terminate the existing terms of the nonqualified deferred compensation plan in a manner which adversely affects the payment of benefits already accrued under such plan."

The amendment made by this section shall apply to assets so designated or otherwise available after the date of the enactment of this Act in taxable years ending after such date.

Proposal to Change the Reporting and Disclosure Requirements of ERISA:
The Secretary of Labor is directed, pursuant to its authority under section 110 of the Act (88 Stat. 851), to provide new regulations applicable to unfunded or insured pension or profit sharing plans maintained by an employer for a select group of management or highly compensated employees requiring the disclosure of information similar to that required under the general reporting and disclosure requirements for pension or profit sharing plans.

Plan terms are to be disclosed to the Department of Labor upon plan adoption. The following financial information is also to be required for top hat plans on an annual basis, (similar to that generally reported on an annual Form 5500):

- basic plan information
- number of participants/beneficiaries
- current account balances/accrued benefit amounts
- current distributions: the amounts and type (*e.g.,* haircut distribution) of annual distributions
- dollar value of assets set aside in a rabbi trust or other security arrangement.

Attestation of Plan Disclosure:

The Secretary of Labor is directed to require that the above information be reviewed by the plan sponsor's independent auditors and receive a signed attestation as to its accuracy.