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Rabbis and Other Top Hats: The Great Escape

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The first "Rabbi trust" was developed by a congregation that wanted to provide for its Rabbi after his retirement. The arrangement consisted of a pension plan and an accompanying trust. Trust assets remained subject to claims of the congregation's creditors, and the Rabbi had a vested interest in the trust. The Rabbi could not withdraw money from the trust until his retirement or other termination of service. A favorable letter ruling from the Internal Revenue Service (IRS) for this arrangement encouraged others to ask for rulings. Rabbi trusts are currently in great demand because many consider them to be the best available choice for deferred compensation plans.

The two types of deferred compensation plans are qualified and non-qualified. Both types permit employees and independent contractors to elect to postpone taxation of a portion of their compensation. The principal advantages of qualified plans are that the employer may deduct contributions when the contributions are paid to the trust, and earnings of

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1. A pension or profit-sharing plan is qualified for special tax treatment if it satisfies several statutory requirements. I.R.C. § 401(a) (1988 & Supp. IV 1992). Any plan which does not satisfy all of the requirements is nonqualified. E.g., Ludden v. Commissioner, 68 T.C. 826, 829-33 (1977), aff'd, 620 F.2d 700 (9th Cir. 1980).


3. Id.

4. Id.

5. Id.

6. Supra note 1.


trust assets are exempt from taxation. However, qualified plans are the most expensive type of arrangement because the advantages are more than offset by the cost of qualification.

This Article explores the requirements for creation of a successful Rabbi trust. Part I outlines the general effects and requirements of qualified plans, nonqualified plans without a trust, nonqualified plans with a secular trust, and nonqualified plans with a Rabbi trust. Part II discusses ways to avoid application of the labor portion of the Employee Retirement Income Security Act (ERISA). Part III summarizes the tax requirements for establishment of a nonqualified plan and Rabbi trust, while parts IV through VI contain detailed consideration of income deferral methods. Part VII covers the treatment of Rabbi trusts operated by governments and exempt organizations. In part VIII the Article concludes that legislation is required to settle the numerous uncertainties associated with the Rabbi trust, and recommends interim measures that can provide predictability.

I. GENERAL COMPARISONS AND REQUIREMENTS

In the case of a qualified plan, the employer gets a deduction when he makes a contribution, the trust is not taxed on its earnings, and participants are not taxed until actual receipt of benefits. The opposite extreme is a nonqualified plan, where the employer retains possession of the assets. Income from the assets is taxed to the employer, the employer gets a deduction when benefits are taxed to participants, and participants are taxed when vesting occurs.

Secular is the term which describes most trusts used in connection with nonqualified plans. With the secular trust, the employer is entitled to an expense deduction when vesting occurs, income is taxed to the trust, and participants are taxed when vesting occurs. Rabbi is the description for a trust used in connection with a nonqualified plan if trust assets remain subject to claims of creditors of the employer. Under the Rabbi Trust, the employer is entitled to an expense deduction when benefits are

12. Id. § 501(a) (1988).
13. Id. § 402(a) (Supp. IV 1992).
16. I.R.C. §§ 83(h), 404(a)(5).
17. Id. § 641(a).
18. Id. § 402(b) (Supp. IV 1992).
taxed to the participants, income of the trust is taxed to the employer, and participants are taxed at the earlier of actual or constructive receipt of benefits. Suppose a participant is hired by an employer at age forty-five and his interest will vest at age fifty. Normal retirement age is sixty-five, and no withdrawals from the plan are permitted prior to that time. The employer begins contributing money to the plan for the participant's account when he reaches age forty-seven. Typical results are set forth in tabular form, where numerical answers identify timing in terms of the participant's age:

<table>
<thead>
<tr>
<th>Type of Plan</th>
<th>Qualified</th>
<th>No Trust</th>
<th>Secular</th>
<th>Rabbi</th>
</tr>
</thead>
<tbody>
<tr>
<td>Contribution</td>
<td>No Tax</td>
<td>No Tax</td>
<td>No Tax</td>
<td>No Tax</td>
</tr>
<tr>
<td>Deduction</td>
<td>47</td>
<td>65+</td>
<td>50</td>
<td>65+</td>
</tr>
<tr>
<td>Earnings of Assets</td>
<td>No Tax</td>
<td>Taxed to</td>
<td>Taxed to</td>
<td>Taxed to</td>
</tr>
<tr>
<td>Benefit</td>
<td>65+</td>
<td>65+</td>
<td>50</td>
<td>65+</td>
</tr>
</tbody>
</table>

A. Qualified Plans

While qualified plans are the most attractive option from a tax perspective, mechanical and subjective criteria are used to determine whether there is excess discrimination in coverage or benefits that would deny qualification. The result is that some rank and file employees who would not have been covered will participate, and participants will be entitled to greater benefits. Since they are the most expensive type to operate and there is no advantage to an employer, a qualified plan should not be adopted unless it is required by a labor agreement.

B. Nonqualified, No Trust Plans

If the employer is unwilling to bear the cost of qualification, other types of plans should be considered. One possibility is a nonqualified plan without a trust. While such plans receive less favorable tax treatment, they are also the least expensive for the employer to operate. If

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the labor provisions of ERISA do not apply,27 there are no participants or benefits other than ones the employer wants to pay for, and there are no costs associated with operating a trust. Participants, however, have reason to be concerned about whether they will be able to collect benefits earned under the no trust plan. Assets in the hands of the employer remain subject to claims of the employer's creditors, and the employer is free to dispose of the assets if he chooses to do so.

C. Secular Plans

A nonqualified plan with a secular trust28 is another possibility. Since assets are placed in a trust not subject to the claims of the employer's creditors, they are protected from the risks of business, and payments cannot be withheld on the whim of management.29 Another advantage is that the discrimination rules30 do not apply. The disadvantages are that secular plans receive the least favorable tax treatment,31 and they are required to comply with various rules in the labor portion of ERISA. These rules involve the adequacy of things such as participation,32 vesting,33 accrual of benefits,34 funding,35 and fiduciary responsibility.36

D. Rabbi Trust

The final choice is a nonqualified plan with a Rabbi trust. While trust assets remain subject to the claims of the employer's creditors, the terms of the trust can prevent the employer from disposing of the assets.37 Rabbi trusts receive the same tax treatment as nonqualified plans without a trust,38 and the plan can be set up so the labor portion of ERISA does not apply.39 Hence the employer's expenses are limited to those it wants to incur.40 Many employers think that the Rabbi trust option is the best

28. Secular is the name for trusts that are not Rabbi because assets are not subject to claims of the employer's creditors.
29. Instead of being taxed to the employer, trust income is taxed to the trust. I.R.C. § 641(a) (1988).
30. Id. §§ 401(a)(4), 410(b), 416.
31. Supra text accompanying notes 21 and 22.
33. Id. § 1053.
34. Id. § 1054.
35. Id. § 1082.
36. Id. § 1104.
38. Supra text accompanying notes 21 and 22.
compromise of tax attributes, operating expenses, coverage, and protec-
tion. Despite their appeal, a number of uncertainties exist with respect
to Rabbi trusts.

1. Top Hat Exemption

One uncertainty is whether the plan will be exempt from the labor por-
tion of ERISA. Since application of the statute would result in a substan-
tial increase in the cost of either a nonqualified plan without a trust or a
Rabbi trust, these plans can be effective only if they satisfy the require-
ments for the top hat exemption.

The requirements for the top hat exemption are uncertain. A plan
must be "unfunded," which means that benefits will be paid directly from
assets of the employer. The IRS has concluded that a plan with a Rabbi
trust is unfunded because trust assets remain subject to claims of the em-
ployer's creditors. The Department of Labor (Labor) has indicated it
will follow the IRS's funding criteria. Hence, if the IRS determines that
a trust satisfies Rabbi criterion, the plan apparently will be unfunded for
top hat purposes.

Another top hat requirement is that the participants must be a select
group. The select group criterion is unclear. Labor believes the plan may
not include any individual who is not management or highly compen-

41. See, e.g., Ronald Fink, Trust Worth, Fin. World, Feb. 18, 1992, at 66; Elizabeth
Karier, Most Firms Fund Executive Plans, Pensions & Investments, Mar. 30, 1992, at 8;
William E. Lissy, To Encourage Executive Stock Ownership: Companies Use Guidelines or
42. E.g., 29 U.S.C. §§ 1052-1054.
43. The top hat exemption applies to unfunded plans where participation is limited to
a select group of management and highly compensated employees. 29 U.S.C. §§ 1051(2),
44. Release of draft Rabbi trust regulations has been repeatedly postponed, and Labor
has not provided any useful guidelines. Hence, many employers have been unable to make
reasonable advance determinations about whether a proposed plan is likely to be
approved.
45. Compare Dependahl v. Falstaff Brewing Corp., 653 F.2d 1208, 1213-14 (8th Cir.)
(holding that a plan will be deemed funded when an employee may rely upon a res sepa-
rating the ordinary asset of the employer in the event that the liability of the plan is
First Nat'l Life Ins. Co., 818 F.2d 661 (8th Cir. 1987) (holding that no separate res exists
from the ordinary assets of the employer when an employer reserves the right to treat the
assets of a plan as unpledged and unrestricted).
47. Letter from Elliot I. Daniel, Assistant Adm'r for Regs. & Interpretations, Office of
Pension & Welfare Benefit Programs, U.S. Dep't of Labor, to Richard H. Manfreda, Chief,
Individual Income Tax Branch, IRS (Dec. 13, 1985) (on file with the Catholic University
sated. Further, Labor finds a group including all of the employer's management and highly compensated employees to not be select. There is no reasonably clear indication of how exclusive the group must be in order to qualify as select.

2. Postponement of Income

For tax purposes, a plan is considered adequate if it postpones receipt of compensation, and trust assets remain subject to the claims of the employer's creditors. The IRS will not issue a favorable ruling on a trust unless the trust satisfies the model Rabbi trust requirements promulgated in a 1992 revenue procedure.

The form of the employer's obligation to pay benefits is important. Obligations paid in cash or tangible property are usually income to the payee, while payments of intangible property are less likely to be income when received. Since the goal of all pension and profit sharing plans is to delay realization of income until the participants receive cash, the critical question is whether the promise to pay is adequate to avoid taxation at the time the promise is received.

The principal criterion for determining whether the receipt of a promise is income is the likelihood of payment. The receipt is not income if substantial doubt exists as to whether the employee will be able to convert the promise to cash. For the purpose of making judgments about the probability of payment, there are three classes of promises. One class of promises is those secured by assets of the employer that have been placed beyond the reach of the employer's creditors.

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48. Compare Dept't of Labor (DOL) Advisory Op. 75-64 (Aug. 1, 1975) (finding exemption for plan covering less than 4% of employees whose annual compensation averaged $28,000 compared to $19,000 for other managerial employees) with DOL Advisory Op. 85-37 A (Oct. 25, 1985) (finding no exemption for a plan covering six officers and directors as well as thirty-three other participants whose annual salaries ranged from $12,121 to $45,000).


52. Id. at 423.


54. E.g., Cowden v. Commissioner, 289 F.2d 20, 24 (5th Cir. 1961).


57. Id.

class is promises with a sufficient degree of liquidity in the marketplace. The third class is promises that provide a right of possession which puts the participant in constructive receipt of income.

II. ERISA Coverage

A. Absence of a Plan

ERISA can be subdivided into labor and tax provisions. The labor provisions generally apply to all deferred compensation plans. The tax provisions apply mainly to pension and profit-sharing plans seeking qualified status. Legislative and administrative materials do not offer a general definition for the term “plan,” and authorities suggest that the principal question is whether an arrangement was intended to benefit members of a group.

Two categories of factors are used to decide whether a plan exists. The first is whether the parties treat the arrangement as benefitting a group of people. One article concluded that no plan exists if the deferred compensation is under a contract negotiated between the employer and one employee. Similarly, no plan exists if promises contained in several individual employment contracts are isolated events. Promises in contracts to multiple individuals, however, may be

59. Diamond & Cutler, supra note 56.
64. I.R.C. § 401(a).
66. Lackey, 704 F. Supp. at 204.
67. Id. at 205.
69. Jervis v. Elerding, 504 F. Supp. 606 (C.D. Cal. 1980). For instance, no plan would exist if an employer offered deferred compensation to attract new employees pursuant to a decision to expand into new markets. In a 1988 case, such promises were included in the employment contracts individually negotiated between the employer and four prospective employees. Lackey, 704 F. Supp. at 201. The court, relying on the Office of Pension and Welfare Benefit Program's definition of a plan, concluded that no plan existed because these agreements were merely individual employment contracts, and therefore did not fall within the definition of a plan under ERISA. Id. The Department of Labor has reached the same result in similar circumstances. E.g., DOL Advisory Op. 76-111 (Sept. 28, 1976); DOL Advisory Op. 76-79 (May 25, 1976).
evidence of a plan. The key issue is how many promises are needed to establish a pattern sufficient to constitute a plan. There would presumably be no doubt that a plan existed if a promise was in every employment contract made by an employer; however, there is no standard for determining the exact number of individual promises that would be necessary.\textsuperscript{71}

The second category of factors evaluates compliance with ERISA requirements. An arrangement that fails to create documents, hold assets in trust, and identify fiduciaries probably will not be considered a plan.\textsuperscript{72} Mass failure is evidence of a lack of intent to benefit the members of a group.\textsuperscript{73}

If the arrangement is not a plan, ERISA does not apply.\textsuperscript{74} If the arrangement does constitute a plan, ERISA applies unless an exemption is available. The exemption for unfunded excess benefit plans is limited to programs that provide benefits in excess of those that can be paid by qualified plans.\textsuperscript{75} This top hat exemption is available to unfunded plans for management and highly compensated employees.\textsuperscript{76}

B. Top Hat

A top hat plan is “unfunded . . . and maintained by the employer primarily for the purpose of providing deferred compensation for a select group of management or highly compensated employees.”\textsuperscript{77} Since the participants usually have the ability to substantially influence the operation of the plan, they do not need the protection otherwise provided under ERISA.\textsuperscript{78} Some question remains as to the specific requirements of the top hat exemption.

There must be an adequate group, which means that all or most of the participants are management or highly compensated employees.\textsuperscript{79} Labor

\textsuperscript{70} See, e.g., McQueen v. Salida Coca-Cola Bottling Co., 652 F. Supp. 1471, 1472 n.1 (D. Colo. 1987) (implying that contractual promises to multiple employees may reveal the existence of a plan).

\textsuperscript{71} Callihan v. Brickford Equip. Corp., 747 F. Supp. 1424, 1429-30 (M.D. Ala. 1990);

\textsuperscript{72} 29 U.S.C. § 1003(a) (1988); Lackey, 704 F. Supp. at 205.

\textsuperscript{73} See Lackey, 704 F. Supp. at 205.

\textsuperscript{74} 29 U.S.C. § 1003(b).

\textsuperscript{75} Id. § 1003(b)(5).

\textsuperscript{76} Id. §§ 1051(2), 1081(a)(3), 1101(a)(1).

\textsuperscript{77} Id. § 1051(2).

\textsuperscript{78} Id.; DOL Advisory Op. 90-14A (May 8, 1990).

\textsuperscript{79} For example, where a select group of participants accounted for less than 4% of the employer’s active work force, and their average annual salary of $28,000 was $9000 above the average of managerial employees, the group was held to qualify under the top hat exemption. DOL Advisory Op. 75-64 (August 1, 1975). On the other hand, a group of
believes coverage cannot be made available to anyone who is not management or highly compensated. An adequate group must be select, which means that a group cannot cover all management and highly compensated employees. An employer may have several top hat plans. One approach is to have a number of programs offering different types of benefits to various groups. One group might consist of those desiring life coverage, while another may select profit-sharing. Since there is a rational ground for distinguishing between the groups, each would appear to be select, even if all management and highly compensated employees receive one sort of benefit or another.

The plan must be unfunded. Legislative materials do not suggest an approach to the funding issue, and courts have dealt with the question simply by examining the details of each particular plan. Labor takes the position that decisions are to be based on an examination of the facts and circumstances including the status of the plan under non-ERISA law. Labor feels that tax rulings should be given significant weight, and thus concludes that a plan would not fail to qualify under the top hat exemption because it includes a Rabbi trust. Labor apparently will continue to follow the IRS approach that treats a plan as unfunded so long as the assets remain subject to claims of the employer's creditors.

executives that included a comptroller, an accountant, three foremen, a scheduler, and a time study position, was found to be inadequate. DOL Advisory Op. 85-37A (Oct. 25, 1985).

84. See id. One plan provided that the employer's obligation was to be secured by purchasing life insurance, and did not give the employer the right to treat the policy as a general and unrestricted asset of the employer. Id. The court concluded that the plan was funded. Id. at 1208. The decision was distinguished by the same circuit in a later case where an employer purchased a separate life insurance policy for each key executive. Belsky v. First Nat'l Life Ins. Co., 818 F.2d 661 (8th Cir. 1987). Under the plan, the employer was not obligated to buy insurance, and if it in fact did so, it was not to be held in trust or as security. Id. at 663. The court construed the plan as unfunded because the rights of participants were merely those of unsecured creditors. Id.
86. Daniel Letter, supra note 47.
If the top hat exemption applies, the plan is exempt from ERISA's participation, vesting, funding, and fiduciary responsibility rules. The exemption does not extend to the reporting and disclosure provisions. Those requirements are satisfied if the plan administrator files a statement giving the name, address, and tax identification number of the employer, the number of top hat plans set up, the number of employees in each, and by furnishing documents when requested by Labor.

An advisory opinion is recommended as the best insurance against a change of heart in the qualification for a top hat exemption. Labor would be reluctant to claim that a plan did not satisfy the top hat criterion if it had issued an opinion reaching the opposite conclusion.

III. TAX REQUIREMENTS

In order to serve its purpose, the plan must postpone taxation to the participants, and assets of the Rabbi trust must remain subject to claims of the employer's creditors.

A. Funding

There are three approaches to funding. The first approach, permitting the employer to remain in possession of plan assets, has the advantages of simplicity and lower cost. On the other hand, unrestricted access makes it easy for the employer to dispose of the assets. Another problem of this approach is that the employer might refuse to pay. While current management may be friendly and cooperative, there is no way of knowing what the attitude may be in subsequent years.

The second approach is to place plan assets in a Rabbi trust. If the plan uses a Rabbi trust, a favorable letter will not be issued on the plan unless the trust follows model language and complies with the other

92. See, e.g., Boggs v. Commissioner, 784 F.2d 1166, 1171 (4th Cir. 1986); Lawsons, Inc. v. Commissioner, 69 T.C. 733, 786-87 (1978), aff'd on retroactive revocation issue, 622 F.2d 774 (5th Cir. 1980).
94. See, e.g., Rev. Rul. 60-31, 1960-1 C.B. 174. This approach is available only if the arrangement is not a plan, or an exemption is available. 29 U.S.C. § 1103(a) (1988).
95. For example, saving the time and cost involved in dealing with the trust.
Rabbis and Other Top Hats

Since assets of the trust must remain subject to claims of the employer's creditors, the trust is unfunded for tax purposes. The trust cannot cause the plan to be funded under the labor portion of ERISA.\textsuperscript{100} The trustee must be an independent third party, such as a bank.\textsuperscript{101} The trustee must be given some investment discretion, such as authority to invest within broad guidelines.\textsuperscript{102}

Plan participants may be given the right to select assets in which their accounts will be deemed invested.\textsuperscript{103} The value of those assets is used to measure benefits eventually payable.\textsuperscript{104} While the trustee may be permitted to actually purchase those assets, he cannot be required to do so.\textsuperscript{105}

While assets of the Rabbi trust must be subject to claims of the employer's creditors, access may be denied unless the employer has become insolvent.\textsuperscript{106} The board of directors and chief executive officer must have an express duty to notify the trustee if the employer becomes insolvent. Upon receipt of notice, the trustee must be obligated to suspend payments to all beneficiaries, and to hold all trust assets for the benefit of creditors. The obligation to pay general creditors must be enforceable under federal and state law, and beneficiaries must be treated as unsecured creditors of the employer.\textsuperscript{107} A spendthrift provision must prohibit transfers by beneficiaries.\textsuperscript{108}

Since a Rabbi trust is a grantor trust, the trust is treated for tax purposes as if it did not exist.\textsuperscript{109} Hence, trust income, deductions, and credits

\textsuperscript{99} Id. at 423.
\textsuperscript{102} Rev. Proc. 92-64, 1992-2 C.B. 422, 423. One letter concludes that investments may be limited to stock of the employer where the trustee was given traditional investment powers, including the right to vote the stock and the right to purchase and sell stock on the open market. Priv. Ltr. Rul. 92-35-006 (Dec. 4, 1991); DOL Advisory Op. 92-13 A (May 19, 1992).
\textsuperscript{104} Id.
\textsuperscript{105} Id.
\textsuperscript{107} Id.
\textsuperscript{108} For example, an interest in the trust cannot be given away or used as security for a loan, nor can it be subject to legal process brought against the beneficiary such as attachment or garnishment. Rev. Proc. 92-64, 1992-2 C.B. 422.
are to be reported by the employer on its tax return, 110 and the trustee is not required to file a fiduciary income tax return for the trust. 111

The third approach is for the assets to be held by a fund. 112 The difference between a fund and a trust is that trustees have broad management powers while the authority of fund custodians is limited. 113 Since the assets are not held in trust, there is no need to file a fiduciary income tax return. 114 The assets and earnings are considered property of the employer, with income from the trust included in its return. 115

Although a fund is not a trust for tax purposes, it probably will be treated as a trust under state law. 116 Hence a custodian who fails to pay benefits without apparent justification may be ordered to fulfill his obligations. 117 Custodians also may be held personally liable for damages. 118

The advantage of the fund approach is that the Rabbi trust restrictions do not apply. 119 For example, the governing document is not required to follow the model trust requirements. 120 Since the fiduciary does not have to be a qualified individual, the employer could hold that office. 121 The fund can be required to acquire assets selected by participants, 122 and plan assets do not have to be subject to the claims of the employer's creditors unless the plan would be funded for top hat purposes. A spendthrift provision is not required under the fund approach.

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110. Treas. Reg. § 1.677(a)-1(d) (as amended 1977); id. § 1.671-3(a)(1) (as amended 1969); id. § 1.61-13(b) (1960).
113. Id. For example, one private letter ruling concerned a bank that was required to make investments pursuant to written directions from the employer, and was not responsible for any investment decisions relating to the fund. IRS observed that the duties of the bank were limited, and concluded that the arrangement was a fund rather than a trust because the bank had limited duties. Priv. Ltr. Rul. 90-37-018 (June 15, 1990) (holding that the bank was not a trust); Priv. Ltr. Rul. 90-16-061 (Jan. 23, 1990) (same).
117. BOGERT & BOGERT, supra note 101, § 861; SCOTT & FRATCHER, supra note 101, § 199.1.
118. Id.
120. Id.
121. In general, anyone may be a trustee. An employer may be the trustee of a plan for his employees. See Rev. Rul. 60-31, 1960-1 C.B. 174.
B. Plans

Deferred compensation arrangements may be established pursuant to an individual employment contract or a plan. Participants may be employees, self-employed, directors, partners, or shareholders. Since there are no discrimination rules, coverage can be extended to any group of individuals that suits the employer or individual maintaining the plan. However, an advance ruling does not apply to a controlling shareholder.

The principal goal is to postpone receipt of compensation until cash payments are due. Whether receipt will be deferred depends upon application of general income timing rules. Under these rules, the questions are whether there was an actual or constructive receipt of a taxable property interest before cash payments are due.

A promise to pay money may be a taxable property interest, which is considered income upon receipt. Receipt of a promise is taxable if the note or other indebtedness can readily be converted into cash. Constructive receipt occurs if an individual with a right to possession of a taxable property interest has not obtained actual possession due to his failure to exercise the right of possession. If receipt did not occur at an earlier time, tax is imposed at the time of actual receipt of benefits.

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126. Discrimination rules are a factor only if the plan seeks qualification. *See, e.g.*, I.R.C. § 401(a)(4) (1988). Participation and other rules of the labor portion of ERISA do not apply to promises in individual contracts, or top hat plans. *See Lackey*, 704 F. Supp. at 201 (holding that the existence of a plan “is a prerequisite to jurisdiction under ERISA”); *see also* 29 U.S.C. § 1051(a)(2).
131. *Id.* § 1.451-2(a) (1979).
C. Results

Income tax is imposed upon beneficiaries at the earlier of the time when benefits are received or made available.\(^1\) Social Security tax is another issue. Employees who receive 1993 compensation at least equal to the contribution and benefit base would not pay more Social Security tax if they received additional compensation in that year.\(^2\) If the additional compensation is deferred under a Rabbi trust, then Social Security tax is imposed in the year when there is a taxable receipt by the employee.\(^3\)

If payments from a Rabbi trust are received after retirement, Social Security tax would be due from the employer as well as the employee each time there is a payment from the trust.\(^4\) The amount of tax would depend upon the contribution and benefit base\(^5\) as well as the tax rates\(^6\) in effect at the time of payment.

Most plans are set up so that there will be no taxable receipt of income before actual payment. While many individuals favor postponing tax payments, it is uncertain whether savings occur as the result of such postponement. For example, if the postponement results in the imposition of a Social Security tax obligation where none would have been due, the benefit of deferral will be diminished.\(^7\)

Income tax burdens must be evaluated. The federal, state, and local burden on additional current compensation will have to be compared to the probable burdens in one or more subsequent years. The process is

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4. I.R.C. §§ 3101(a)-(b), 3111(a)-(b), 3121(v)(2)(A).
6. 141. I.R.C. §§ 3101(a)-(b), 3111(a)-(b).
complicated by the unpredictable fluctuations in tax rates,144 and by the equally uncertain time value of money.145

The employer cannot deduct for contributions to the plan, or for his share of Social Security tax on those contributions, until the beneficiary is taxed.146 Since contributions are treated as if they were paid by the employer,147 the amount of the deduction is the lesser of the amount received by the beneficiary or the amount contributed by the employer.148 Because the amount is not limited by the value of the beneficiary's interest, there is no requirement of keeping separate accounts for each participant.149

Earnings of assets held by Rabbi trusts and custodial funds are taxable to the employer.150 The burden of paying tax on earnings before a salary deduction is available can be avoided if the assets do not produce currently taxable income. That result can be achieved with tax-exempt bonds,151 or assets without current earnings such as stocks that do not pay dividends.152

D. Rulings

An advance ruling from IRS on the treatment of a Rabbi trust is not required. If the transaction is adequate to avoid funding and defers receipt of income to the participant, the goal has been achieved. Many of the issues are subjective, however, and most individuals prefer to deal with them in advance.

A request for an advance ruling should raise two issues for consideration. A ruling on the status of the trust is concerned primarily with whether the trust is funded. The IRS will not issue an advance ruling on a

145. 2 Bittker & Lokken, supra note 55, at 56-5 to -7. Comparing tax burdens may be unnecessary. If the reason for the deferral of income is to purchase employee loyalty, the employer will not be willing to pay the additional sum as current compensation. The limit of its cooperation will be arranging the plan so that the tax is postponed until actual payment can be obtained from the plan.
147. Id. § 1.404(a)-12(b)(2).
148. Id. § 1.404(a)-12(b)(1).
149. Id. § 1.404(a)-12(b)(3).
Rabbi trust unless it complies with the model trust requirements. The second issue is whether the plan is adequate to defer the receipt of income. Receipt is deferred if the plan does not provide actual or constructive receipt of a taxable property interest before cash benefits are to be paid.

IV. History

A. In General

The timing of compensation income has never been entirely certain. The 1913 Revenue Act declared that compensation was gross income regardless of the form of payment. Corresponding regulations concluded that fair market value was the amount to be reported if property was received. It was generally assumed that all individuals used the cash method of accounting, and that no need existed for records of their relatively simple affairs.

People immediately began using the cash method to postpone reporting by failing to take immediate possession of their income. The dodge was discovered almost as soon as it began, and the actual possession requirement was modified with a constructive receipt rule. This rule mandated that if the only thing between an individual and actual receipt of income was a failure to take possession, it would be treated as if the individual were in actual possession. Constructive receipt occurred at the earliest time when there was an adequate right of possession.

While the constructive receipt rule dealt with cases such as uncashed checks and interest left in bank accounts, it did not apply to noncash benefits, like interest in trusts and insurance protection. The 1918 reg-

158. See 4 Bittker & Lokken, supra note 55, at 105-52.
159. Treas. Reg. 33, art. 67 (1914), reprinted in 132 U.S. REVENUE ACTS, supra note 156.
160. Id.
161. Id.
162. E.g., 4 Bittker & Lokken, supra note 55, at 105-52 (stating that the constructive receipt doctrine prevented taxpayer manipulation of the progressive tax rate structure by taxing uncashed checks and interest when constructively received).
ulations introduced an economic benefit rule.\textsuperscript{164} Benefits such as employer-provided health and life coverage were gross income even though the employees might never receive any cash from the transaction.\textsuperscript{165} The amount was equal to the premium paid by the employer, and it was received on the first day that the premium provided coverage.\textsuperscript{166}

Notes and other evidences of indebtedness were another sort of economic benefit, and the IRS thought this category included interests in pension and profit-sharing trusts.\textsuperscript{167} When it appeared that efforts to dissuade the IRS from pursuing this line of reasoning were not likely to succeed, people decided to seek legislation exempting interests in pension and profit-sharing trusts from the constructive receipt rule.\textsuperscript{168} Treasury agreed to cooperate and presented the proposal to Congress during hearings on the 1921 bill.\textsuperscript{169}

Concern about the timing of income from pension and profit-sharing plans was resolved by a statutory timing rule for participants and their beneficiaries.\textsuperscript{170} Plans that qualified under the rule were not taxable until the earlier of the time a payment was received, or the time when they had a right to receive payment from the trust.\textsuperscript{171} Interest in nonqualified plans remained low until restrictions began to increase the cost of qualification.

The first substantial restriction was enacted in 1942.\textsuperscript{172} In order to emphasize the consequences of failure to satisfy the restriction, the changes included a timing rule for nonqualified trusts.\textsuperscript{173} Under this rule, a participant received compensation when a contribution was made, if his interest was vested.\textsuperscript{174} If the interest was not vested when the contribution was made, there was no tax until payment was received from the trust.\textsuperscript{175}


\textsuperscript{165} L.O. 1014, 2 C.B. 88 (1920).

\textsuperscript{166} Id.


\textsuperscript{169} Id.


\textsuperscript{171} Id.

\textsuperscript{172} Revenue Act of 1942, Pub. L. No. 77-780, § 162, 56 Stat. 798.

\textsuperscript{173} Id.

\textsuperscript{174} Id.

\textsuperscript{175} Id.
The treatment of contributions to nonvested interests was changed in 1969.\textsuperscript{176} The new rule imposed tax on the value of the interest when vesting occurred.\textsuperscript{177}

\section*{B. Economic Benefit}

\subsection*{1. Notes and Other Promises}

Payments of cash or tangible property normally are considered income when received,\textsuperscript{178} while intangible property is less likely to be considered income at that time.\textsuperscript{179} Receipt of a promise is income if it is considered to be the equivalent of cash.\textsuperscript{180} A promise is equivalent to cash if it is likely that the recipient eventually will receive cash or property.\textsuperscript{181} On the other hand, if substantial doubt exists concerning eventual collection, the promise is not the equivalent of cash.\textsuperscript{182}

Application of the constructive receipt theory to specific situations developed in stages. The 1913 regulations called for inclusion in income of the fair market value of noncash receipts but did not suggest a concrete example involving receipt of a promise.\textsuperscript{183} The 1916 regulations applied the rule by imposing tax on compensation paid in corporate stock.\textsuperscript{184}

Employers avoided the new rule by changing the form of their transactions. Instead of paying in stock, they conveyed options which gave their employees the right to make bargain purchases of stock.\textsuperscript{185} There was no response until 1923, when Treasury announced that income would be realized when an option was exercised.\textsuperscript{186} The taxable income from the transaction equalled the difference between the fair market value of the stock acquired and the amount paid by the employee upon exercise.\textsuperscript{187}

The treatment of employer-supplied insurance was a related issue. Initially, the government considered recoveries on accident, health, and life

\begin{itemize}
  \item \textsuperscript{177} Id.
  \item \textsuperscript{178} 4 Bittker & Lokken, supra note 55, at 105-49; Gertzman, supra note 53, at 3-16.
  \item \textsuperscript{179} 4 Bittker & Lokken, supra note 55, at 105-49.
  \item \textsuperscript{180} Id.
  \item \textsuperscript{181} Id.
  \item \textsuperscript{182} Id.
  \item \textsuperscript{183} Treas. Reg. § 33, art. 4(a) (1914), reprinted in 132 U.S. Revenue Acts, supra note 156.
  \item \textsuperscript{184} Treas. Reg. § 33 (rev.), art. 139 (1918), reprinted in 132 U.S. Revenue Acts, supra note 156.
  \item \textsuperscript{185} T.D. 3455, I-1 C.B. 50 (1923).
  \item \textsuperscript{186} Id.
  \item \textsuperscript{187} Id.
\end{itemize}
insurance policies taxable. A questionable 1924 Supreme Court decision concluded that life insurance recoveries were not taxable, and a threat of legislation led to the 1918 withdrawal of regulations asserting the tax on accident and health recoveries.

Withdrawal of the tax on recoveries from accident and health insurance policies caused Treasury to look for another approach. The preliminary edition of the 1918 regulations imposed tax on the value of employer supplied accident and health coverage, which was measured by the premiums paid by the employer. Treasury realized that the theory would be equally applicable to life insurance and notes received in payment of compensation, and those transactions were added to the next version of the 1918 regulations.

In 1921, an undocumented occurrence caused Treasury to reverse the 1918 approach to most types of insurance coverage. The regulations concluded that group life premiums were not taxable, but they did not mention health and accident coverage. This omission led to the assumption through the early fifties that there was no tax on employer-supplied accident and health coverage. One can only speculate about why Treasury voluntarily withdrew from the field of battle.

A 1921 ruling announced a campaign to enforce the rule for notes. The IRS concluded that vested interests in pension and profit-sharing plans were taxable when employers contributed to the plans. Concerned by the prospect of tax liability without having cash to pay, people

189. United States v. Supplee-Biddle Hardware Co., 265 U.S. 189 (1924) (holding that life insurance recoveries were not included in gross income).
197. Id.
promptly obtained legislation postponing the tax until payment was re-
ceived or made available.198

Retirement annuities were the subject of a 1923 ruling.199 Employers
paid a single premium for annuity bonds, which were immediately deliv-
ered to employees.200 Ownership did not depend on continuation of em-
ployment. One type of annuity denied recovery if the annuitant died
before a stated age,201 while another guaranteed some recovery regard-
less of the date of death.202 Since the bonds were not assignable and did
not make an unconditional promise, the IRS found that their value was
not readily realizable, and concluded that there was no income to em-
ployees when the bonds were received.203

Two astounding rulings were issued in 1935.204 People generally had
been satisfied with the 1923 ruling on annuities until the early thirties
when the Teacher's Insurance Annuity Association (TIAA) decided
there might be a problem. After discussion with representatives of the
TIAA,205 the IRS ruled that participants in an annuity plan did not re-
ceive income when a school paid their retirement annuity premiums.
Since there was no discussion of the circumstances, the result did not de-
pend on matters such as vesting or marketability.206 The TIAA's success
couraged other members of the insurance industry to seek rulings, and
another 1935 ruling reached the same result without identifying the type
of employer.207

200. Id.
201. Id.
202. Id.
203. Id. at 71.
204. I.T. 2874, XIV-1 C.B. 49 (1935), declared obsolete without replacement, Rev. Rul.
205. Technical Amendments to Internal Revenue Code: Hearings Before a Subcomm. of
the House Comm. on Ways and Means, 84th Cong., 2d Sess. 129 (1956) (statement of John
Paul Good, TIAA Secretary), reprinted in 12 U.S. REVENUE ACTS, supra note 156.
207. I.T. 2891, XIV-1 C.B. 50 (1935), revoked, I.T. 4041, 1951-1 C.B. 5. A third as-
tounding ruling involved the deductibility of premiums. Even though past service con-
tributions to a pension trust had to be amortized, past service premiums for a retirement
annuity were deductible in full in the year of payment. Compare Revenue Act of 1928,
§ 23(q), Pub. L. No. 70-562, 45 Stat. 802 (allowing a deduction of an employer's payments
to pension funds only if the deduction was equally distributed over 10 consecutive years)
with I.T. 2910, XIV-2 C.B. 152 (1935) (allowing employers to deduct premium payments
on past service annuities in full in the year of payment), declared obsolete without replace-
IRS dug in its heels when attention was directed to the inconsistent treatment of insurance premiums.208 Exclusion was upheld for employer payments to acquire retirement annuities and group life coverage, while premiums on individual life policies remained taxable to the employee.209 The fact that the courts had no trouble taxing premiums on individual policies where the benefits were indistinguishable from typical group arrangements did not appear to bother the IRS.210

The IRS still had not come to grips with the disparate treatment of notes and other promises when the Ways and Means Committee held hearings on the 1942 revenue bill.211 Several witnesses at these hearings pointed out that if proposed restrictions212 on pension trusts were enacted, similar rules for retirement annuities would be necessary.213 The Ways and Means Committee agreed, and conforming rules became part of the statute.214

Treasury and the IRS apparently preferred the uncertainty that continued to surround the treatment of most fringe benefits. When a congressional committee investigated President Nixon's tax returns in 1974, it found its work to be complicated by the lack of official policy on the general issue.215 The ensuing scandal caused by publication of the committee's report forced authorities to begin trying to formulate an adequate response to the problem.216 Twenty years later, there remains considerable doubt about the results.217

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209. Id.
210. Compare id. with Yuengling v. Commissioner, 69 F.2d 971 (3d Cir. 1934) (holding that premiums paid by an employer on a life insurance policy are taxable).
212. Id. at 87 (statement of Randolph E. Paul, Tax Advisor to the Secretary of the Treasury), reprinted in 33 U.S. REVENUE ACTS, supra note 156.
213. E.g., id. at 2387-88 (statement of Denis B. Maduro, counsel for the Law and Legis. Comm., Nat'l Assoc. of Life Underwriters).
2. **Nonqualified Pension and Profit-Sharing Trusts**

An interest in a trust is a promise that may be the equivalent of cash.\(^{218}\) Many pension and profit sharing plans agree to make payments from the assets of a trust, and delivery of an agreement constitutes transfer of an interest in the trust to the participant.\(^{219}\) There is an additional transfer each time the employer makes a contribution to the employee’s trust account.\(^{220}\)

Since there were no special rules for deferred compensation plans in the beginning, the general rules governing compensation applied. Hence, employers could take a deduction for contributions to pension and profit-sharing trusts,\(^{221}\) trusts were taxed on their earnings,\(^{222}\) and participants frequently had to pay tax before cash benefits were received. A 1921 ruling concluded that participants were taxed when employer contributions were received by the plan if the participant had a vested interest.\(^{223}\)

Outraged by the treatment of trusts and participants, business leaders approached Treasury, which agreed to present the problem to Congress during hearings on the 1921 revenue bill. Congress found that the trusts should be exempt from taxation, and that benefits should not be taxable until the earlier of actual receipt or the time receipt was made available.\(^{224}\)

The timing result was available only if the plan satisfied the terms of the statute, which required that the assets be held by a trust and that the plan be for all or some of the employees.\(^{225}\) Although an early ruling under the statute seemed to announce the beginning of an antidiscrim-

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\(^{219}\) I.R.C. § 402(b).

\(^{220}\) Treas. Reg. § 1.402(b)-1(a) (1978).


\(^{222}\) Sears, Roebuck & Co. Employee’s Sav. and Profits Sharing Pension Fund v. Commissioner, 17 B.T.A. 22 (1929), rev’d, 45 F.2d 506 (7th Cir. 1930); A.A.R. 477, 4 C.B. 264 (1921).


mination program,\textsuperscript{226} the ruling was never enforced.\textsuperscript{227} In fact, the IRS encouraged discrimination by issuing favorable letter rulings to discriminatory plans during the twenties and thirties.\textsuperscript{228} There was little interest in nonqualified plans during this period since qualification under the statute was easy and the results were clear.

Circumstances changed when the United States entered World War II. Income tax rates in excess of ninety percent sent highly compensated people looking for ways to shelter their income while at the same time, a discrimination limit was placed on qualified plans.\textsuperscript{229} In order to emphasize the difference between qualified and nonqualified plans, the statute included a description of the treatment of beneficiaries of nonqualified plans.\textsuperscript{230}

Participants could receive taxable income at three points in time.\textsuperscript{231} The first was upon initial receipt of an interest if it was vested at that time.\textsuperscript{232} The second was each time a contribution was made for the participant if his interest was vested.\textsuperscript{233} Contributions before an interest vested were not taxed until cash benefits were made available. The third time was changed from availability to vesting in 1969.\textsuperscript{234}

C. Constructive Receipt

The general rule under the cash method is that income is received when it is reduced to possession. Early attempts to postpone reporting by failing to take possession led to inclusion of a constructive receipt rule in the 1913 regulations.\textsuperscript{235} Under these regulations income was deemed constructively received if the owner could draw on it at any time, unless there was a substantial restriction on his right to possession.\textsuperscript{236}

\textsuperscript{227} Albert Handy, Private Pension Plans and the Federal Revenue Act, 16 N.Y.U. L. Rev. 408, 413-14 (1939).
\textsuperscript{229} Revenue Act of 1942, § 162(a), 56 Stat. 862.
\textsuperscript{230} Id., 56 Stat. at 866; Rudick, supra note 228, at 163-64.
\textsuperscript{231} I.R.C. § 83(a) (1988).
\textsuperscript{232} Treas. Reg. § 1.402(b)-1(a) (1978).
\textsuperscript{233} Id. Contributions made when the participant's interest was not vested were not taxed until cash benefits were paid or made available. I.R.C. § 165(c) (1942).
\textsuperscript{234} I.R.C. § 402(b) (1969).
\textsuperscript{235} Treas. Reg. 33, art. 67 (1914), reprinted in 132 U.S. REVENUE ACTS, supra note 156.
\textsuperscript{236} Treas. Reg. § 1.451-2(a) (1979).
The constructive receipt doctrine led individuals to seek alternative mechanisms for deferral of income.

The path to deferral was illuminated by two decisions rendered on different phases of a single transaction. The first decision involved a share of 1940 profits payable to an employee in 1941. Before the end of 1940, the parties entered into a new employment contract which deferred the 1941 payments until 1942. The change was an arm's length business agreement, the Tax Court concluded that there was no constructive receipt of income in 1941. The IRS promptly announced agreement with the decision.

The second decision, rendered two years later, concerned the payments that had been deferred from 1941 to 1942, which were delayed to 1943 by a new employment contract made in 1941. Because there had never been a time when the employee had a right to possession of the money, the Tax Court again held that there was no constructive receipt.

There are several lists of restrictions that will avoid constructive receipt of income. Individuals seeking a letter should comply with conditions for a favorable advance ruling on a plan accompanying a Rabbi trust. The IRS frequently asks for things not required by law as conditions for an advance ruling. Those conditions are not binding on the courts.

Planning for a Rabbi trust can be difficult. Since the issues are factual, there is no guarantee that a transaction will not end up in court.

237. Veit v. Commissioner, 8 T.C. 809 (1947), acq., 1947-2 C.B. 4. The change was profitable to both parties since the employer wanted use of the money for an extra year, and the employee received interest payments for the extra year.

238. Id.

239. Id.


241. Veit, 18 T.C.M. (P-H) at 811. The existence of a restriction on the right to possession sufficient to avoid the constructive receipt of income is a question of fact, and each case is being decided on its own circumstances unless the issue is foreclosed by administrative action. Martin v. Commissioner, 96 T.C. 814, 822 (1991).


245. Martin, 96 T.C. at 822.
To avoid such uncertainty, the first step in designing a transaction is to take maximum advantage of published guidelines and letter rulings. The next step is to consider obtaining a letter ruling for a particular plan. Many practitioners think that the uncertainty inherent in a Rabbi trust makes a letter indispensable.

D. Rulings

The IRS has never published a policy for issuing rulings on nonqualified plans. Since qualification was inexpensive during the twenties and thirties, interest in nonqualified plans was low and the IRS routinely issued favorable letters. Introduction of a discrimination limit for qualified plans and tax rates in excess of ninety percent sent highly compensated individuals looking for shelters during the forties. With no indication of its reasoning, the IRS halted the issuance of private letter rulings in 1948. Practitioners received the impression that the IRS: (1) was reconsidering its overall policy; (2) planned to issue published rulings; and (3) did not like dealing with the marginal cases.

Two court decisions directed attention to some of the possibilities for nonqualified plans, and a growing interest in the matter led to discussion of the problems at professional meetings and to the publication of law review articles. Unmoved by all of the activity, the IRS continued to

248. Paul, supra note 228, at 79; Rudick, supra note 228, at 164.
250. Rudick, supra note 228.
251. Id.
operate without a published position and refused to consider requests for letter rulings. 256

Politics finally forced a change. The demand for guidance continued to increase, and there was a growing possibility of legislation. 257 The IRS decided that the way to provide guidance and to avoid dealing with marginal cases was to publish a ruling and continue its no letter policy. 258 A 1960 ruling was insufficient because it only covered a few clear cases. 259 In the end, the ruling may have caused more pressure for the issuance of letter rulings because it further increased interest in nonqualified plans. The IRS finally succumbed to the political pressures and started issuing letter rulings on nonqualified plans in 1964. 260

It was a shotgun wedding, and the IRS was not happy. Personnel were instructed to be conservative in issuing letters in 1964 and 1965 because the IRS had little experience in dealing with nonqualified plans. 261 The issuance of letters was suspended in 1966 when the IRS became uncomfortable with the direction of its rulings and wanted to review its overall policy. 262 After the suspension, no further interruptions occurred until 1977.

Discomfort became acute in early 1977 when the IRS suspended issuance of rulings on nonqualified plans of state and local governments pending a study of the situation. 263 At the conclusion of that study, the IRS proposed that amounts deferred under all nonqualified plans be currently taxable. 264 The proposal was not expected, and there was a determined public outcry. 265


257. Id. at 209.


259. Id.


261. McDonald, supra note 256, at 220.

262. Id.


265. E.g., Richard W. Skillman, How Would the New Proposed Regs Affect Deferred Compensation Arrangements?, 48 J. TAX’N 258 (1978) (analyzing the broad effects upon established treatment of unfunded, nonqualified deferred compensation plans); Michael G.
There were two legislative reactions. First, Congress found that the limitations imposed by the labor portion of ERISA and the employer's desire for a current expense deduction were adequate limitations, and froze the administrative treatment of nonqualified plans of taxable employers to the situation existing just before the proposal. This is as close as Congress has come to legislative approval of the tax treatment of nonqualified plans.

Secondly, Congress thought employees of state and local governments should be eligible for analogous treatment. Since the ERISA and deduction restrictions did not apply, Congress enacted Section 457, which limited annual deferrals and imposed other restraints.

Administrative approaches to the two types of nonqualified plans are revealing. Treasury and the IRS have applied the liberal principles applicable to qualified plans to nonqualified plans under Section 457. At the same time, the IRS has continued the conservative approach for other nonqualified plans.

The comfort factor is the only apparent reason for the difference in treatment. There has been no suggestion of a suspension of letter rulings under Section 457 since its enactment in 1978. Other nonqualified plans are a different matter. Even though there was some degree of legislative approval in 1978, the IRS is still not comfortable in the absence of explicit legislative approval of a definite program.

Recent events offer a degree of insight into the current IRS attitude. In 1984, the General Counsel's office undertook an extensive evaluation of the treatment of nonqualified plans. The issuance of letter rulings was suspended for periods in 1985 and 1986, while the IRS was reconsidering its position. The IRS resumed its rulings with a carefully considered

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274. G.C.M. 39230 (May 7, 1984).
Hence, the IRS does not think the congressional freeze precluded some modifications to the 1978 administrative position. The IRS believed that the administrative requirements for letter rulings might be enforceable in court. The guidelines were argued in a 1991 case where the participants had never had a right to possession of the benefits. However, in that case, all of the IRS arguments were rejected by the Tax Court.

The Tax Court's decision may have brought the IRS to realize that non-qualified plans are here to stay. Two procedures published in 1992 outline the steps necessary to obtaining a favorable ruling on nonqualified plans and Rabbi trusts. Although there are still a number of requirements that have never been published, the procedures certainly are a large step in the right direction.

Some uncertainty remains because published and letter rulings are not always followed. Since changes in IRS ruling are normally retroactive, people who relied on the 1960 ruling and the 1992 procedures could find they are no longer in force. Withdrawal of a letter has the same effect. While people may ultimately prevail on a theory such as detrimental reliance, who wants to depend on something as uncertain as equitable relief? Therefore, conditions other than those set forth by the 1960 ruling and the 1992 procedures should be used as insurance.

V. Economic Benefit

A. In General

Payments of cash or tangible property usually are income when received, while intangibles are less likely to be income at that time. Receipt of a promise is income if it is considered to be the equivalent of cash. A promise is equivalent to cash if the recipient probably will receive cash or

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275. Robert K. Johnson & C. David Anderson, Executive Compensation Deferred: Should the Rabbi be Trusted?, in 1989 So. Calif. Tax Inst. 9-1, 9-36. Given that the IRS continued to test new theories in court, however, it apparently did not think the freeze precluded some modifications to the existing administrative position. See Billman & Karig, supra note 271, at 213-14; Klein & Acker, supra note 268, at 10.
280. E.g., Boggs v. Commissioner, 784 F.2d 1166, 1171 (4th Cir. 1986); Lansons, Inc. v. Commissioner, 69 T.C. 773, 786-87 (1978), aff'd on retroactive revocation issue, 622 F.2d 774 (5th Cir. 1980).
property sooner or later. On the other hand, if there is substantial doubt about eventual collection, the promise is not the equivalent of cash.\textsuperscript{282}

There are two categories of promises. A promise is funded if property has been set aside so it is not subject to the claims of creditors of the employer.\textsuperscript{283} If an employer delivers a policy of insurance or an interest in a trust to an employee, he probably will receive cash at some future time. Hence, the promise is funded,\textsuperscript{284} and the promise is income when received by the employee if he has an adequate ownership interest.\textsuperscript{285}

A promise to pay is unfunded if the employee must look to assets of the employer for payment.\textsuperscript{286} Because no separate pool of assets exists to ensure payment, an unfunded promise is not income when received unless it is adequately marketable. Since an employee who receives a marketable promise probably can obtain cash by disposing of the promise, promises of this type are income when received by the employee.\textsuperscript{287}

\section*{B. Funded Promises}

Funded promises are considered property.\textsuperscript{288} Regardless of their classification under state law,\textsuperscript{289} funded promises are property under the statute for compensation paid in property.\textsuperscript{290} An obligation of a third person to satisfy an employer's promise to pay is a common form of funded promise.\textsuperscript{291} The third person promise rule usually involves insurance policies.\textsuperscript{292} An employee does not have income if the policy is owned by the

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\textsuperscript{282} Rev. Rul. 60-31, 1960-1 C.B. 174, 177-78; Rev. Proc. 92-64, 1992-2 C.B. 422; Rev. Proc. 92-65, 1992-2 C.B. 428. IRS employees tend to be concerned with having a good track record, and avoid pursuing cases that they may lose. Hence the greater the number of conditions imposed on actual receipt of income from a nonqualified plan, the more likely the tax treatment of such a plan will be resolved on favorable terms at an early stage.

\textsuperscript{283} Treas. Reg. § 1.83-3(a) (1985).

\textsuperscript{284} Daniel S. Knight, \textit{Income Tax Consequences of Nonqualified Deferred Compensation}, 21 TAX LAW. 163, 165 (1967).


\textsuperscript{286} Minor v. United States, 772 F.2d 1472, 1474-75 (9th Cir. 1985) (holding that the employee received no economic benefit from the deferred compensation plan because the employer was the beneficiary of the trust).

\textsuperscript{287} Diamond & Cutler, supra note 56, at 67-68. "[A] promissory obligation which is not negotiable within the meaning of the Uniform Commercial Code," cannot be a cash equivalent "since such an obligation is not 'freely and easily negotiable so that it passes from hand to hand in commerce.'" \textit{Id.} (quoting Ennis v. Commissioner, 17 T.C. 465 (1951)).

\textsuperscript{288} I.R.C. § 83(a) (1988).


\textsuperscript{290} Treas. Reg. § 1.83-3(e) (1985).

\textsuperscript{291} Sproull v. Commissioner, 16 T.C. 244, 247 (1951), aff'd, 194 F.2d 541 (6th Cir. 1952).

\textsuperscript{292} E.g., I.R.C. § 83(a), (c).
employer who promises a benefit to the employee, because the asset is still subject to claims of creditors of the employer.293 Claims cease to be a factor when the employer transfers the policy to the employee. The employee will be deemed to receive income from the insurance policy at the time of transfer.294

The scope of the third person promise rule is unclear. In general, it applies to situations where the employer creates a fund by paying premiums for a benefit that has been transferred to the employee.295 The uncertainty created by the general rule is illustrated in a situation where an employer pays premiums on a policy that guarantees that the employee will receive benefits promised by a Rabbi trust. Shortly after a 1984 letter approved the transaction, the IRS announced suspension of letters pending review of the issue,296 and no letters have been issued since that time.

On the other hand, letters issued in 1987297 and 1989298 concluded that benefit guarantees provided by the employer's parent corporation did not constitute funding.299 When the issue arose in the context of self-employment, a Tax Court decision went even further. A guarantee of earnings by a party apparently unrelated to the transaction did not constitute funding. The IRS has announced agreement with the decision.300

From the employee's viewpoint, there is no difference between a promise secured by an insurance carrier and any other guarantor of equal solvency. Results suggest that the question of funding depends on whether there was a transfer of assets by the employer. The suspension of letter rulings suggests that the IRS had second thoughts about employer involvement in the 1984 transaction.301 Other approved guarantees were

294. E.g., I.R.C. §§ 83(a), 403(c); Treas. Reg. § 1.83-3(e) (1993). However, the promise is not funded if the policy was issued by an insurance company that itself is the employer. E.g., Oates v. Commissioner, 18 T.C. 570 (1952), aff'd, 207 F.2d 711 (7th Cir. 1953), nonacq., 1952-2 C.B. 5, nonacq., withdrawn and acq. substituted, 1960-2 C.B. 5.
299. See id. (concluding that because the trust's assets remained subject to claims of the employer's creditors, payments to the trust would not be considered income to plan beneficiaries).
300. In that case, the promoter of a boxing match promised to pay a boxer's compensation at some time in the future, a promise that the Tax Court found was not funded, even though it was guaranteed. Robinson v. Commissioner, 44 T.C. 20, 37 (1965), acq., 1970-2 C.B. xxi.
301. See supra text accompanying note 296.
made by third parties for the purpose of completing arms-length business deals. The IRS approved these because there was no transfer of assets by the employers.  

An interest in a trust is another type of funded promise. A trust can be defined as a holding of "title to property for the purpose of conserving or protecting it" for other persons. Arrangements must be examined carefully because a trust relationship may be inferred from the circumstances. An attempt to create an express trust will fail if the arrangements are inadequate. One requirement is that the fiduciary must be given adequate authority to deal with the assets. Another requirement is that the trust must be funded. If assets remain subject to claims of the employer's creditors, they are not treated as if the employer set them aside to pay benefits to employees, and a trust has not been created. A beneficiary receives income from the trust when his interest becomes vested.  

Whether particular conditions constitute a substantial risk of forfeiture depends on the facts and circumstances. A substantial risk may exist where ownership depends on the performance of future services, non-

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304. Id. § 301.7701-4(a) (1986).
305. For example, suppose an employer sets up a reserve account and makes periodic contributions to guarantee that money will be available in the future to pay benefits. An express declaration that the account is not held in trust should ensure a finding that the parties did not create a trust. E.g., Rev. Rul. 60-31, 1960-1 C.B. 174, 175.
306. Compare Rev. Rul. 76-265, 1976-2 C.B. 448 (bank fund held to be an agent and not a trustee because it did not hold title to the property for the purposes of protecting and conserving it for beneficiaries) with Rev. Rul. 69-300, 1969-1 C.B. 167 (bank fund held to be a fiduciary on the ground that it was granted discretionary powers in administration and management of the property). For example, one private letter ruling involved a bank that held assets in an account for an employer under a declaration of trust. Priv. Ltr. Rul. 90-07-018 (June 15, 1990). The bank's investment authority was limited to following the employer's directions, and the parties agreed that the bank would not be liable for investment decisions. Id. The IRS found that this arrangement did not give rise to a trust and concluded that the bank did not qualify as a fiduciary, but rather was merely an agent of the employer. Id.; see also United States v. Anderson, 132 F.2d 98, 100 (6th Cir. 1942), cert. denied, 318 U.S. 790 (1943); Rev. Rul. 76-265, 1976-2 C.B. 448.
310. Id. §§ 1.83-3(b) (1985), 1.83-3(c)(4).
311. A risk of forfeiture is substantial if the employee's "rights to full enjoyment are conditioned upon future performance of substantial services." I.R.C. § 83(c)(1) (1988). Legislative history does not suggest standards for determining whether other risks are substantial enough to prevent vesting. Every ownership interest is presumed to be vested, and
competition, or the occurrence of a condition related to the purpose of the transfer.\textsuperscript{312} Since the employer's state of mind is relevant, an otherwise adequate condition does not constitute a substantial risk if it seems unlikely that the employer would insist on enforcement.\textsuperscript{313}

Illustrations in the regulations provide guidance for various transactions.\textsuperscript{314} Since the regulations presume that future service and noncompetition requirements are insubstantial,\textsuperscript{315} people have the burden of proof if they disagree.\textsuperscript{316} Additional future service factors include the employer's expectation of substantial future services\textsuperscript{317} and the employee's right to decline performing the services without a possibility of forfeiture.\textsuperscript{318}

Results in cases where a noncompetition agreement is made prior to retirement are relatively clear.\textsuperscript{319} Treasury has concluded that where an employee is required not to compete with his employer for a period of years and where he would encounter great difficulty reaching a similar level of success with a new undertaking, a substantial risk of forfeiture exists.\textsuperscript{320} The treatment of postretirement noncompetition depends on application of the factors.\textsuperscript{321}

The fact or amount of benefits may depend on the relative success of the employee or the employer. Conditions such as the continued existence of the employer, an identified increase in the profits of the employer, continued employment, or an adequate increase in the performance of the employee, typically create a substantial risk of forfeiture.\textsuperscript{322} In contrast, bad boy clauses are not substantial restrictions because they involve matters within the control of the participant.\textsuperscript{323} Thus, the fact that a benefit will be lost if the participant commits a crime

\begin{footnotes}
\footnote{312. Treas. Reg. \textsection 1.83-3(c)(2).}
\footnote{313. \textit{Id.}}
\footnote{314. \textit{Id.}}
\footnote{315. \textit{See} 3 \textsc{Bittker} \& \textsc{Lokken}, \textit{supra note} 55, \textit{at} 60-36 to -39.}
\footnote{316. \textit{Id.} Factors used to determine whether an agreement not to compete imposes a substantial risk include the employer's age, health and skill, the availability of alternative employment opportunities and the likelihood of the employee obtaining them. Treas. Reg. \textsection 1.83-3(c)(2).}
\footnote{317. Treas. Reg. \textsection 1.83-3(c)(2).}
\footnote{318. \textit{Id.}}
\footnote{319. \textit{Id.} \textsection 1.83-3(c)(4), (c)(5).}
\footnote{320. \textit{Id.}}
\footnote{321. \textit{Id.} \textsection 1.83-3(c)(1).}
\footnote{322. \textit{Id.} \textsection 1.83-3(c)(2).}
\footnote{323. \textit{Id.}}
\end{footnotes}
or is discharged for cause does not constitute a substantial risk of forfeiture.\textsuperscript{324}

Additional guidelines apply when an employee has a significant ownership interest in the employer.\textsuperscript{325} To illustrate, a husband and his wife owned all the stock of a corporation. Their interests in the company's retirement plan were vested except for a bad boy clause,\textsuperscript{326} which provided that if they were discharged for an intentional act that would injure the company, they would forfeit their interests.\textsuperscript{327} The Tax Court observed that the probability of forfeiture was too remote to be considered a substantial risk, and therefore the interests were vested.\textsuperscript{328}

Some people have tried to burn the candle at both ends, by giving an appearance of forfeitability to a nonforfeitable interest. One case involved a physician who made an employment contract for current compensation.\textsuperscript{329} Amendments placed conditions on the right to payments.\textsuperscript{330} The Tax Court observed that he began with the absolute right to all compensation and had no reason to subject it to a risk of forfeiture.\textsuperscript{331} Various terms in the trust instrument provided him with several ways to avoid any attempt to cause a forfeiture.\textsuperscript{332} The fact that postretirement services were to be paid at an adequate rate negated any inference that forfeiture was a penalty for failure to serve.\textsuperscript{333} The employer had never asked any retired physician for consulting services, and had no plan to begin a program to do so, despite a provision in the trust instrument that the benefits from the trust could not be received unless the physician performed postretirement services.\textsuperscript{334} Because the physician's

\textsuperscript{324} Id.

\textsuperscript{325} Id. § 1.83-3(c)(3). The term "significant" is not defined, and examples given by the regulations illustrate that the focus of the guidelines is on the ability of the participant to control the employer. Factors to be considered under the guidelines include: the employee's relationship to other shareholders and the extent of their control, potential control; and possible loss of control, the employee's position in the corporation and the extent to which he is subordinate to other employees; the employee's relationship to the officers and directors; the person who must approve the employee's discharge; and past enforcement actions by the employer. Id.

\textsuperscript{326} Ludden v. Commissioner, 68 T.C. 826, 827, 836 (1977), aff'd, 620 F.2d 700 (9th Cir. 1980).

\textsuperscript{327} Id. at 836.

\textsuperscript{328} Id.

\textsuperscript{329} Richardson v. Commissioner, 64 T.C. 621, 622-23 (1975). A few years later, the contract was amended so that part of the current compensation would be placed in a pension trust, and benefits from the trust were conditioned upon the physician's performance of any post-retirement services requested by the employer. Id.

\textsuperscript{330} Id. at 626. The court offered an extensive analysis of the circumstances.

\textsuperscript{331} Id.

\textsuperscript{332} Id. at 626-29.

\textsuperscript{333} Id. at 629.

\textsuperscript{334} Id. at 630-31.
employer had no need or desire for future services, the court found that the future services requirement was not substantial.\textsuperscript{335}

If an interest in a trust is always vested, a participant is taxed on initial receipt of interest, and there is an additional tax each time the employer makes a contribution.\textsuperscript{336} If the interest did not vest upon initial receipt, there is no tax before vesting.\textsuperscript{337} Tax is imposed when vesting occurs, and there is additional tax each time the employer makes a contribution.\textsuperscript{338}

The foregoing consequences will only apply if an entity is treated as a trust for tax purposes.\textsuperscript{339} Where there is no trust, the promise will be considered unfunded,\textsuperscript{340} and tax consequences will be governed by the general rules for timing of income from unfunded promises.\textsuperscript{341}

\section*{C. Unfunded Promises}

An unfunded promise to pay benefits is intangible property that is income when received if payment is made sufficiently available.\textsuperscript{342} Practical access to a market for the promise is critical in deciding whether unfunded promises are income to the beneficiary.

One type of unfunded promise is included in an employment contract.\textsuperscript{343} Because no market exists for employment contracts, the IRS has announced that receipt of this type of promise is not income.\textsuperscript{344} The IRS position presumably will change should a market develop.\textsuperscript{345}

\begin{enumerate}
\item \textsuperscript{335} Id.
\item \textsuperscript{336} Treas. Reg. § 1.402(b)-1(a)(1) (1978).
\item \textsuperscript{337} Id. § 1.402(b)-1(b)(1).
\item \textsuperscript{338} Id.
\item \textsuperscript{339} See, e.g., Priv. Ltr. Rul. 90-16-061 (Jan. 23, 1990).
\item \textsuperscript{341} Id.
\item \textsuperscript{342} Knight, \textit{supra} note 284, at 174-78.
\item \textsuperscript{343} Id.
\item \textsuperscript{344} Rev. Rul. 60-31, 1960-2 C.B. 174 at 7-9; see Knight, \textit{supra} note 284, at 175-76. Since IRS's position is different if the item sold was property, cases involving the issue of the marketability of promises received in that type of transaction are irrelevant to the characterization of promises included in employment contracts. Warren Jones Co. v. Commissioner, 524 F.2d 788 (9th Cir. 1975); Rev. Rul. 58-402, 1958-2 C.B. 15.
\item \textsuperscript{345} Even if a market develops for employment contracts, however, various factors could cause a particular contract to be unmarketable. They include the ability of the debtor to pay, and whether the promise bears interest and is negotiable or secured. Those and other variables that could reduce the attractiveness of many contracts to the point that no one would consider buying them. See, e.g., Western Oakes Bldg. Corp. v. Commissioner, 49 T.C. 365, 376-77 (1968) (holding that because a debtor's promise to pay was included in restricted savings accounts that were not easily negotiable, they could not be included as taxable income), \textit{nonacq}., 1968-2 C.B. 3; McIntosh v. Commissioner, 26 T.C.M. (CCH) 1164, 1179 (1967) (holding promissory notes to be unmarketable because they merely evinced a promise to make future payment and were unsecured); Segel v. Commissioner, 24 T.C.M. (CCH) 1131, 1139 (1965) (holding notes to be unmarketable because the
The second type of unfunded promise is promises that are not a physical part of an employment contract. The 1918 regulations announced that notes and other evidences of indebtedness were income to the extent of their fair market value if received as payment for services.\textsuperscript{346} However, promises were not income if received merely as security for payment\textsuperscript{347}

The language was contained in all editions of the regulations from 1918 until 1932.\textsuperscript{348} The security clause was deleted from the 1934 version.\textsuperscript{349} Since there was no change in the statute and the regulations continued to require that the promise be received as payment,\textsuperscript{350} the modification did not appear to alter the substantive rule. Many cases governed by the new regulations were concerned with whether a promise was received as payment or merely as evidence of a right to be paid.\textsuperscript{351}

Cash equivalence is similar to constructive receipt in that both doctrines are premised on a reasonable opportunity to obtain payment.\textsuperscript{352} Income may be constructively received where there is a right to obtain actual possession of an item of income,\textsuperscript{353} while a promise may be the equivalent of cash if it can be converted into money by a disposition.\textsuperscript{354} One method of conversion is discounting to a financial institution.\textsuperscript{355}

Since the controlling factor is the practical ability to obtain payment, a promise cannot be marketable unless it has a fair market value.\textsuperscript{356} Even

\textsuperscript{346} Treas. Reg. 45, art. 34 (1919), \textit{reprinted in} 134 U.S. \textit{REVENUE ACTS, supra} note 156.

\textsuperscript{347} \textit{Id}. 45, art. 34 (1919), \textit{reprinted in} 134 U.S. \textit{REVENUE ACTS, supra} note 156.

\textsuperscript{348} E.g., Treas. Reg. 77, art. 54 (1933), \textit{reprinted in} 139 U.S. \textit{REVENUE ACTS, supra} note 156.

\textsuperscript{349} Treas. Reg. 86, art. 22(a)-4 (1935) \textit{reprinted in} 140 U.S. \textit{REVENUE ACTS, supra} note 156.

\textsuperscript{350} \textit{Id}. 86, art. 22(a)-4 (1935) \textit{reprinted in} 140 U.S. \textit{REVENUE ACTS, supra} note 156.

\textsuperscript{351} \textit{Id}. 86, art. 22(a)-4 (1935) \textit{reprinted in} 140 U.S. \textit{REVENUE ACTS, supra} note 156.


\textsuperscript{354} Diamond & Cutler, \textit{supra} note 56, at 66-67.

\textsuperscript{355} \textit{Id}. 66-67.

if the promise has substantial value, if that value is sufficiently uncertain to make it inappropriately speculative, then the promise has no fair market value.\textsuperscript{357}

Third party promises with a fair market value may be income when received.\textsuperscript{358} One issue is whether assets of the employer were used to create a fund. Where there is a fund, another question is certainty of payment. Some authorities appear to assume that payment is sufficiently certain if made by someone other than the employer.\textsuperscript{359} In comparison, promises made by the employer with an ascertainable fair market value are subject to marketability and acceptance as payment rules.\textsuperscript{360} Most cases involving promises that are negotiable under the Uniform Commercial Code conclude that such promises are marketable.\textsuperscript{361} However, this is not always the case. If the promise would be denied ready acceptance in the market place because, for example, the promise was issued by a maker of doubtful solvency, then it will not be deemed marketable.\textsuperscript{362}

Promises that fail to satisfy the requirements for negotiability normally are not marketable. The accepted statement of principle is that nonnegotiable promises are marketable if they pass readily through the flow of commerce.\textsuperscript{363} Since nonnegotiable notes remain subject to personal de-

\textsuperscript{357} The classic example is Burnet v. Logan, 283 U.S. 404 (1931), which involved a promise with an estate tax value exceeding a quarter of a million dollars. The promise could not be assigned an income tax value because of its speculative character. \textit{Id.} at 413-14; see, \textit{e.g.}, Western Oakes Bldg. Corp. v. Commissioner, 49 T.C. 365, 376-77 (1968) (ruling that restricted savings accounts were not taxable income because they could not be freely negotiated), \textit{nonacq.}, 1968-2 C.B. 3; Edelman v. United States, 329 F.2d 950, 954 (Ct. Cl. 1964) (holding that contingent fee agreements could not be freely negotiated, and therefore had no taxable income value); Marcello v. Commissioner, 43 T.C. 168, 180-81 (1964) (deciding that the sale of property had income tax value because property was exchanged for negotiable promissory notes), \textit{aff'd in part and remanded in part}, 380 F.2d 499 (5th Cir. 1967); Estate of Hurlburt v. Commissioner, 25 T.C. 1286 (1956) (concluding that a contract to make future payments had no tax significance because the agreement lacked a market value), \textit{nonacq.}, 1956-2 C.B. 10.


\textsuperscript{359} \textit{Id.}

\textsuperscript{360} \textit{Id.}

\textsuperscript{361} \textit{E.g.}, Lowe v. Commissioner, 44 T.C. 363, 372-73 (1965).

\textsuperscript{362} Dial v. Commissioner, 24 T.C. 117, 123 (1955) (holding notes to be non-taxable on the ground that they were intended to serve solely as additional security for principle debts), \textit{acq.}, 1955-2 C.B. 5; Hexter v. Commissioner, 8 B.T.A. 888 (1927) (concluding that notes issued by a corporation did not have market value because the corporation was insolvent), \textit{acq.}, VII-1 C.B. 14 (1928). \textit{See generally} Diamond & Cutler, \textit{supra} note 56, at 66-67.

fenses of the maker, one article observes that it would be difficult to imagine a situation where they could be readily converted into cash.364

Recent decisions have recognized the existence of an established market as an alternative to negotiability.365 Obligations are usually marketable where a solvent obligor has made an unconditional, assignable promise that is not subject to set-offs. These obligations are frequently transferred to lenders or investors at a discount not substantially greater than the generally prevailing premium for the use of money.366 That statement has been accepted by several subsequent opinions.367

Whether a marketable promise of the employer constitutes payment depends on the intent of the parties.368 The promise and the contract governing the underlying transaction may be the best evidence of that intent.369 Several decisions list a number of factors regarding the intent of the parties, and conclude that the parties did not accept the notes as payment.370 Other cases look to the general nature of the documents,371 while a third class of cases focuses on the debtor's ability to pay.372

Some cases have permitted the introduction of oral evidence concerning the intent of the parties. Such evidence may be offered to demon-

364. Diamond & Cutler, supra note 56, at 67-68.
366. Id. at 24.
367. E.g., Warren Jones Co. v. Commissioner, 524 F.2d 788, 790 (9th Cir. 1975). Crosby v. Commissioner, 14 B.T.A. 980 (1929), acq., VIII-2 C.B. 12, illustrates the characterization of a promise to pay. Crosby involved a lawyer who sold an interest in his law firm for a nonnegotiable note. Id. at 981. The note provided that unpaid installments would be canceled in the event of the death of the purchaser or on the occurrence of other contingencies. The court deemed the promise to be unmarketable because the right to receive payments was subject to such unpredictable conditions. Id. at 982-83; see Hudson v. Commissioner, 11 T.C. 1042, 1050-51 (1948) (holding that notes could not be deemed marketable because they were subject to various restrictions), aff'd, 183 F.2d 180 (5th Cir.), and aff'd, 184 F.2d 518 (5th Cir. 1950).
368. Williams v. Commissioner, 28 T.C. 1000, 1002 (1957) (holding that the note received by the employee was evidence of the indebtedness, rather than payment for his services), acq., 1958-2 C.B. 8; Dial v. Commissioner, 24 T.C. 117, 123 (1955) (concluding that the issuance of promissory notes to employees did not qualify as payments because the employer only intended the notes to serve as security for debts owed), acq., 1955-2 C.B. 5.
369. See, e.g., Segel v. Commissioner, 34 T.C.M (P-H) ¶ 65,221, at 1237, 1246 (1965) (concluding that the parties did not intend notes to be payment because they agreed that the notes would not be negotiated or used as security), aff'd, 370 F.2d 107 (2d Cir. 1966).
370. E.g., McIntosh v. Commissioner, 36 T.C.M. (P-H) ¶ 67,230, at 1278, 1295-96 (1967) (listing the nonnegotiability of notes as one reason why notes could not be defined as payments); Dial, 24 T.C. at 123.
372. See, e.g., Dial, 24 T.C. at 123-25.
strate that the debtor was unable to pay,\(^{373}\) that the promise was not marketable,\(^{374}\) that there was an oral agreement not to dispose of the promise,\(^{375}\) or other factors tending to indicate that the creditor did not accept the promise as payment.\(^{376}\) Subsequent actions of the parties with regard to the promise may shed light on their original intent.\(^{377}\)

If a marketable promise is accepted as payment, the recipient has gross income at the time the promise is received.\(^{378}\) If a marketable promise is accepted as security for a loan, or as evidence of an underlying debt, there is no gross income at the time the promise is received.\(^{379}\)

VI. CONSTRUCTIVE RECEIPT

A. In General

Under the cash method of accounting, income is received when cash or property is reduced to possession.\(^ {380}\) Although the general rule calls for actual possession, an individual is treated as being in possession if he has an adequate right of possession. A right is adequate if it is not subject to a substantial restriction.\(^ {381}\)

Authorities have provided some guidance for determining whether there is a substantial restriction.\(^ {382}\) Although court decisions follow the general principal, they are not particularly useful planning tools because

\(^{373}\) McIntosh, 36 T.C.M. (P-H) at 1295-96; Williams, 28 T.C. at 1000.

\(^{374}\) McIntosh, 36 T.C.M. (P-H) at 1295-96; Williams, 28 T.C. at 1000.

\(^{375}\) Segel v. Commissioner, 34 T.C.M. (P-H) ¶ 65,221, at 1237, 1246 (1965), aff’d, 370 F.2d 107 (2d Cir. 1966); Williams, 28 T.C. at 1000.


\(^{377}\) For example, consider a situation where after the promise was made, the parties agreed that the promise would not be sold or used as security for a loan. The person who accepted the promise as payment would desire to convert it to cash. It would seem unlikely that he would agree to hold on to the promise and therefore, the agreement itself tends to prove that the promise was not accepted as payment. See Diamond & Cutler, supra note 56, at 66-68.

\(^{378}\) Marcello v. Commissioner, 43 T.C. 168, 188-91 (1964), aff’d in part and remanded in part, 380 F.2d 499 (5th Cir. 1967).

\(^{379}\) McIntosh, 36 T.C.M. (P-H) at 1295-96.


\(^{382}\) E.g., Martin, 96 T.C. at 821-20; Veit v. Commissioner, 18 T.C.M. (P-H) ¶ 49,253, at 811 (1949).
results are somewhat inconsistent. They are helpful, however, in determining whether or not administrative requirements may be upheld.

Policy on rulings for nonqualified plans developed slowly. Available evidence suggests that there was either no policy or that the policy was very general prior to 1948 when the IRS suspended issuing private letter rulings. When issuance resumed in 1964, the IRS proceeded slowly because it had inadequate information. Although substantial policy exists today, much of it has never been published. Private letter rulings issued to other individuals may provide some assistance. Although they may not be cited as precedent, they can be used as evidence of administrative practice.

The only reasonably complete published approach to the problem is in the area of substantial risk of forfeiture regulations. While these regulations would never apply to a Rabbi trust, they represent an official statement on an analogous topic. If a substantial risk of forfeiture exists under a Rabbi trust, one should argue that even the government should accept it as a substantial restriction sufficient to prevent constructive receipt treatment.

Published rulings may be more helpful. The Tax Court has concluded that rulings issued under the pre-1981 version of the statute regulating treatment of interests in qualified trusts use the same principle as the constructive receipt regulation. Hence, there should be no constructive receipt if the plan satisfies the requirements of those rulings. The most effective published rulings are those dealing with the issue of constructive receipt by holders of interests in nonqualified plans. A plan should be successful if it satisfies the requirements of these rulings. However, not many such rulings exist and those that do only apply to clear cases. Therefore, they are usually not very helpful.

I. The 1960 Ruling

The 1960 ruling addressed some circumstances that were adequate to postpone the receipt of compensation. The ruling discussed various

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383. See, e.g., McDonald, supra note 256, at 211.
384. Rudick, supra note 228, at 164.
385. McDonald, supra note 256, at 220.
393. Id.
administrative rulings and court decisions, and employed five examples to illustrate application of the rules.\textsuperscript{394}

In the first example, an executive was entitled to a fixed salary plus additional compensation for each year of service.\textsuperscript{395} The additional compensation was credited to a bookkeeping reserve,\textsuperscript{396} and payments would commence upon the termination of his employment, his becoming a part-time employee, or his becoming incapacitated.\textsuperscript{397} The contract provided that the employer did not hold the reserve in trust. The conclusion that there was no constructive receipt\textsuperscript{398} is consistent with theory since the executive did not have a right to possession prior to actual payment.\textsuperscript{399} Because the IRS in effect held that there was no need for other conditions, requirements such as future services or noncompetition are not necessary for postponement.

In another example, a corporation provided a plan of additional compensation for officers and key employees selected by the board of directors.\textsuperscript{400} A percentage of the corporation's annual earnings would be divided among the participants, and held in separate accounts by the employer.\textsuperscript{401} Any revenues generated from investing the funds in an account would be credited to that particular account.\textsuperscript{402} The contract provided that the employer did not hold the accounts in trust.\textsuperscript{403} The employer was not liable for payments if the participant competed with the employer, did not make himself available for consultation, or failed to retain his interest in the plan and keep it unencumbered.\textsuperscript{404} Payments would begin when the participant reached age sixty and was no longer employed by the company, or became unable to perform his duties.\textsuperscript{405} There was no constructive receipt.\textsuperscript{406} Reading examples one and two together tells us that it does not matter whether deferral is under a single contract or if it is under a plan covering a large number of employees.

\begin{table}
\begin{tabular}{ll}
394. & Id. \\
395. & Id. at 175. \\
396. & Id. \\
397. & Id. \\
398. & Id. at 175, 178. \\
400. & Rev. Rul. 60-31, 1960-1 C.B. 174, 175. \\
401. & Id. \\
402. & Id. \\
403. & Id. at 176. \\
404. & Id. at 175-76. \\
405. & Id. \\
406. & Id. at 175-76, 178-79. \\
\end{tabular}
\end{table}
In example three, an author exchanged the exclusive right to publish his book for a royalty contract. On the same day, the author and publisher executed a second agreement which provided that the publisher would not pay more than a specified amount under the initial contract in any given year. Any excess amount would be retained by the publisher and would be paid in subsequent years. The agreement did not require that the retained amounts be segregated by the publisher in any manner. There was no constructive receipt.

Example three is not materially different from the first two illustrations. It does add that the ruling can be used to defer self-employment earnings, and that contracts made on the same day will apparently be treated as a single agreement. Several court decisions have concluded that there was no constructive receipt where the effect of a series of contracts executed in different years was that the employee never had a right of possession.

The fourth example involved a football player who was entitled to a bonus for signing a contract. The money was delivered to a bank which agreed to act as trustee, and to pay the money to the player over a period of five years. Because the player's interest was vested, he received a taxable property interest in the year the trust was created.

The IRS greed is illustrated by example five. A boxer agreed to a fight on a standard form contract. At the same time, he made arrangements to defer a substantial portion of the proceeds to subsequent years. Defer-

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407. Id. at 176.
408. Id.
409. Id.
410. Id.
411. Id. at 176, 179.
412. Id.
413. See, e.g., Martin v. Commissioner, 96 T.C. 814, 821-30 (1991); Veit v. Commissioner, 18 T.C.M. (P-H) ¶ 49,253, at 811 (1949). Timing is an important issue in the area of constructive receipt. The IRS believes that an agreement to defer income is not effective unless it was made before the employee earned the income. Rev. Proc. 71-19, 1971-1 C.B. 698. In the first example, however, the employee earned the compensation after the arrangements were made whole; in the third example, the author earned his royalties after the parties signed the contract. Rev. Rul. 60-31, 1960-1 C.B. 174, 175-76, 178-79. These examples illustrate that as long as the employee never had a right of possession, it does not matter that the agreement to defer was made after the employee earned the income. See, e.g., Martin, 96 T.C. at 814 (holding that petitioners were not in constructive receipt of plan benefits upon conversion to a new plan or termination of their employment); Veit, 18 T.C.M. (P-H) at 811.
415. Id.
416. Id. Trusts and other economic benefits are further considered in separate sections of this Article. See discussion supra part V.
erals were not common in the boxing industry and in this example, deferral was made at the demand of the boxer. The IRS thought the fight was a joint venture, and found that all of the boxer’s share of the proceeds were income in the year of the fight.

The boxer was Sugar Ray Robinson, and the IRS wanted to score a knockout. The IRS advanced every argument it could think of, and the Tax Court dismissed all arguments in summary fashion. The fact that the promoter was able and perhaps anxious to pay at an earlier time was simply not relevant. The contract was not a sham since the parties intended to be governed by it. Since Mr. Robinson was a mere unsecured creditor of the promoter, he had no right to possession of the money and there was no constructive receipt.

The IRS was stunned by the blow, and smelling salts seemed ineffective. Five years later, the IRS swallowed its pride, announced agreement with the decision, and substituted a new example. A theatrical performer agreed to share in the profits and losses from a play. No more than twenty-five percent of any profits were payable to the performer during the run of the play, with the balance being delivered in subsequent years. Since partnership profits are considered taxable income to the partners in the year received by the partnership, the agreement to defer was irrelevant.

Example five was a place for trial balloons in cases involving a lot of money. No apparent justification existed for the attempt to tax Mr. Robinson in the year of the fight. The new example was based on a medical partnership plan where people had won in the district court, and an appeal was pending. The IRS position was upheld by the Supreme Court in 1973.

2. Elections

The 1960 ruling announced a conservative policy. Deferral would be permitted if an election to defer related to services that had not been performed. A 1971 procedure extended the policy to advance rul-

418. Id. at 26-27.
419. Id. at 33.
420. Id.
421. Id. at 36.
422. Id.
423. Id. at 35-37.
425. Id.
426. Id.
427. Id.
ings.\textsuperscript{430} The general rule requires elections to be made before the calendar year when services are performed.\textsuperscript{431} In the case of elections made at any other time, payment must be subject to a substantial risk of forfeiture that continues from the time of the election until actual payment is due.\textsuperscript{432} For advance ruling purposes, a risk of forfeiture is not substantial unless two criteria are satisfied.\textsuperscript{433} First, there must be a definite possibility that the event could occur, and second, a meaningful effort by the employee will be required to avoid occurrence of the event.\textsuperscript{434}

An exception exists for new plans and newly eligible employees.\textsuperscript{435} Elections made within thirty days after the effective date of a new plan will postpone compensation for services performed after the date of the election.\textsuperscript{436} The same rule applies to elections made by newly eligible employees if the employee makes the election within thirty days of the commencement of eligibility.\textsuperscript{437} Deferral elections usually cannot be revoked.\textsuperscript{438} Revocation is permitted if the employee may not participate in the plan for the balance of the year.\textsuperscript{439} Employees may express investment preferences.\textsuperscript{440} Although the plan may follow these expressions, it cannot be required to do so.\textsuperscript{441}

Payouts to participants must be made at the time and in the manner specified by the plan.\textsuperscript{442} Employers may not have discretion over the time or manner of payment,\textsuperscript{443} and they usually cannot be made before retirement or other termination of employment.\textsuperscript{444} Earlier payments will be accepted in the case of automatic payouts of small amounts and hardship relief.

The right to emergency withdrawals must be limited. An event does not qualify as an emergency unless it is foreseeable,\textsuperscript{445} beyond the con-

\begin{footnotesize}
\begin{enumerate}
\item[431.] Id.
\item[432.] Id.
\item[433.] Id.
\item[434.] Id.
\item[436.] Id.; Priv. Ltr. Rul. 84-21-063 (Feb. 21, 1984).
\item[437.] Priv. Ltr. Rul. 84-21-063 (Feb. 21, 1984).
\item[440.] Id.
\item[441.] Rev. Proc. 92-64, 1992-2 C.B. 422.
\item[442.] Priv. Ltr. Rul. 88-34-015 (May 25, 1988).
\end{enumerate}
\end{footnotesize}
trol of the beneficiary,\textsuperscript{448} and severe financial hardship would result if early withdrawal were not permitted.\textsuperscript{449} The amount must be limited to the sum reasonably needed to deal with the emergency.\textsuperscript{450}

Plans may permit payout elections by participants. The times when payments may be made cannot be before the earlier of death, retirement, or employment termination.\textsuperscript{451} Payout elections must be made at the same time as deferral elections.\textsuperscript{452} Subsequent elections are permitted if payment is subject to a substantial risk of forfeiture from the time of the election until actual payment is due.\textsuperscript{453}

Consider the differences between letter ruling results and those under the general rule. Under the general rule, no constructive receipt occurs if an election to defer was made before the employee had a right to actual receipt.\textsuperscript{454} The Tax Court has concluded that elections were effective in a variety of cases involving several aspects of nonqualified plans,\textsuperscript{455} including initial elections to set up plans and defer compensation,\textsuperscript{456} and elections to extend the period of original,\textsuperscript{457} or modified deferral.\textsuperscript{458} The IRS has announced agreement with several of those decisions.\textsuperscript{459}

The Tax Court\textsuperscript{460} and the IRS\textsuperscript{461} have concluded that the pre-1981 version of the statute governing distributions from qualified plans\textsuperscript{462} used the same legal standard as the constructive receipt regulation. Rulings under the statute are indistinguishable from the Tax Court decisions on nonqualified plans. There is no constructive receipt if an election is made after the employee performs services, but before the payment due date.\textsuperscript{463} Hence, the only inquiry is whether the election was made before the compensation was due to be paid.

\textsuperscript{448} Id.
\textsuperscript{449} Id.
\textsuperscript{450} Id.
\textsuperscript{453} Id.
\textsuperscript{455} Oates v. Commissioner, 18 T.C. 570 (1952), non acq., 1952-2 C.B. 5, non acq. withdrawn and acq. substituted, 1960-2 C.B. 6, aff'd, 207 F.2d 711 (7th Cir. 1953).
\textsuperscript{457} Veit, 8 T.C. at 809.
\textsuperscript{458} Martin, 96 T.C. at 818.
\textsuperscript{459} See 1970-1 C.B. xxi (acquiescing in Robinson, 44 T.C. at 20); 1960-2 C.B. 5; (acquiescing in Oates, 18 T.C. at 570); 1947-2 C.B. 4 (acquiescing in Veit, 8 T.C. at 809).
\textsuperscript{460} Blyler v. Commissioner, 67 T.C. 878, 884 (1977).
\textsuperscript{462} I.R.C. § 402(a) (1980).
\textsuperscript{463} Rev. Rul. 55-423, 1955-1 C.B. 41.
Both qualified\textsuperscript{464} and Section 457 Rabbi plans\textsuperscript{465} may require the trustee to follow the investment directions of participants. Since there is no relevant distinction between the two types of Rabbi trusts, one can only speculate as to why the IRS uses inconsistent approaches. Perhaps Section 457 trusts are given favorable treatment because they are expressly authorized by statute.\textsuperscript{466}

If an irrevocable election was made before a distribution was payable, and it created a substantial restriction, there would be no constructive receipt.\textsuperscript{467} A mere deferral creates a substantial restriction if the period was more than inconsequential.\textsuperscript{468}

A profit-sharing plan permitted distributions at the end of fifteen years of participation if an employee made an irrevocable election.\textsuperscript{469} An election could be made anytime until completion of the fourteenth year of service.\textsuperscript{470} If there was no election, the balance in the account would be distributed on death or other termination of employment.\textsuperscript{471} The irrevocable election was a substantial restriction.\textsuperscript{472}

Another profit-sharing plan permitted withdrawals at various times, including financial necessity if a committee agreed that an adequate reason justified a withdrawal.\textsuperscript{473} The requirement that elections be approved by a committee constituted a substantial restriction.\textsuperscript{474} Loss of an interest in the plan would also be considered a substantial restriction.\textsuperscript{475}

A profit-sharing plan permitted employees to withdraw employer contributions made during the last two years.\textsuperscript{476} A withdrawal caused a six month suspension in participation, which meant that the employee lost his right to share in employer contributions during that period.\textsuperscript{477} Suspension qualified as a substantial restriction. But if an employee with-

\textsuperscript{466} Section 457 Rabbi trusts will be discussed in the next part of this Article. I.R.C. § 457(a) (1988).
\textsuperscript{467} Rev. Rul 55-423, 1955-1 C.B. 42.
\textsuperscript{468} Examples of substantial periods include restrictions of ten years, or until retirement, severance of employment, death, or disability. Rev. Rul. 55-423, 1955-1 C.B. 41.
\textsuperscript{469} Rev. Rul. 55-425, 1955-1 C.B. 43.
\textsuperscript{470} Id.
\textsuperscript{471} Id.
\textsuperscript{472} Id.
\textsuperscript{473} Rev. Rul. 55-424, 1955-1 C.B. 42.
\textsuperscript{474} Id.
\textsuperscript{475} Rev. Rul. 60-292, 1960-2 C.B. 153. A pension plan permitted participants to withdraw their contributions plus interest at normal retirement age. Id. Since a withdrawal would cause a loss of the employee's prior service credits on reemployment, a substantial restriction existed.
\textsuperscript{477} Id.
drew part of the money, the balance was deemed to be constructively received.\textsuperscript{478} There was no penalty on withdrawing the balance because the penalty had already been incurred.\textsuperscript{479}

**B. Seeking A Private Letter Ruling**

There are three categories of uses for authorities under the general rule.\textsuperscript{480} One is deciding whether to seek a private letter ruling.\textsuperscript{481} Many individuals believe that an advance ruling is necessary. Others have concluded that they do not want to be governed by the conservative approach, and prefer to play the audit lottery. Another use is resisting challenge to the plan. The advance ruling standards have been used as an auditing guideline, but they are not enforceable.\textsuperscript{482} Hence, the general rule should be presented to the auditor and pursued during all phases of a challenge. The third use is as a negotiating tool. If a plan is fairly close to the conservative approach, it may be possible to get the IRS to relax the advance ruling guidelines by pointing to the fact that its requirements are not the law, and that individuals have obtained favorable court decisions under similar circumstances.\textsuperscript{483}

**VII. GOVERNMENT AND EXEMPT ORGANIZATION PLANS**

**A. In General**

Rabbi plans usually depend on the general rules governing timing of compensation income.\textsuperscript{484} Private letter rulings applied the general rules to plans of state and local governments until the IRS decided to study the situation.\textsuperscript{485} The study led the IRS to propose current taxation of amounts deferred under nonqualified plans.\textsuperscript{486} Public outcry over the proposal led to two legislative responses.\textsuperscript{487}

\textsuperscript{478} Id.
\textsuperscript{479} Id.
\textsuperscript{480} E.g., Martin v. Commissioner, 96 T.C. 818 (1991).
\textsuperscript{483} E.g., Martin, 96 T.C. at 818.
\textsuperscript{487} Skillman, supra note 265, at 258.
The first applied to nonqualified plans of taxable employers. These employers were limited by the labor portion of ERISA to excess benefit or top hat plans, and the desire for an expense deduction at the time of a contribution. Congress found the limitations sufficient and froze the general rules to the situation existing just before the proposal.

Congress believed that employees of state and local governments should be eligible for analogous treatment. Since the ERISA and deduction limits did not apply, Congress decided to limit annual deferrals and impose other restraints. The legislative responses were inadequate because they failed to provide for everyone. Since tax exempt employers were generally unable to use the rule for government plans or the freeze, the proposal was applied to them.

The government rule was extended to all exempt employers in 1986. President Reagan thought all employees should be given essentially the same ability to use constructive receipt rules, and recommended that the statute be expanded to include them. Congress agreed, but it did not explain why an exemption for churches was enacted in 1988.

Deferred compensation plans generally are subject to the labor portion of ERISA. While government plans are automatically excluded from coverage, plans of tax exempt organizations must satisfy the requirements.
ments. If the arrangement qualifies as a plan, it must comply with the participation and other rules, or qualify for an exception as either an excess benefit or a top hat plan.

B. Technical Requirements

The plan must be maintained by an eligible employer. States and their political subdivisions qualify as eligible employers, as do other tax-exempt organizations, with the exception of churches. The plan must provide that all income deferred under the plan and all plan assets and earnings remain the property of the employer. The property must continue to be subject to claims of the employer's general creditors until it is made available to a beneficiary.

Participation must be limited to employees and independent contractors who perform services for the employer. Since participation does not have to be voluntary, all employees can be required to participate as a condition of employment. Participants may be given different options within the plan, or everyone can be required to accept the same treatment.

Deferral of income must be agreed to in advance. Compensation may be deferred for a particular calendar month only if the employee executed a deferral agreement before the beginning of the month. Compensation of new employees may be deferred for the first month if

505. Id. §§ 1051(2) (1988), 1081(a)(3), 1101(a)(1).
507. Id. § 457(e)(1)(A).
508. Id. § 457(e)(1)(B).
509. Id. § 457(e)(13) (Supp. IV 1992).
510. Id. § 457(b)(6) (1988).
512. I.R.C. §§ 457(b)(1), (e)(2)-(3).
516. Id.
the employee and employer agree to a deferral before the first day of employment.\textsuperscript{517}

Annual deferrals must be limited. The amount usually cannot exceed the lesser of $7500 or one third of includable compensation.\textsuperscript{518} Includable compensation means the amount of money that must be reported as current gross income.\textsuperscript{519} The regulations take the position that a third of includable compensation is "generally the equivalent of 25 percent of gross compensation."\textsuperscript{520} Although the twenty-five percent rule is an attempt to simplify accounting for the limit, inclusion of the word "generally" renders it unreliable unless a private letter ruling approves the use of the twenty-five percent rule in the particular plan.

The $7500 limit must be reduced by amounts deferred under certain other plans. If a participant is covered by more than one Section 457 plan for the year, the $7500 limit under a plan is reduced by the amount deferred under the other plan or plans.\textsuperscript{521} Amounts deferred on various other arrangements cause the same result.\textsuperscript{522}

During the last three years before a participant reaches his normal retirement date,\textsuperscript{523} the plan can increase the limit to the lesser of $15,000 or the appropriate part of the plan ceiling.\textsuperscript{524} The appropriate part is the ceiling under the general rule for the current year plus the unused part of the ceiling for one or more previous years.\textsuperscript{525} The increased amount is called "catch up" since it permits deferrals for amounts which were not used in earlier years.\textsuperscript{526}

Any type of plan is permissible. Hence, it may be an individual account, or a pension, profit-sharing, excess benefit, or top hat plan.\textsuperscript{527} The plan must have adequate distribution rules. The plan usually cannot make anything available to a participant until the earlier of reaching age seventy and one-half, separation from service, or facing an unforeseeable emergency.\textsuperscript{528} The general rule is modified to the extent that the minimum distribution requirement calls for a different result.

\textsuperscript{517} Treas. Reg. § 1.457-2(g) (1982).
\textsuperscript{518} I.R.C. § 457(b)(2); e.g., Priv. Ltr. Rul. 92-25-022 (Mar. 20, 1992).
\textsuperscript{519} I.R.C. § 457(e)(5)-(7).
\textsuperscript{520} Treas. Reg. § 1.457-2(m) eg. (1) (1982).
\textsuperscript{521} I.R.C. § 457(c)(1).
\textsuperscript{522} Id. § 457(e)(2) (1988 & Supp. IV 1992).
\textsuperscript{523} Treas. Reg. § 1.457(f)(4) (1982).
\textsuperscript{524} I.R.C. § 457(b)(3) (1988).
\textsuperscript{526} Id. § 1.457-2(m) eg. (2-3).
There are several aspects to the minimum distribution requirement. Distributions must begin no later than April first of the year after the employee reaches age seventy and one-half. If distributions begin while the participant is still alive, payments must be adequate to satisfy distribution regulations. The general criterion is that more than two-thirds will be paid during the life expectancy, and any amount not distributed to the participant during his life will be distributed at least as rapidly to his beneficiaries.

If distributions do not begin before the participant dies, the full amount due usually must be paid over a period not exceeding fifteen years. If the beneficiary is the surviving spouse, distributions can be over the spouse's life expectancy. Where distributions are to be made over a period of more than a year, the amount must be substantially nonincreasing and payable at least annually.

C. Results

There are three categories of tax consequences. Trust income is not taxed because it is attributed to a tax-exempt employer. Compensation is received at the earlier of the time benefits are paid or made available.

Congress and Treasury have adopted a conservative approach to contributions. Compensation cannot be deferred unless an agreement to defer was made before the services are rendered. An amount equal to the plan limit may be deferred even if the contribution exceeds the plan limit. The statute does not specify how a contribution should be treated to the extent it exceeds the plan limit.

Regulations take the position that Section 457 is the only ground for deferral. One example involved a single plan that permitted a participant to defer an amount exceeding the limit. Another example deals

530. Id. § 457(d)(2)(B)(i)(I).
534. Id. § 457(d)(2)(C).
536. I.R.C. § 457(a).
537. Id. § 457(b)(4).
538. Id.
540. Id. § 1.457-1(b)(2) eg. (5) (1982).
with deferrals under Section 457 and Section 403(b).\textsuperscript{541} Deferral under the Section 457 plan exceeded the limit only if the Section 403(b) contribution was counted.\textsuperscript{542} Both examples\textsuperscript{543} found that there was no deferral for the excess amounts.\textsuperscript{544} The result is justified by legislative history which concludes that Section 457 is the only ground for deferral.\textsuperscript{545}

Excess contributions may cause disqualification of the plan. For example, suppose the plan makes an innocent mistake in computing a participant's limit for a year, or a participant conceals the fact that he was covered by another plan that would reduce the limit under the plan. The IRS presumably would not seek to disqualify the plan as long as it appeared that there was a good faith effort to comply with the rules.

In contrast, suppose a significant number of employees under a plan also work for other employers and the employer makes no effort to determine whether reductions are in order. The IRS could easily find that excess deferrals were not innocent.\textsuperscript{546} The penalty for violations can be disqualification of the plan.\textsuperscript{547} Government plans are given a period of over 180 days to cure defects in administration,\textsuperscript{548} but there is no grace period for the plans of other tax-exempt employers. Hence, the IRS could retroactively disqualify plans of other tax exempt employers for the entire period of their existence.\textsuperscript{549}

Results are different if an eligible employer\textsuperscript{550} has a plan that does not satisfy Section 457. Any agreement or other arrangement for deferral is defined as a plan.\textsuperscript{551} However, the bad plan rule does not apply to plans governed by certain other provisions such as Section 401 or Section 403.\textsuperscript{552}

Compensation covered by the bad plan rule is taxed in the first year when there is no substantial risk of forfeiture.\textsuperscript{553} Substantial risk of forfeiture means payment is conditional on future performance of substan-

\textsuperscript{541} Id. § 1.457-1(b)(2).
\textsuperscript{542} Id. eg. (6); Priv. Ltr. Rul. 92-25-037 (Mar. 25, 1992); Priv. Ltr. Rul. 91-52-026 (Sept. 27, 1991).
\textsuperscript{543} Treas. Reg. § 1.457-1(b)(2) egs. (5-6) (1982).
\textsuperscript{544} Id.
\textsuperscript{545} S. REP. NO. 1263, supra note 263, at 69.
\textsuperscript{547} I.R.C. § 457(b).
\textsuperscript{548} Id.
\textsuperscript{549} I.R.C. § 7805(b).
\textsuperscript{550} Id. § 457(e)(1) (1988), (e)(13) (Supp. IV 1992).
\textsuperscript{551} Id. § 457(f)(3)(A) (1988).
\textsuperscript{552} Id. § 457(f)(2).
\textsuperscript{553} Id. § 457(f)(1)(A).
Since the statute and regulations do not offer any guidance for applying the future services rule, the Section 83 standards for applying those words is the best starting point.\footnote{554}{Id. § 457(f)(3)(B).}

The bad plan rule can be useful. Suppose the parties do not want to use Section 457 because of the dollar limit on contributions, or the distribution requirements. If the employer makes a bad plan that requires substantial future services before an actual distribution is made available, the bad plan rule has in effect permitted an eligible employer to set up a Rabbi plan under the general rule.\footnote{555}{Treas. Reg. § 1.83-3(c) (1983); Priv. Ltr. Rul. 92-36-014 (June 5, 1992). In one case, a physician made a contract for deferred compensation from a hospital. Richardson v. Commissioner, 64 T.C. 621, 623 (1975). The payment of benefits under the contract was conditioned on performance of post retirement services requested by the employer. \textit{Id.} at 624. The employer had never asked the retired physician for consulting services, and had no plans to begin such a program. \textit{Id.} Since the employer had no need or desire for future services, the future services requirement was not substantial and the physician was not faced with a substantial risk of forfeiture. \textit{Id.; see also} Priv. Ltr. Rul. 91-36-005 (May 31, 1991).}

One class of individuals escapes both the limits of Section 457 and the bad plan rule. This class consists of independent contractors if everyone, other than those who have not satisfied any initial service requirements, with the same relationship to the payor is covered under the plan with no individual variations or options.\footnote{556}{Anthony L. Scialabba, \textit{Special Rules Allow Flexible Deferred Comp. Plans for Exempt, Government Employers}, 76 J. Tax’n 294, 297 (1992).}

Suppose a tax-exempt hospital knows many of its physicians who are independent contractors also work at several other hospitals. The hospital sets up a plan for those physicians, and there are no individual variations or options. Since Section 457 does not apply, the timing of income is governed by the general rules.

Various events could be considered distributions. The availability of investment options does not cause constructive receipt of income. The result does not change even if an option is exercised after the beginning of actual distributions.\footnote{557}{I.R.C. § 457(e)(12)(B); see Priv. Ltr. Rul. 91-49-032 (Sept. 10, 1991).}

A transfer of assets from one Section 457 plan to another Section 457 plan generally does not cause constructive re-
However, a transfer of assets from a Section 457 plan to any other sort of plan is a taxable distribution.\textsuperscript{561}

The treatment of distributions can be divided into two categories. If the plan satisfies Section 457, deferred amounts are received under the general rule at the earlier of the time when benefits are paid or made available.\textsuperscript{562} The made available language presumably was borrowed from the pre-1981 rule for distributions from qualified plans,\textsuperscript{563} and regulations confirm the suspicion that the two statutes use the same constructive receipt criterion.\textsuperscript{564}

Constructive receipt cannot occur until a participant has a right to actual receipt of benefits.\textsuperscript{565} Thus, distribution elections can be made anytime before benefits are payable. If the plan provides that a lump sum will be paid ninety days after pre-retirement separation from service unless deferral is elected within thirty days after separation, then a timely election will postpone receipt.\textsuperscript{566}

The right to make emergency withdrawals does not cause constructive receipt under specified circumstances.\textsuperscript{567} The right must be limited to extraordinary and unforeseeable circumstances, such as sickness or injury of the participant or his dependent, or a casualty loss.\textsuperscript{568} Withdrawals must be limited to the amount reasonably needed to deal with the emergency.\textsuperscript{569} The right to a small lump sum distribution does not cause constructive receipt if no additional amounts can be deferred, and the amount to be distributed does not exceed $3500.\textsuperscript{570}

The other category is the bad plan rule. A second tax may be imposed under the bad plan rule. Tax is imposed at the earlier of actual distribution or the time when payment ceases to be subject to a substantial future service requirement.\textsuperscript{571} There is no double taxation. The amount of an actual distribution is reduced by the amount of a constructive distribution.\textsuperscript{572}

\begin{itemize}
\item \textsuperscript{560} I.R.C. § 457(e)(10); Priv. Ltr. Rul. 93-14-006 (Dec. 28, 1992).
\item \textsuperscript{562} I.R.C. § 457(a).
\item \textsuperscript{564} E.g., Treas. Reg. § 1.457-1(b)(2) eg. (1)(ii) (1982).
\item \textsuperscript{565} Id.; Treas. Reg. § 1.457-1(b)(2) e.g. (4) (1982).
\item \textsuperscript{566} Treas. Reg. § 1.457-1(b)(2) e.g. (4) (1982).
\item \textsuperscript{568} Treas. Reg. § 1.457-2(h)(4) (1982).
\item \textsuperscript{569} Id. § 1.457-2(h)(5).
\item \textsuperscript{571} I.R.C. § 457(f)(1)(A).
\item \textsuperscript{572} Id. §§ 457(f)(1)(B), 472(b).
\end{itemize}
VIII. Conclusion

Several factors must be examined in order to decide whether a Rabbi arrangement is the best choice. If the employer wants to pay additional compensation, the easy approach is to pay cash. Many employers would prefer to keep the cash and issue a promise to pay in the future. Golden handcuffs may be another employer goal. Employers are aware of the ability to take cash and leave, and most would prefer to make a promise to pay in the future as a method of retaining employees.573

Some employees do not want more cash because they believe their tax burden will be reduced if they defer their compensation until after retirement when they anticipate being in a lower tax bracket. If the employer wants to purchase loyalty, future payments should be subject to conditions such as noncompetition.574

Deferral can be accomplished with a qualified plan, which is the best tax shelter from the viewpoint of most potential participants. The employer is entitled to an immediate deduction for contributions,575 contributions are held in trust for the exclusive benefit of beneficiaries,576 trust income is not taxed,577 and federal insurance reduces the risk of loss.578 Beneficiaries are not taxed until there is an actual distribution.579

There are several negative features of the qualified plan. Conditions such as the participation and coverage rules580 make qualified plans the most expensive sort of deferral mechanism. Amounts that can be made available to executives may be unsatisfactory because of the limits on contributions581 and benefits,582 and the ability to purchase loyalty is limited. Some vesting must occur no later than completion of the fifth year of service,583 and vested benefits cannot be conditioned on factors such as continued employment or noncompetition.584

574. Greene, supra note 573, at 200-25; Johnson & Anderson, supra note 573, at 9-1 to 9-16.
581. E.g., id. §§ 401(a)(17), 415(c)(1).
582. Id. § 415(b)(1).
583. Id. § 411(a)(2).
584. Id. § 411(a)(1).
A nonqualified plan with a Rabbi trust may be the best way to provide additional compensation while simultaneously purchasing executive loyalty. While the tax results are less favorable, other factors make them less expensive than qualified plans. There are no coverage rules, contributions and benefits are unlimited, and interests can remain unvested, or vesting can be subject to whatever conditions the employer wants to impose.\footnote{585}

Labor has been intentionally vague about the requirements necessary to satisfy the top hat criterion. Labor feels that participation must be limited to management or highly compensated employees,\footnote{586} but has made no concrete suggestions about what is required to place an individual in either category. Apparently, Labor will continue to follow the IRS criterion in determining whether a plan is unfunded.\footnote{587} The best way to deal with the uncertainties is to obtain an advisory opinion.\footnote{588}

The plan must be adequate to defer compensation under the general rules for timing of income. The question is whether there will be an actual or constructive\footnote{589} receipt of a taxable property interest\footnote{590} before benefits are due to be paid.\footnote{591}

The conservative approach of the IRS has continued to the present day. A 1992 procedure\footnote{592} expressly continued the 1971\footnote{593} procedure with two modifications of the time when initial elections could be made.\footnote{594}

Several new restrictions were added to the published list. The plan must state that the parties intended that the plan be unfunded under the labor portion of ERISA,\footnote{595} that participants are unsecured general creditors of the employer,\footnote{596} and that their interests are not transferable.\footnote{597} The plan also must identify the time and method for payment of

\begin{footnotes}
\footnote{586. DOL Advisory Op. 90-14 A (May 8, 1990).}
\footnote{587. At one point Labor flatly stated that a trust that satisfied IRS's requirements for unfunded status would also be considered unfunded for top hat purposes. Daniel Letter, supra note 47. Other pronouncements suggest that IRS findings are merely a factor to be considered. E.g., DOL Advisory Op. 92-13 A (May 19, 1992).}
\footnote{589. Treas. Reg. § 1.451-1(a) (1978).}
\footnote{590. E.g., Treas. Reg. §§ 1.61-2(d)(4) (1989); Id. § 1.83-3 (1985).}
\footnote{591. Treas. Reg. § 1.451-2(a) (1979).}
\footnote{593. Rev. Proc. 71-19, 1971-1 C.B. 698.}
\footnote{595. Id.}
\footnote{596. Id.}
\footnote{597. Id.}
\end{footnotes}
benefits, which may include distributions in the case of an unforeseeable emergency.\footnote{598}{Id.}

Since other limitations have been regularly enforced, the IRS apparently does not intend to include them in the published list. The IRS sometimes becomes confused about its unpublished requirements. A 1987 letter approved a plan which gave the employer discretion to pay either a lump sum or in installments. Nine months later, another letter explained that the original decision was contrary to the longstanding IRS position.\footnote{599}{A 1987 private letter ruling approved a plan that gave the employer discretion to pay either a lump sum or in installments. Priv. Ltr. Rul. 87-39-031 (June 29, 1987). Nine months later, however, another letter explained that the original decision was contrary to the long standing IRS position. Priv. Ltr. Rul. 88-30-069 (May 5, 1988).}

Two approaches are available to deal with unpublished requirements. One is to become familiar with private letter rulings by reading the letters\footnote{600}{Several hundred Rabbi letters have been issued since 1981. See, e.g., Johnson & Anderson, supra note 573, at 9-36, 9-37.} or by consulting a summary such as a law review article.\footnote{601}{E.g., Rev. Proc. 93-1, 1993-1 I.R.B. 10.} The second approach is to submit a plan for approval knowing that the IRS may require one or more changes as a condition to a favorable letter.\footnote{602}{Brrtker & Eustice, supra note 243, at 14-17.}

The treatment of trusts shows a similar pattern of development.\footnote{603}{Compare Priv. Ltr. Rul. 81-13-107 (Dec. 31, 1980) with Rev. Proc. 92-64, 1992-2 C.B. 422.} The IRS compiled a list of requirements for unfunded status and published some of these in a 1992 model trust procedure.\footnote{604}{Rev. Proc. 92-64, 1992-2 C.B. 422.} The effect of the model trust is not entirely clear. If a trust does not satisfy the terms of the model, the IRS will probably not issue a favorable letter.\footnote{605}{Id.} One issue is the circumstances under which the IRS would issue a favorable private letter ruling for a trust that did not satisfy the model. Another is whether trusts that satisfy the model will always receive a favorable letter. There is no way of knowing whether all of the requirements were in the model, or whether new conditions will be imposed at a later time.

The importance of a letter ruling depends on the attitude of the individuals involved in the transaction. Most revenue agents are conservative bureaucrats who will automatically approve a plan with a favorable letter and automatically disapprove the same plan without a letter. People who are concerned about whether there is a low probability of controversy
over the terms and conditions of the plan during an audit presumably will obtain a letter.

An advance ruling is not required for deferral. There is no taxable property interest if the trust is unfunded, beneficiaries usually cannot market their interests, and constructive receipt does not occur until a beneficiary has a right to possession. The additional conditions to an advance ruling on a trust and plan are not enforceable.

Some individuals have been successful with the audit lottery. Even though the additional conditions are not enforceable, they frequently are used as audit guidelines. Hence, the question is whether the savings from avoiding the additional conditions seem to offset the aggravation and expense of a controversy if a plan attracts unfavorable attention during an audit.

Most employers can set up nonqualified plans with Rabbi trusts under the general rules. Congress believed that the limitations of the labor portion of ERISA and the desire for current deductions for contributions were adequate restrictions for those plans. Nonqualified plans of state and local governments and other tax-exempt employers, except churches, must comply with Section 457.

The principal goal of Section 457 is to place dollar limits on tax-free deferrals. The technical requirements of the statute are reasonably easy to satisfy. A search of the letter rulings revealed little or no controversy. Most of the requests were from those who may not have looked at the statute, or who were concerned with unusual situations, such as the application of the 1986 and 1988 transitional rules.

One can only speculate as to why the IRS has been permitted to retain almost absolute discretion to establish conditions necessary for a favorable private letter ruling. With a few minor exceptions, individuals who wanted to avoid controversy by arranging their affairs in advance

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608. Minor v. United States, 772 F.2d 1472, 1474 (9th Cir. 1985).
614. Id. § 457(e)(13).
615. The bad plan rule applies to plans which do not comply. Id. § 457(f).
have been forced to follow the IRS's requirements.\textsuperscript{619} While there is something to be said for administrative discretion, almost absolute discretion is hard to swallow.

In some areas, the discretion has put the IRS in the position of a legislative body. Where most of the issues are clear, the amount of discretion is relatively small. In transactions such as reorganizations\textsuperscript{620} and deferred compensation plans\textsuperscript{621} of taxable employers where numerous grey areas exist, the IRS or individual IRS employees can in effect make law. Because the courts have been slow to reject administrative actions of the IRS, legislation is the only way to change the system. There are some suggestions, however, that Congress wants to continue this sort of informal legislation.\textsuperscript{622}

There are a variety of possibilities for deferred compensation plans under the present system. With adequate planning, the prudent attorney can establish a plan beneficial to both employer and employee, and satisfy IRS's changing requirements.


\textsuperscript{620} Bittker & Eustice, supra note 243, at 14-17.

\textsuperscript{621} See, e.g., Johnson & Anderson, supra note 275, at 9-36 to -37. See generally MacCracken, supra note 546, at 677-79.