ERISA ISSUES IN NONQUALIFIED PLANS WITH INDIVIDUAL "SELF-DIRECTED" ACCOUNTS

BY
Louis R. Richey, JD
Principal, Magner Financial Network
and
Michael A. Swirnoff, LLB
President, Swirnoff Consulting Group

Copyright 2000. All rights reserved.
(REPRINTED WITH PERMISSION BY THE PANGBURN COMPANY, INC)

"Self-Directed" 401(k) Accounts - a Growing Trend

A recent trend in larger qualified 401(k) plan designs is to allow a self-directed investment account feature. Initially popular in the privately held, corporate market, this design feature has found its way into the 401(k) plans of increasingly larger and larger corporations. With this account feature, a plan participant can select virtually any single investment inside this special account in a 401(k) plan. As a consequence, a plan participant is not just limited to the select mutual fund array typically offered in such plans, but can individually pick any single stock, if desired, for his or her own account. The administration of such a self-directed feature is obviously complex, and the complexity increases with the number of participants. Thus, organizations and firms that can offer and administer such a feature have a competitive edge, and are aggressively pushing the marketing of this design. This development in the qualified plan realm has led to requests for versions of this same self-directed investment account feature *in nonqualified plan designs*. After all, if 401(k) investment choices and other qualified plan design features can be "mirrored" in nonqualified plans, why not this particular feature?

Unfortunately, there is not an easy answer to this question. Including such a participant self-directed feature in a nonqualified plan design may increase the risk of adverse ERISA and income tax consequences that may be unacceptable for many plan sponsors. Understanding the reason for this increase in risk requires a review and understanding of certain fundamental differences between qualified and nonqualified pension plans.

Background - "Funding" Differences Between Qualified and Nonqualified Plans

One of the constant challenges in designing nonqualified plans is reconciling the fundamental differences between qualified 401(k) deferred savings pension plans and nonqualified deferred savings pension plans.[1] Increasingly, the frequent nonqualified plan design objective is to parallel or mirror a company's qualified 401(k) plan in so far as is possible given the differences between the two basic types of retirement plans. As a consequence, the limits of nonqualified design are constantly being pushed.[2]

One important difference that most often presents the thorniest nonqualified design obstacle is the "funding" requirements and limitations of a nonqualified plan versus a qualified plan. In general, a qualified 401(k) plan is *required* to escrow all executive (and employer) contributions to an individual trusteed account *for the benefit of* each participant in order to claim both the tax deferral aspects for the plan participants and the current employer deduction.[3] In contrast, to obtain current income tax deferral for participants in a nonqualified deferral plan, the contributions into the plan specifically <u>*cannot*</u> be

escrowed or trusteed ("securitized") for the exclusive benefit of the participant.[4] Thus, the general nonqualified pension plan structure objective is just the opposite of a qualified 401(k) plan.

Moreover, there are ERISA issues hidden in this "funding" difference that are frequently overlooked and ignored. Prior to the enactment of ERISA in 1974, there was only one "funding" issue - the income tax issue - impacting plan design and structure.[5] Since ERISA's enactment, there are two funding issues. For a nonqualified plan to claim a safe harbor (the design objective) from most of the burdensome ERISA requirements, it must not only be limited to the so-called "top hat" select group, but it also must be "*unfunded*".[6] This ERISA "unfunded" requirement is significant. Initially presumed to be the same as the Service's "economic benefit" income tax concept[7], the ERISA concept has proven to be broader and more elusive.

Under IRS guidelines, a plan participant's nonqualified plan benefit is to be only an "unsecured promise to pay" of the employer. So long as it is subject to a risk of loss to the employer's general creditors in bankruptcy, there is no economic benefit or constructive (current) receipt of income deferred and taxation occurs when the benefit is later actually or constructively received.[8] As an "unsecured promise to pay," any investment choices permitted by the nonqualified plan for the investment of deferral contributions must therefore be "hypothetical" (sometimes also referred to as "notional" or "deemed investments") in nature. This issue has historically and is currently addressed by a specific provision in the plan document.

While the Department of Labor (DOL) initially concluded that the Service's definition of "unfunded" was a good starting point,[9] it has been clear almost from the beginning that the ERISA definition of "unfunded" is not necessarily the same as the Service's "economic benefit" concept. Whether or not the plan is "unfunded" for income tax purposes, "unfunded" may also include an ERISA concept of participant "beneficial ownership interest" generated by the operation and communication of a plan.[10] This difference means that plan designers must carefully design and structure the plan to thread the path between *both* the Service's definition and the ERISA definition in order to assure both the desired income tax deferral and ERISA exemption results. Those who follow only the Service's definition put at the risk the desired plan design consequences of their plan.

The problem is that a nonqualified plan may become "funded" for ERISA purposes as a consequence of the actual plan structure and operation, notwithstanding the language in the plan document. And if the nonqualified plan is determined to be "ERISA-funded" (because the plan provides a participant with a real or beneficial interest in a specific fund, account or property) the participant should become currently taxable for income tax purposes.[11] If participants have a real or beneficial interest in a specific fund or property, the plan benefits should thereby be deemed sufficiently escrowed and secured, for income tax purposes, to be taxable under the economic benefit theory.[12]

How could a nonqualified plan become "funded" for ERISA purposes by its structure and operation? This result may occur if the company (through its plan communication and day-to-day functioning of the plan) suggests or implies to the participant that he or she has a beneficial interest in specific property apart from the general assets of the employer, instead of an "unsecured promise to pay."[13] Of course, the starting point to guide the desired results is the plan document, and the ownership and beneficiary provisions of any accounts or property in which the employer invests to support the liabilities created by the plan. If not done, or done improperly, a participant might actually get a *real* and not just a beneficial interest in property acquired by the company in connection with a plan.[14] Proper, clear plan documentation goes a long way toward minimizing the risk of unintended consequences.[15]

However, the plan document may not be the final stopping point.[16] What if the Participant receives periodic plan communications[17] that suggests and/or poorly disclaims a participant property interest in

supporting accounts and assets? Moreover, what if the plan arrangement gives a participant the ability to change the actual investment account or property with the fund provider in virtually the same administrative manner applicable to a 401(k) plan, or personal brokerage account?[18] At some point on the ERISA continuum the participant may obtain more than an unsecured interest in a specific account(s) or asset(s). The result will depend on the plan language and disclaimers (or the lack of them), and upon plan communications and the actual day-to-day operation of the plan.

The Risk Continuum - High Risk to Low Risk Nonqualified Plan Arrangements

So which nonqualified plans arrangements are at most risk under this analysis? In the authors' view, the most obvious ones are nonqualified plans using a financing arrangement in which "the account is the fund is the account", frequently referred to as "401(k) bookkeeping."[19] Under this type of arrangement, the plan frequently gives a plan participant the right and the ability to contact the account holder/fund manager and make direct changes to his or her own individual account/investment fund. In effect, there is no "hypothetical account" actually operating and the plan appears and operates for a participant virtually like a 401(k) plan. [20] The risk is even higher if the account holder/investment fund manager for the plan administrator provides the same or substantially similar account/fund reporting to a plan participant that it would provide to a non-plan investment fund client. The risk is further elevated if the account holder/investment fund manager for the plan provides no consolidated, aggregate reporting of the plan accounts and liabilities to the plan sponsor. Finally, in the authors' view, the risk is even greater if, in addition, the plan also provides (without adequate disclaimers) the same fund or investment prospectuses to participants that would be given to 401(k) plan participants or nonplan investment purchasers. In summary, if the plan actually operates in direct contradiction to the plan's contractual language, there is a significant risk the plan maybe "funded" for ERISA purposes, notwithstanding conservative language in the plan document.[21]

What nonqualified plans are least at risk of being "funded' for ERISA purposes? Applying the above analysis, the plans least at risk are both drafted conservatively and have participant bookkeeping accounts that are truly "hypothetical". Under such plan arrangement, a Participant's changes to an account are reflected in changes to the "hypothetical" account crediting index. There is no automatic change in the actual underlying plan investments. Any adjustment of the company's actual investments for the plan may only be instigated by the employer, and may or may not follow the change on an account-by-account basis.[22] Moreover, the risk is likely further minimized to the extent the company's own separate funding is done on an aggregate basis (not account-by- account) and not necessarily changed in the same time frame as individual plan participants. [23] Thus, the actual operation of the plan and financing arrangements clarify the distinctness of the plan and financing arrangement, and support rather than challenge the contractual language of the nonqualified plan document.

"Self-directed" Participant Investment Accounts Push the Limits

This brings us full circle. What are the issues for self-directed accounts in nonqualified plans under this analysis? The complex plan administration for self-directed plans is probably best handled using the 401(k) plan bookkeeping arrangement where the "account is the fund is the account." However, as we have discussed, this nonqualified plan arrangement is the riskier financing arrangement on our risk continuum. Further, in a plan using 401(k) bookkeeping, especially when a plan participant can act directly on the investment account itself, the self-directed accounts become <u>participant specific and individualized</u> to the point it may be difficult to argue that the participant is *not* looking to specific property for the satisfaction of his or her benefit. Thus, there is the maximum risk with this plan financing arrangement that the plan with a self-directed account feature would be deemed "funded" for ERISA purposes and subsequently for income tax purposes as well.[24]

The nonqualified plan should therefore be done in the lower risk "hypothetical" plan financing arrangement if a self-directed feature is desired. However, the complexity of any reasonable size plan makes use of this approach more difficult. An employer will be challenged to monitor and respond with its corporate investments to match multiple individual self-directed investments unless the administrative system is closely tied to the movement of individual participant accounts. It's one thing for a company to address substantial participant mutual fund equity investments, since the company knows equities have averaged about 12% over a long-time horizon, and can invest to parallel or even outperform them over a long time horizon. However, it's quite another thing for a company to address a participant's potential individual investment in a single equity that might move up (or down) 300% in a single year, unless the company's investment closely tracks the specific participant's investment. At a minimum, dual accounting systems should be used, if the separate hypothetical participant account and corporate investment account are to move in lock-step, to minimize the adverse ERISA and tax risks generated by a self-directed plan feature.

Conclusion

Although neither the DOL nor the Service has spoken directly to self-directed account features, in the authors' opinion there is a significant risk that a nonqualified plan with a self-directed account feature would be deemed "funded" for ERISA purposes. If "funded", then it would be currently taxable to a participant. While this self-directed investment design is statutorily enabled to be part of a qualified 401(k) plan, the same is *not true* for a nonqualified plan. The very nature of this self-directed investment feature can jeopardize the ERISA and tax consequences of the plan. The "account is the fund is the account" 401(k) bookkeeping approach to nonqualified plans already increases the risk of adverse ERISA and income tax consequences, especially if not carefully constructed. Therefore, the addition of a self-directed investment account may be "the straw that breaks the camel's back," causing the plan with this structure to go over the line on the risk continuum.[25] The lower risk nonqualified plan arrangement with true "hypothetical" participant accounts appears the preferred platform, but the asset/liability-matching problem is a practical problem that must be adequately resolved to comfortably install this feature. With either approach, plan designers must proceed carefully with both total plan documentation and the actual plan financing arrangement when a self-directed feature is desired in a nonqualified plan.[26]

For more information or questions concerning this article, contact either of the authors as noted below:

Louis R. Richey, JD, is co-author of *Comprehensive Deferred Compensation, 3rd Edition,* published by National Underwriters of Cincinnati, Ohio. He has authored or co-authored more than 100 books and articles on executive and employee benefit topics, and is a frequent speaker at financial service industry seminars and conferences. Lou is an attorney, consultant, and quality expert with more than 25 years experience marketing, designing and implementing executive and employee compensation and benefit plans products and services. He is currently a Principal with the Magner Financial Network (with headquarters in Atlanta, GA), an Internet provider of financial service sales-enabling applications and support found at www.Magner.net. He may be reached at LRR@magner.net.

Michael A Swirnoff, LD, LLM, is co-author of *Taxation and Funding of Nonqualified Deferred Compensation,* 1998, published by the Real Property, Probate and Trust Section of the American Bar Association. He is the retired CEO of a major executive benefits consulting firm and has more than 25 years experience in the field. He speaks frequently at law and insurance conferences, seminars and

meetings, and has authored numerous articles and other publications on benefits topics. Mike currently runs his own benefits consulting and marketing practice and expert witness service. With offices in Minneapolis, MN and La Jolla, CA, he may be reached at (612) 377-4173 in Minneapolis, and at (858) 459-9474 in La Jolla, or MSwirn@aol.com.

This article is designed to provide accurate and authoritative information in regard to the subject matter covered. However, it is provided with the understanding that the authors are not engaged in rendering legal, accounting or other professional services. If legal or other expert assistance is required, the services of a competent professional person should be sought.

---

[1] These differences are *real* and *important* as evidenced by a "Question & Answer Session" at a recent (November, 1999) ABACLE executive benefit conference attended by one of the authors. During the session, a senior counsel for the IRS commented that a nonqualified "mirror" plan and qualified plan "*must* be looked at separately" to determine the income tax consequences, since qualified plans have statutory delayed distribution election authority under IRC § 401(a)(9) and nonqualified plans do not. He specifically reminded the audience that "none of these rules (qualified plan tax rules) apply to nonqualified deferred compensation plans." He made these comments in response to a question about using a qualified 401(k) plan's distribution election provisions to automatically govern a nonqualified "mirror" plan's distribution. He suggested there was a serious "constructive receipt" issue for the nonqualified plan by the facts presented in the question.

[2] The development of the so-called "Rabbi Trust" grantor trust and other security devices (e.g., "partial forfeiture" provisions and indemnity insurance) to better secure the unsecured nonqualified plan is an example of this plan design push.

[3] *See generally*, IRC, § 401(a), and Employment Retirement Income Security Act of 1974 (hereinafter "ERISA"), TITLE III. To be "qualified," plans must comply with the "exclusive benefit rule" of Section 401(a) and "funding" requirements of ERISA, TITLE III.

[4] *See* Rev. Rul. 61-30, 1960-31, 1960-1 C.B. 174 (general discussion of income tax consequences of nonqualified deferred compensation), modified by Rev. Rul. 64-279, 1964-2, C.B. 121, and Rev. Rul. 70-435, 1970-2 C.B. 100; and, ERISA, § 301. In contrast to qualified plans, which are subject to extensive and specific statutory and regulatory requirements, nonqualified plans are primarily the product of the common law, including court cases and IRS rulings. For an excellent digest of this complex area, *see also* McNeil and Brisendine, "Structuring Nonqualified Deferred Compensation", *Journal of Deferred Compensation,* Vol. 4, No. 2, p. 70 et seq. (1999). The corporate income tax deduction is deferred until the benefit is actually or constructively received in the case of a nonqualified plan.

[5] Although there were numerous transition rules, ERISA (P.L. 93-406) became generally effective in 1975 for new plans. Prior to 1975, tax requirements were the primary requirements to obtain the current income tax deduction for pension plans. ERISA was primarily focused on the issue of the funding of plans seeking to claim tax-advantaged "qualified plan" status, hence the name "Employee Retirement Income Security Act of 1974" ("ERISA"). Prior to that date many pension plans were unfunded or substantially under-funded. The mandatory funding of such pension promises was one of the primary motivations for Congressional action.

[6] *See* ERISA, § 4(b)(5) as to an "excess benefit plan"; and ERISA, §§ 201(2), 301(a)(3), and 401(a)(1); and ERISA, Reg. § 2520.104-23, as to a "select group". An ERISA "top hat" group is a "select group of management and highly compensated employees". An "unfunded" ERISA plan would be one without "plan assets" in ERISA terminology.

[7] The "economic benefit" and "constructive receipt" doctrines might be thought of the opposite sides of the same coin. The economic benefit doctrine derives from Code Section 61(a) that requires the taxation of "all income from whatever source derived, including compensation for services." In the *Smith Case* [*see* 324 US 177 (1945) at 181], the Court said Section 61(a) "is broad enough to include in taxable income any economic or financial benefit conferred…." This doctrine has been codified in Code Section 83, the section taxing transfers of "property" in connection with the performance of services. For an excellent recent discussion of the "economic benefit" doctrine, *see* McNeil and Lloyd, "The Other Sister: The Economic Benefit Doctrine" *Journal of Deferred Compensation*, Vol.5, No. 1, Fall, 1999, pp. 59-72.
In contrast, IRS Regulation Section 1.451-2(a) describes the constructive receipt doctrine as follows:

> *(a)* *General rule.* Income although not actually reduced to a taxpayer's possession is constructively received by him in the taxable year during which it is credited to his account, set apart for him, or otherwise made available so that he may draw upon it at any time, or so that he could have drawn upon it during the taxable year if notice of intention to withdraw had been given. However, income is not constructively received if the taxpayer's control of its receipt is subject to substantial limitations or restrictions. Thus, if a corporation credits its employees with bonus stock, but the stock is not available to such employees until some future date, the mere crediting of the corporation does not constitute receipt.

The courts rarely distinguish clearly between these two concepts in their opinions, and the finding of an ascertainable "economic benefit" typically brings with it a "constructive" taxable receipt of income. However, this issue of "funding" (segregation of assets) would most appropriately be discussed as one of whether there is an ascertainable "economic benefit" *on the income tax side.*

[8] IRC, § 451; Reg. §§ 1.451-2(a) and 1.446-1(c)(1)(i); Rev Rul. 60-31, 1961-1 C.B. 174, modified by Rev. Rul. 64-279, 1964-2 C.B. 121, and Rev. Rul. 70-435, 11970-2 C.B. 100. *See also* Rev. Rul. 71-19, 1971-1 CB 698, as amplified by Rev. Proc. 92-65, 1992-2 CB 428 outlining the Service's letter ruling position.

[9] The Department of Labor (hereinafter "DOL") has never defined the term "unfunded" as used in the ERISA exemptions in regulations, although it has had a project to do so occasionally, going back as far as 1979 [*See* Prop. DOL Reg. 29 CFR 2550.401b-1 (44 FR 50363, August 28, 1979; modified 45 FR 38084, June 6, 1980) that would have clarified the meaning of "plan assets" for purposes of Title I; hence defining "unfunded", but the regulation as proposed was never finalized]. ERISA does not require the DOL to use tax law definitions, and it has not done so to date. In the Manfreda Letter (From Elliot Daniel at the

DOL to Richard Manfreda at the IRS), dated December, 13, 1985 (concerning the ERISA consequences of using "Rabbi Trusts" to hold company assets in connection with nonqualified plans), the DOL said, "In the absence of legislative history…the positions adopted by the Service regarding the tax consequences… should be accorded significant weight under Title I." *But see* footnote 11.

[10] Dependahl v. Falstaff Brewing Corp., 491 F.Supp. 1188 (E.D. Mo. 1980), *Aff'd.* 653 F.2d 1208 (8th Cir.); DOL Adv. Op. 81-11A (Jan. 16, 1981). *Consider* Belka v. Rowe Furniture Corp., 571 F. Supp. 1249 (D Md. 1983); Belsky V. First National Life Insurance Company, 818 F.2d 661 (8th Cir. 1987); and Darden v. Nationwide Mutual Insurance Co., 717 F. Supp. 388 (E.D. NC. 1989) for court thinking about Dependahl.

In the Manfreda Letter written to the IRS, concerning the ERISA consequences of the use of "Rabbi Trusts", the DOL said, "The Department is generally of the view that any determination of the "funded" or "unfunded" status of a plan of deferred compensation requires an examination of the facts and circumstances, including the status under relevant non-ERISA law". *See also* DOL Adv. Op. 91-16A (April 5, 1991). Interestingly, in a footnote to one of its advisory opinions concerning the identification of "plan assets" for welfare plans, the DOL has since added confusion to this issue by suggesting that the analysis for determining ERISA "plan assets" is different than determining whether a plan is "funded" or "unfunded" for pension plans. However, it didn't clarify how that analysis would be different. The existence of the footnote suggests the DOL is concerned that additional clarification regarding the identification of "plan assets" will destabilize their position expressed to the IRS in the Manfreda Letter that the use of "Rabbi Trusts" in connection with nonqualified pension plans does not create a funded ERISA plan. [*Consider* DOL Adv. Op. 94-31 A, (Sept. 9, 1994), note 3]. *Also consider e.g.,* Dependahl v. Falstaff Brewing Corp. 491 F.Supp. 1188 (E.D. 1980), *Aff'd* 653 F.2nd 1208 (8th Cir.).

[11] *Consider* Daniel Letter, March 7, 1985 from Richard Manfreda of the IRS to Elliot Daniel at the DOL asking specific questions concerning the impact of ERISA, Title I on nonqualified plans supported by Rabbi Trust (This letter generated the "Manfreda Letter" discussed above). *Also consider* Dependahl v. Falstaff Brewing Corp., 491 F.Supp 1188 (E.D. 1980), *Aff'd* 653 F2d 1208 (8th Cir.) re: ERISA; and, Frost v. Com'r, 52 T.C. 89 (1969), and Goldsmith v. U.S., 586 F.2d 810 (Ct. Cl. 1978) re: income taxation. *Also consider* DOL Adv. Op. 81-11A (January 16, 1981) wherein the DOL said the assets acquired in connection with a nonqualified plan would not be "plan assets." The DOL's conclusion was based upon a listing of corporate representations that included a statement that there "would be no representation to any participant or beneficiary" that only the assets in question (life insurance contracts) would be used to provide the plan's benefits. It should be noted that the DOL expressed no opinion as to the relative importance of any one representation made by the corporation over another as to its conclusion. However, in light of the fact the DOL opinion was given post *Dependahl* (Dist. Ct. decision), this representation should probably should be accorded some weight.

[12] *Consider* Frost v. Com'r, op. cit. and Goldsmith v. U.S., op. cit. *Also see generally* IRC § 83. If the transaction ceases to be an "unsecured promise to pay", it may effectively become an IRC §83 "transfer of property". The risk of the employer's insolvency is not a "substantial risk of forfeiture" under Code § 83(c).

The authors would suggest that the ERISA beneficial interest concept should, in fact, parallel the income tax law "economic benefit" and/or Section 83 "beneficial ownership" concept. That is, the participant's interest in the property rises to a taxable level if substantial economic benefit, or "beneficial ownership" (to use the Section 83 language) is conferred, even though he or she may not possess full legal title. An analogous transaction might be real estate (a house) given to an executive for his or her use by an employer. The employee does not have title or receive title to convey, but possesses sufficient other rights (dominion and control, use and economic enjoyment) over such property so as to be currently income taxable on its economic value (the lease value in the case of real property). *See* IRC § 83(b).

[13] The Courts seem to go two directions on this important issue. One direction is represented by the 3rd Circuit Appellate Court in Dependahl V. Falstaff Brewing Corp. The Court said, "funding implies a res separate from the ordinary assets of the corporation. **** The employee may look to a res separate from the corporation…." In effect, the court asked, "Can the plan participants and beneficiaries look to separate property for the payment of the benefits?"

This might be characterized as the "ERISA plan asset" direction. The second direction is the two-part test suggested by the District Court in Northwestern Mutual Life Insurance Co. V. Resolution Trust Corp., 848 F.Supp. 1515, (E.D. Ala. 1994) at 1517. It said "[t]he essential feature of a funded plan is that it's assets are segregated from the assets of the employer and are *not available to general creditors if the employer becomes insolvent*"(court's emphasis). The Court in Miller v. Heller, op. cit. at p. 660 phrased this approach into the following question, "[C]an the beneficiary establish, through the plan documents, a legal right any greater than that of an unsecured creditor to a specific set of funds from which the employer is, under the terms of the plan obligated to pay the deferred compensation?" This might be characterized as the "economic benefit doctrine" direction. For an excellent more detailed discussion of these issues, *see* Goldstein, Swirnoff, and Drennan, "Taxation and Funding of Nonqualified Deferred Compensation", *American Bar Association* (Real Property, Probate and Trust Law Section), 1998, pp.129-132.

[14] U.S. v. Drescher, 179 F.2d 863 (2nd Cir. 1950). The employee was held to have received taxable "economic benefit" equal to the annuity deposits when the employer purchased an annuity and named the employee the beneficiary. Misnaming the owner and/or beneficiaries on a life insurance contract or mutual fund or brokerage account should produce the same result.

[15] For court-approved language, *see* Belsky v. First National Bank of Vermont, 818 F.2d 661 (8th Cir. 1987). However, contract language may or may not be finally determinative, depending upon the *"parol evidence rule"* under the law of contracts applied. The 3rd Circuit Court of Appeals, in In re New Valley Corporation, 89 F.3d. 143 (3rd Cir. 1996), *Cert. Denied* 1175 S.Ct. 947(1997), determined the Federal common law of contracts should be applied to nonqualified plans, and said, "cases which limit employees strictly to the terms of the plan document are inapposite. **** Applying the federal common law of contracts, we believe that the bankruptcy court erred in construing the plan documents. A Court cannot interpret words in a vacuum, but rather must carefully consider the parties' context and other provisions of the plan. Moreover, *extrinsic evidence* should have been considered in determining whether an ambiguity existed, especially in the absence of an integration clause."(Emphasis added). *Also Compare* Dependahl v. Falstaff Brewing Corp., op. cit. to Miller v. Heller 915 F. Supp 651 (S.D.N.Y.).

[16] *See* footnote 16.

[17] E.g., annual enrollment materials, mutual fund prospectuses, account statements.

[18] This participant authority to act directly on the investment accounts apparently bothers the Service, regardless of the ERISA impact. An IRS official indicated the Service may look at the participant's "dominion and control" over specific assets acquired in connection with a plan (especially when the participant can designate investments inside a "Rabbi Trust") as giving rise to currently taxable "economic benefit". *See* "Directed Investments in Rabbi Trusts May Create Tax Problems", *Washington Report, AALU Bulletin.* No. 94-107 (Dec. 1994). For a thorough discussion and treatment of the IRS's "dominion and control" theory and the income tax issues of investment selection with reference to nonqualified plans, *see generally* Brisendine, "Selection of Investment Options Under Nonqualified Plans: Is There A Problem?", *Benefits Law Journal*, Vol. 1, Spring 1998, p.81.

[19] The advantage is that the plan asset and liability are exactly equal at all times on an individual account-by-account basis just as it would be in a qualified 401(k) plan. This type plan (commonly with multiple "401(k)-like fund" accounts) will really focus this ERISA issue, since most plans litigated to date have been in the lower risk structure with a hypothetical index and distinct separate investments.

[20] The only exception is in the case when the plan uses 401(k) bookkeeping but is totally "unfunded". That is, the employer will not set assets aside in connection with the plan, but plans to pay benefits from future company cash flows using the "pay-as you-go" approach. Only in this rare case will the participant accounts operate as truly "hypothetical." The plan document commonly provides that the plan administrator (trustee) is not obligated to follow such participant directions (especially when these investment accounts are held by a Rabbi Trust) if 401(k) bookkeeping is used.

[21] The authors' experience is that many mutual fund houses, brokerage houses, (and some 401(k) administrators, and some insurance company plan designs) handle their nonqualified plan business this way. Language and disclaimers in prototype plan, communication and enrollment materials (by those who provide them) that have been reviewed by the author are often inadequate or marginally adequate to minimize this risk. Moreover, some standard form participant

statement reporting language the authors have seen is defective (using qualified plan "for the benefit of" language on the participant statement). This situation is likely the result of designers and administrators who have a qualified plan [401(k)] background and orientation and may actually be using their 401(k) administrative systems without modification. In the authors' view, nonqualified plans using 401(k) bookkeeping require more extensive, complete and precise disclaimers than plans with true hypothetical accounts to reduce the risk discussed in this article. For example, it may be wise to add a clear statement in the plan document and any plan summary that the participant's ability to directly and actually make changes to his or her own individual investment account is *not* a suggestion that he or she has any "beneficial ownership interest" in that account. Such a statement should not be necessary in a nonqualified plan with true hypothetical accounts.

[22] In this case there is a separate and distinct set of real investment fund accounts and a separate accounting system for them independent of the participants' "hypothetical" accounts, and the tracking of the plan's general assets, acquired in connection with a plan, can be set up independently of the participants' accounts.

[23] E.g., participants might be allowed to change their allocations daily, but the company might normally adjust its plan investments monthly or quarterly.

[24] *See* footnote 19. The Service might reach this conclusion on its own based upon "dominion and control" theories. In addition, this "single-bucket" 401(k) bookkeeping approach means a loss of any opportunity to build-in attractive nonqualified plan design features like in-service educational distributions and fixed future year distributions. These features can provide more distribution flexibility than is generally available under a 401(k) qualified plan.

[25] Or, at least the plan sponsor may conclude the risk is too great based upon its assessment of its own risk posture.

[26] Nonqualified plan designers and administrators will also probably wish to have adequate discussion with and make proper disclosure of these issues and risks to the sponsoring client before incorporating a self-directed account feature into a nonqualified plan.