WRMarketplace
An AALU Washington Report

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The *WRMarketplace* is created exclusively for AALU Members by the AALU staff and Greenberg Traurig, one of the nation's leading tax and wealth management law firms. The *WRMarketplace* provides deep insight into trends and events impacting the use of life insurance products, including key take-aways, for AALU members, clients and advisors.

TOPIC: Constructive Receipt and Economic Benefit Principles in Deferred Compensation Arrangements Planning.

MARKET TREND: With high-earning executives increasingly focused on income tax planning, deferring compensation often will be a primary objective. Taxpayers and advisors will need to understand fundamental principles of income taxation to effectively implement deferred compensation arrangements as a part of the overall tax plan.

SYNOPSIS: Individuals pay taxes not only on amounts actually received, but also on amounts they constructively receive, as well as the value of any economic benefit conferred upon them. This report provides an overview of how these principles of taxation are applied, particularly with regard to compensation deferral.

TAKE AWAYS: A fundamental understanding of the tax principles relating to constructive receipt and economic benefit will enable an advisor to better navigate the challenges of deferred compensation planning for his or her clients.

PRIOR REPORTS: 12-32, 09-42, 09-12, 08-108, 07-44, 07-37, 04-135, 04-133.

MAJOR REFERENCES: *IRC §409A, IRC §83, Treas. Reg. §1.415-2.*

With recent increases in federal income taxes, including the raising of the highest marginal income tax rate to 39.6% and increased Medicare taxes on both earned and unearned income, individual taxpayers have increased their focus on income tax planning. In particular, high-level executives and key employees will be particularly interested in methods to defer their compensation in order to better manager their increased income tax liability. In analyzing the availability and benefits of any specific tax planning arrangement, including deferred compensation plans, taxpayers and their advisers must understand two fundamental principles of federal income taxation that determine the timing of the recognition and taxation of income – "constructive receipt" and "economic benefit." This *Washington Report* provides an overview of the salient aspects of these two basic principles and is the first in a series of three reports that discuss key concepts relevant to the effective deferral of income and income taxation.

CONSTRUCTIVE RECEIPT

Generally. IRC §451 provides that, generally, "the amount of any item of gross income shall be included in the gross income for the taxable year ***in which received by the taxpayer***" (*emphasis added*). Receiving income for this purpose, however, does not require that the taxpayer actually receive or take possession of the income. A taxpayer can effectively (even if not actually) receive and be taxable on income within the meaning of the statute through the concept of "constructive receipt." Treasury regulation §1.451-2 defines "constructive receipt" as follows:

> 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*** (*emphasis added*).

Application to Deferred Compensation Planning. Over the years, the IRS attempted to establish specific guidelines as to whether an arrangement to defer compensation would avoid constructive receipt of the income deferred. The enactment of IRC §409A in 2004 codified much of this constructive receipt guidance as part of an overall framework that severely restricts the deferral of compensation and the payment of deferred compensation.

IRC §409A is complex and will be discussed in greater detail in a future *Washington Report* in this series. For purposes of the constructive receipt doctrine, IRC §409A states that an election to defer compensation generally must be made before the beginning of the calendar year in which the services for which the compensation is earned are performed. In addition, an election to defer compensation until a specific date generally cannot be amended unless the further-deferral election is made at least twelve months in advance of the date originally set for payment and defers payment by at least an additional five years. Relatedly, the date originally established for payment cannot be accelerated except under a very limited number of circumstances specified in regulations.

Because IRC §409A imposes significant penalties for failure to comply, and because its requirements will, in most cases, cause an amount deferred to avoid being constructively received, there is typically less attention paid now to the concept of constructive receipt. But there may be circumstances in which an IRC §409A-compliant arrangement will actually give rise to constructive receipt of amounts deferred, as determined under the constructive receipt regulations. Thus, it remains important to keep this fundamental tax principle in mind when developing deferred compensation arrangements. In that regard, the previous guidance of the IRS may be helpful, specifically their focus on the following aspects of the constructive receipt regulations:

1. **Taxpayer Generally Must Make Deferral Election in Prior Year.** As the regulations provide that an amount is constructively received "in the taxable year during which" the taxpayer could access the money, the IRS has attempted to take the position that an

amount would be constructively received, and therefore taxable, in the first year in which the taxpayer could get the money. Therefore, the IRS generally took the position that an amount was not constructively received in a particular year if the deferral election was made ***before*** the beginning of the taxpayer's taxable year (generally, the calendar year) in which the services were performed. For instance, if a taxpayer wanted to defer an amount earned in 2014, the election to defer the income had to be made before the end of 2013 (limited exceptions were available for newly established plans and newly eligible plan participants).

2. **Taxpayer's Ability to Accelerate or Defer Previously Scheduled Payment Date Is Limited.** Questions arose as to whether the ability of a taxpayer to change the date previously set for payment of his or her deferred compensation gave rise to constructive receipt. The IRS refused to issue rulings on these questions, so it was left to practitioners to determine an approach that balanced the taxpayer's needs against the risk that the deferred amounts would be considered constructively received and, therefore, taxable. In making this assessment, many looked to the regulations providing that an amount is not constructively received if the taxpayer's control of the receipt of it was subject to substantial limitations or restrictions. Thus, one might decide that a further deferral election was permissible if it were made at least six months before the participant was scheduled to receive the distribution, or that a participant could accelerate the distribution of his or her deferred compensation if there was a "haircut" imposed on the distribution (*i.e.*, a forfeiture of a portion of the balance of the participant's deferred compensation account).

ECONOMIC BENEFIT

Generally. Another tax principle that is relevant in connection with the effective deferral of compensation is the "economic benefit" doctrine. Under this principle, even if an individual does not actually or constructively receive an item of income, he or she will have taxable income if an economic benefit is conferred upon him or her. Examples of arrangements that gave rise to taxation under the economic benefit doctrine include the establishment of an escrow account or a trust funded with an amount intended to be used to make a payment to an individual in the future, and that cannot be accessed by the grantor's creditors or used for any purpose other than the payment to the beneficiary of the trust or escrow account. Similarly, the purchase of an annuity or insurance contract for the benefit of an employee but held by the employer in a manner that is insulated from claims of the employer's creditors and prevents the contract from being used for any other purpose will be considered to confer an economic benefit on the employee, thereby subjecting him or her to current taxation.

Application to Deferred Compensation Planning. Based on the economic benefit doctrine and its application through IRC §83, current taxation under a deferred compensation plan may be avoided in the following cases:

1. **There Is a "Substantial Risk of Forfeiture."** IRC §83, which defines the tax treatment of the payment of compensation in the form of "property," effectively reflects the "economic benefit" doctrine. It states that an individual is taxable on the fair market value of property transferred to him or her as compensation when the property is transferred to him or her or, if later, when the individual's rights to the property cease to be subject to a ***substantial risk of forfeiture***. For this purpose, property ceases to be

subject to a substantial risk of forfeiture when the property right transferred "***vests***," which typically occurs when the person is not required to perform any more services for the transferor of the property.

2. **There is an Unfunded or Unsecured Promise to Pay Compensation.** Perhaps the most significant IRC §83 concept to note in the deferred compensation context is that the applicable regulations define "property" as including "real and personal property other than either money or an unfunded and unsecured promise to pay money in the future…." In other words, a "funded" or "secured" promise to pay money in the future is property. Because participants in most deferred compensation arrangements do not want to subject the amounts they defer to a substantial risk of forfeiture, the effective deferral of income taxation requires ensuring that the promise to pay the compensation in the future is not "funded" or "secured."

   The IRS has never given a clear definition of when a promise to pay money is "unfunded" or "unsecured." In creating a "model" rabbi trust, which is a vehicle used to set aside amounts ultimately to be used to pay deferred compensation obligations (and which will be the subject of a separate *Washington Report* in this series), the IRS issued a revenue procedure indicating they would treat a promise to pay money in the future as "unsecured" so long as the assets set aside in the trust remain subject to the claims of the general creditors of the employer that established the trust. Accordingly, care must be taken in structuring any vehicle in which amounts may be set aside to pay or hedge an employer's deferred compensation obligations to avoid shielding those amounts from the reach of the employer's general creditors.

CONCLUSION

Executives are increasingly interested in income tax planning, particularly methods to defer compensation. Accordingly, a fundamental understanding of how to structure deferred compensation arrangements to avoid constructive receipt and economic benefit is critical for an advisor to assist clients. Key components in avoiding current taxation under these principles include compliance with IRC §409A requirements regarding the employee's elections to defer compensation, and proper structuring of the deferred compensation plan so that it is subject to a substantial risk of forfeiture or is unfunded and unsecured promise to pay (*i.e.*, the plan assets are subject to the claims of the employer's creditors).

In the event that this Washington Report is also considered to be a "marketed opinion" within the meaning of the IRS guidance, then, as required by the IRS, please be further advised of the following:

THE ABOVE ADVICE WAS NOT WRITTEN TO SUPPORT THE PROMOTIONS OR MARKETING OF THE TRANSACTIONS OR MATTERS ADDRESSED BY THE WRITTEN ADVICE, AND, BASED ON THE PARTICULAR CIRCUMSTANCES, YOU SHOULD SEEK ADVICE FROM AN INDEPENDENT TAX ADVISOR.

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WRM 13-41 was written by Greenberg Traurig, LLP
Jonathan M. Forster
Martin Kalb
Richard A. Sirus
Steven B. Lapidus
Rebecca Manicone

Counsel Emeritus
Gerald H. Sherman 1932-2012
Stuart Lewis 1945-2012