

THE DEMISE OF THE RABBICULAR TRUST

I. INTRODUCTION

Recently, the Internal Revenue Service ("IRS" or "Service"), through Thomas Brisendine,¹ Branch 1 Chief of the Office of Associate Counsel for Employee Benefits/Exempt Organizations, announced that it would take an adverse position² on deferred compensation arrangements commonly known as Rabbicular Trusts.³ The announcement is a blow to the purveyors of these plans, given the high-stakes nature of the Service's position, and litigation is almost certain to follow.⁴ This Recent Development examines the implications for non-qualified deferred compensation planning if the Service fails to halt the use of Rabbicular Trusts. The Recent Development also analyzes the principles upon which this issue will ultimately be decided in litigation.

II. IF THE RABBICULAR TRUST SURVIVES—IMPLICATIONS FOR THE HIGHLY COMPENSATED EMPLOYEE

In order to appreciate the significance of the Rabbicular Trust debate, it is first necessary to understand the current options available for deferred

1. Meegan M. Reilly, *Updated Guidance on Nonqualified Plans, Split-Dollar Arrangements Unlikely*, *Brisendine Says*, 68 TAX NOTES 1457 (1995). The Associate Counsel's office, of which Thomas Brisendine is the Chief Counsel, is responsible for providing taxpayer guidance on specific questions relating to contemplated actions. This guidance may take several forms; however, the most common is the Private Letter Ruling. A Private Letter Ruling is a binding commitment by the Service that if the facts are exactly as the taxpayer presents them, the Service will treat the arrangement in the agreed-upon fashion for tax purposes. Private Letter Rulings are both fact-intensive and expensive, and provide no precedential support to similarly situated taxpayers absent their obtaining a similar ruling. I.R.C. § 6110(j)(3) (1994).

2. An adverse position indicates that the Service will refuse to issue favorable rulings on these plans and will demand current inclusion of income attempted to be deferred through the use of such an arrangement. An adverse position is not an immutable stance, because it may be challenged either directly or through a refund suit. However, a statement of an adverse position is a strong indication of the Service's interpretation of the law. See DOUGLAS A. KAHN, *FEDERAL INCOME TAX: A STUDENT'S GUIDE TO THE INTERNAL REVENUE CODE* 11 (3d ed. 1994).

3. The Rabbicular Trust is a creation of St. Louis attorney Michael Goldstein of the firm Husch & Eppenberger. Reilly, *supra* note 1, at 1457. The term Rabbicular Trust is a Registered Service Mark of Husch & Eppenberger. *Id.* The use of a Service Mark to denote an employee deferred compensation vehicle is more than a little unusual and has drawn bemused comment both from representatives of the Service and from other practitioners. See Lee A. Sheppard, *Substance and Form and 'Rabbicular' Trusts*, 70 TAX NOTES 349 (1996). Mr. Brisendine himself uses a mocking hand-signaled quotation mark when using the term in his own talks to the practitioner community.

4. For a discussion of the potential benefits of a positive ruling on the Rabbicular Trust, see *infra* Part II.D.

compensation,⁵ and how these choices would be affected by the use of a Rabbicular Trust. The currently available options considered will be limited to the two most common nonqualified deferral arrangements:⁶ the secular trust⁷ and the rabbi trust.⁸ The Rabbicular Trust will then be contrasted to these currently approved arrangements in both its technical differences and the practical implications of its use.⁹

A. *The Secular Trust*

The secular trust is a device whereby an employer pays compensation directly into trust for payment to its employee at some future date.¹⁰ At all times after payment into trust, the trust funds are reserved for the exclusive benefit of the employee,¹¹ the employee has a vested right to the future

5. As discussed in this Recent Development, deferred compensation refers exclusively to plans which are not "qualified" under I.R.C. § 401(a). Nonqualified plans are nonetheless governed by the provisions of ERISA. Employee Retirement Income Security Act of 1974, Pub. L. N. 93-406, 88 Stat. 829, § 3(3) (1976) (codified as amended in 29 U.S.C. § 1002(3) (1994)). However, they are not generally subject to some of the more onerous administrative regulations, such as many of the reporting provisions, due to their status as "Top Hat" plans. A "Top Hat" plan is one that benefits only a select group of highly compensated employees ("HCEs"). The definition of what exactly constitutes an HCE is rather vague; however, it is clear the employees considering the use of rabbi and Rabbicular Trusts, ostensibly because they have exceeded the \$30,000 limit on qualified plan contributions, I.R.C. § 401-409 (1994), fall within this HCE classification. "ERISA exempts . . . unfunded arrangement[s] 'primarily for the purpose of providing deferred compensation for a select group of management or highly compensated employees.'" James C. Dinan, *Nonqualified Deferred Compensation Plans Get A Boost*, 22 TAX'N FOR LAW. 324, 331 (1994) (citing ERISA §§ 201(2), 301(a)(3), 401(a)(1), 29 U.S.C. §§ 1051(2), 1081(a)(3), 1101(a)(1) (1994)).

6. The distinction between qualified and nonqualified deferral arrangements is beyond the scope of this Recent Development. For a full discussion of the distinction between the two types of deferral arrangements, see C. Wells Hall III, *Nonqualified Deferred Compensation: Rabbi and Secular Trusts*, CA17 ALI-ABA 779 (1995).

7. The specifics of the secular trust are outlined in greater detail *infra* Part II.A.

8. The specifics of the rabbi trust are outlined *infra* Part II.B. The rabbi trust began with Priv. Ltr. Rul. 81-13-107 (Dec. 31, 1980). The name "rabbi trust" stems from the fact that the taxpayer who requested the ruling was a rabbi. *See id.*; *Service to Resume Ruling on Rabbi Trusts*, 65 J. TAX'N 108, 108 (1986). In the often colorful world of the tax attorney, the alternative arrangement, under which benefits are secured for the employee, has been dubbed a "secular trust."

9. *See infra* Part II.C. The main distinction between a Rabbicular Trust and a rabbi trust is the presence of financial performance "vesting triggers." *See infra* notes 26, 31 and accompanying text.

10. The trust is created and funded by the employer. The exact terms of the trust vary; however, there is no requirement that the employee attain retirement age for distribution. In fact, many such arrangements defer benefits only for a period of years. This result follows from the nonqualified nature of the plans, under the Internal Revenue Code and the exemptions of ERISA. I.R.C. § 401(a) (1994); ERISA § 401(a), 29 U.S.C. § 1101(a) (1994).

11. These benefits are immediately vested, with no possibility of forfeiture. This result is contractual, since the employer has funded the arrangement with funds set aside solely for the

payments of this income, and the assets are protected against the claims of the firm's unsecured creditors in the event of an insolvency.¹² Because only the timing of receipt is affected,¹³ an interest under a secular trust is considered "property" transferred in connection with the performance of services for purposes of § 83(a) of the Internal Revenue Code (I.R.C.),¹⁴ and is therefore taxable to the employee when earned.¹⁵ Since these contributions are paid for

employee's benefit. See generally Hall, *supra* note 6. It is in fact this "ownership" of the assets, or more precisely the absence of a substantial risk of forfeiture, that results in current income tax liability for the assets when earned. I.R.C. § 83(a) (1994); Treas. Reg. § 1.83-3(e) (as amended in 1985).

12. Early variations of secular trusts included restricted stock plans, insurance, and other insundry annuity plans. These efforts met with mixed success in litigation against the Service. The success of restricted stock plans in achieving deferral led to the adoption of I.R.C. § 83 by Congress in 1969. See WILLIAM A. KLEIN & JOSEPH BANKMAN, *FEDERAL INCOME TAXATION* 399-410 (10th ed. 1994).

13. See *supra* notes 10-11. Timing of receipt relates directly to the doctrine of constructive receipt which is discussed *infra* note 15.

14. I.R.C. § 83(a) states that:

(a) If, in connection with the performance of services, property is transferred . . . the excess of—

- (1) the fair market value of such property . . . [when the] property [rights] are transferable or are not subject to a substantial risk of forfeiture . . . over
- (2) the amount (if any) paid for such property, shall be included in the gross income of the person who performed such services. . . .

I.R.C. § 83(a).

Noticeably absent from this analysis is a discussion of the economic benefit doctrine. This is a common-law doctrine which developed through a series of court cases. See, e.g., *Sproull v. Commissioner*, 16 T.C. 244 (T.C. 1951), *aff'd per curiam*, 194 F.2d 541 (6th Cir. 1952). The purpose of the economic benefit doctrine was to stymie the efforts of taxpayers to achieve deferral by cleverly drafting around the constructive receipt doctrine, discussed *infra* note 15. See, e.g., *United States v. Drescher*, 179 F.2d 863 (2d Cir.), *cert. denied*, 340 U.S. 821 (1950) (taxing annuity contract to employee despite employer's purchase and the non-alienability of the employee's interest); *Robinson v. Commissioner*, 44 T.C. 20 (T.C. 1965) (preventing the application of the constructive receipt doctrine through a taxpayer-engineered, arms-length transaction).

While there is nothing to suggest that this policy concern is not still present, there is support for the contention that I.R.C. § 83, adopted in 1969, may have codified the elements of the economic benefit doctrine and effectively replaced it. This view has been widely championed in academic publications. See, e.g., Bruce Wolk, *Discrimination Rules for Qualified Retirement Plans: Good Intentions Confront Economic Reality*, 70 VA. L. REV. 419 (1984).

For an excellent discussion of the Service's position on the economic benefit doctrine and the application of I.R.C. § 83(a) to rabbi trusts, see Dinan, *supra* note 5, at 326-28. Dinan also discusses constructive receipt. See *infra* note 15.

15. I.R.C. §§ 61(a), 63(a), 451 (1994). I.R.C. § 61(a) defines gross income as "all income from whatever source derived . . ." I.R.C. § 63(a) defines taxable income as "gross income minus the deductions allowed by this chapter (other than the standard deduction)." I.R.C. § 451 provides that the proper year of inclusion is "the taxable year in which received by the taxpayer . . ." Treasury Regulation § 1.45-1(a) (1996) includes income "actually or constructively received." Additionally, regulation § 1.446-1(c)(1)(I) (1996) relating to the cash method of accounting also states that "[g]enerally . . . all items which constitute gross income . . . are to be included for the taxable year in

the employee's sole benefit, they are also deductible by the employer when paid into the trust.¹⁶ The earnings of the monies placed in the secular trust are taxed at the corporate rate while so held.¹⁷ With the exception of the first few years following the Tax Reform Act of 1986 (the "1986 Act"),¹⁸ corporate tax rates have been lower than the top marginal individual rates,¹⁹ making the tax savings on the trust earnings the engine driving the use of secular trusts.²⁰

B. The Rabbi Trust

The rabbi trust is similar in operation to the secular trust. However, unlike the secular trust, rabbi trust assets held by the company are not protected against the claims of the company's general unsecured creditors.²¹ Thus, if the company were to become insolvent, it is possible that the deferred compensation placed in the rabbi trust would never be paid to the employee²²

which actually or constructively received." See also Rev. Rul. 60-31, 1960-1 C.B. 174, examples 1-3 (giving examples of actual and constructive receipt).

16. I.R.C. §§ 162(a)(1), 404(a) (1994); Treas. Reg. § 1.404(a) (1996).

17. I.R.C. § 404(a) (1992); Treas. Reg. §§ 1.404(a)-1 to 1.404(k)-1T (1996). This follows from the more general "matching" principle. I.R.C. § 404(a) (1994). See also *Drescher*, 179 F.2d at 541 (6th Cir. 1952) (articulating matching of income with regard to an annuity). The matching principle is a device designed to ensure that income does not escape taxation. See generally *supra* note 11. Thus, if income is not currently taxable to the employee, it is not deductible by the employer except for qualified plans. I.R.C. § 401(a) (1994) (establishing requirements for qualified plans). In the case of the rabbi trust, see *infra* Part II.B, the employer is not permitted a deduction because the employee is allowed deferral until and to the extent that the employee includes the compensation in taxable income.

18. Tax Reform Act of 1986, Pub. L. No. 99-514, 100 Stat. 2085 (codified as amended in scattered sections of 26 U.S.C.). The 1986 Act dramatically flattened the progressive marginal individual income tax rates and replaced them with a two-tiered rate structure. See *infra* note 20.

19. See *infra* note 20.

20. Of course, to the extent the employer's tax rate is below that of the employee's, there is a net tax benefit on the trust income. Were the income taxed to the employee, the higher personal rate would apply. However, if the income is taxed to the employer, the employee pays less taxes to the extent that the employee avoids the difference between the higher personal income tax rates and the lower corporate rates. After the 1986 revision of the tax rates, individual top rates fell below the corporate tax rate for the first time in recent memory—since at least the Korean War. While subsequent changes in the tax code have pushed the top rates above the corporate rate again, these increases are not nearly the incentive that 50% and 70% top rates were for the use of secular trusts. See Hall, *supra* note 6, at 783-84. Currently, the top rate for up to \$250,000 in annual income is 36%, I.R.C. § 1 (1994), only 2% above the large corporate rate of 34%. I.R.C. § 11 (1994). For individual incomes over \$250,000, the top rate increases to 39.6%, I.R.C. § 1 (1994), a differential of 5.6% over the corporate rate. This is precious little compensation for the rigidity inherent in a secular trust arrangement.

21. E.g., KAHN, *supra* note 2, at 149. For a discussion of the characteristics of the secular trust, see *supra* Part II.A.

22. KAHN, *supra* note 2, at 149. The possibility of loss is not a certainty even in the event of corporate insolvency. The requirements of Rev. Rul. 60-31, *supra* note 15, examples 1-4, and Rev. Rul. 70-435, 1970-2 C.B. 100 (modifying Rev. Rul. 60-31, example 5), requiring a substantial risk of

but would instead be used to satisfy the claims of the company's general unsecured creditors.²³ This difference is significant in two ways. First, the risk of loss removes rabbi trust interests from the ambit of I.R.C. § 83(a) "property," resulting in the exclusion of the deferred compensation from the employee's income until actual receipt.²⁴ Second, the resulting risk also renders these plans less attractive to the very types of companies that regularly utilize nonqualified deferred compensation arrangements.²⁵

There have thus been a number of efforts to capture both the tax deferral benefits associated with the rabbi trust and the security of the secular trust in one instrument. The Rabbicular Trust is one example of this effort.

C. The Rabbicular Trust

The Rabbicular Trust seizes upon a feature of the rabbi trust known as a "triggering event" or a "vesting trigger"²⁶ in an attempt to adhere to the required form of the rabbi trust²⁷ while increasing the security of the assets so held. Rabbi trust interests, which are not protected from the employer's creditors, vest in the employee and are placed out of the reach of the employer's creditors upon the occurrence of a triggering event.²⁸ Triggering

forfeiture, do not require that the employee must risk loss of everything.

23. KAHN, *supra* note 2, at 149. However, the employees do have some recourse in case of employer insolvency. Under Chapter 11 of the Bankruptcy Code, 11 U.S.C. §§ 1101-1174 (1994), the employees would have claims as general unsecured creditors of the firm, and would in fact have some priority among such creditors. 11 U.S.C. § 507(a)(3) (1994). However, since the employees still remain in the pool of unsecured creditors, it is almost certain that the employees would be paid less than full value, probably receiving only pennies on the dollar.

24. Priv. Ltr. Rul. 81-13-107, *supra* note 8 (permitting the first rabbi trust).

25. Companies that regularly utilize nonqualified compensation arrangements often include smaller, more entrepreneurial companies, in which there are typically greater degrees of risk than other types of companies. *But see* Alexander Cockburn, *Glass-Steagall and the Fall of the House of Barings*, SEATTLE TIMES, Mar. 2, 1995 (trading activities of a lone trader financially destroyed one of the oldest, and most prestigious, major securities firms), available in 1995 WL 5002748.

26. In a discussion of a Rabbicular Trust, the term "vesting trigger" does not refer to vesting as prescribed by I.R.C. §§ 401(a), 411 (1994) or ERISA § 3(25), 29 U.S.C. § 1002(25) (1994). Instead, "vesting trigger" is a defined term referring to events that trigger the transformation of the interest from unsecured to secured for purposes of I.R.C. § 83(a) (1994). Examples of permitted triggers are discussed *infra* at notes 29-30 and accompanying text.

27. *See* Priv. Ltr. Rul. 81-13-107, *supra* note 8 (upholding the viability of the instrument). This Recent Development assumes that rabbi trusts, as discussed, meet the Service's requirements as set forth in Rev. Proc. 92-64, 1992-2 C.B. 422. One model provision given by the Service requires that "[a]ny assets held by the [rabbi] Trust will be subject to the claims of the Company's general creditors under federal and state law in the event of Insolvency, as defined in Section 3(a) herein." *Id.* at 424 (emphasis added).

28. The conversion from a rabbi trust to a secular trust involves the elimination of the

events contemplated by the Service include death, disability, and the employee's voluntary or involuntary separation from service.²⁹ In addition, the Service has approved triggering events that rely on the mere passage of time or the employee's attainment of a certain age.³⁰ The Rabbicular Trust would extend the breadth of these triggering events to include declining financial prospects for the employing company.³¹

A Rabbicular Trust uses the required model format for a rabbi trust³² but, in the optional trigger section,³³ it adds vesting triggers based upon the occurrence of a financial event involving the company. Examples of the

"substantial risk of forfeiture" provision. The elimination causes the secular trust to fall within I.R.C. § 83(a) and thus funds within it are treated as income. The secular trust funds are held by the employer solely for the employee's benefit. See *supra* notes 10-11. The general unsecured creditors of the firm have no ability to claim these funds in the event of the employer's insolvency. Thus, with regard to these funds there is no substantial risk of forfeiture.

29. See Priv. Ltr. Rul. 92-33-005 (May 8, 1992); *infra* note 30. An interesting side issue involving the Rabbicular Trust looks to the vesting triggers as a factor in a bankruptcy case. The court would determine if the "vesting" of the trust constitutes a preference in favor of the employee, and if it is thus subject to being set aside by a bankruptcy court. The court would almost certainly set aside the trust. Such an action would make the drafting of Rabbicular Trust triggers an even more skillful exercise, because to protect the employee's interest the trigger must not only vest the benefits prior to bankruptcy, but must do so at least one year prior to the bankruptcy filing. See 11 U.S.C. 507(a)(3)(8) (1994). Designing such a trigger that would not be so sensitive to short-term financial crises as to vest employees' interests prematurely is another topic altogether, if Rabbicular Trusts are in fact a viable arrangement.

30. Priv. Ltr. Rul. 92-05-033 (Nov. 6, 1991) (occurrence of a specific event); Priv. Ltr. Rul. 92-27-020 (Apr. 1, 1992) (passage of time triggers). Additionally, Priv. Ltr. Rul. 92-03-018 (Oct. 18, 1991) includes several distinct triggers, while Priv. Ltr. Rul. 94-03-008 (Oct. 19, 1993) includes none. The Service has not commented on the number of permitted triggers, probably because the triggers so far permitted do not affect the fundamental tax features of the trust.

31. A financial performance trigger behaves no differently from the garden variety triggers of death, disability, or change of control. For a discussion of the garden variety triggers, see *supra* notes 26-30 and accompanying text. However, financial performance triggers depend upon events relating to the company as opposed to those relating to the employee, which are the basis for the garden variety triggers. An important area of overlap between the permissible triggers and the financial performance trigger is the change of control provision. This change of control trigger focuses on an event unrelated to the employee's control and is expressly permitted. Rev. Proc. 92-64, 1992-2 C.B. 422, 424, § 1(e) (laying out the model trust).

The clear difference between previously allowed triggers and financial performance triggers is their purpose. The permissible triggers, including the change of control trigger, were designed to protect the interests of the employee from frustration by those with whom she did not bargain. In contrast, a financial performance trigger works to secure benefits prior to the issuing company's descent into bankruptcy. From a policy perspective, this purpose is not beneficial, because financial performance triggers seek to indemnify the employee from the very risks that allowed income deferral in the first instance. See *supra* note 29 (concerning the practical limits imposed by the Bankruptcy Code, 11 U.S.C. §§ 1101-1174 (1994)).

32. Rev. Proc. 92-64, *supra* note 27 (giving a model format for rabbi trusts).

33. Rev. Proc. 92-64, 1992-2 C.B. 424.

additional financial triggers include a drop in the company's stock price or a negative change in a company's financial ratios.³⁴ The Rabbicular Trust could utilize one or more of these devices.³⁵ However, the goal would remain the same: to protect the deferred compensation from loss due to company insolvency.³⁶ The question is whether this protection drags the deferred compensation back under the I.R.C. § 83 definition of property—similar to a secular trust³⁷—or whether model provisions given by the Service³⁸ permit these arrangements to qualify for deferral of compensation like rabbi trust interests. Although the Service has indicated that the first position is appropriate,³⁹ not all indicators support that conclusion.⁴⁰

D. The Impact on Deferred Compensation of an Approved Rabbicular Trust

Before the 1986 Act, when the top marginal individual tax rates were significantly higher than corporate rates,⁴¹ the secular trust afforded an attractive deferred compensation device for highly compensated employees (“HCEs”).⁴² Currently, however, the minute gap between top individual tax rates and corporate rates⁴³ tends to reduce the attractiveness of a secular

34. Negative changes in a company's financial ratio could occur, for example, in either the price to earnings ratio or the debt coverage ratio. However, a discussion of the appropriate use of financial performance ratios to properly insulate the trust assets from corporate insolvency is beyond the scope of this Recent Development. For an excellent discussion of the appropriate use of financial ratios in evaluating corporate performance, see DIANA R. HARRINGTON & BRENT D. WILSON, *CORPORATE FINANCIAL ANALYSIS* (1983).

35. The particular measure of a company's financial health is well beyond the scope of this Recent Development. The measures used to illustrate are simply well known financial yardsticks, and are by no means either the best or the most effective triggering standards.

36. Once the concept of the financial trigger is approved, there will be little principled basis for distinguishing between either the type of trigger or the number of triggers. *See supra* note 30 (discussing the use of varying amounts of currently allowed triggers in approved rabbi trusts).

37. *See supra* notes 11-15 and accompanying text.

38. Rev. Proc. 92-64, *supra* note 27.

39. *See IRS Official Discusses Nonqualified Plan Issues*, PENSION & BENEFITS WEEK, Dec. 13, 1993, at 2, 3.

40. *See, e.g.*, Priv. Ltr. Rul. 95-08-014 (Nov. 22, 1994) (permitting a net worth trigger); Priv. Ltr. Rul. 93-44-038 (Aug. 2, 1993) (permitting an insurance policy on a rabbi trust without affecting ability to defer tax liability).

41. *See supra* notes 18-20 and accompanying text.

42. Highly compensated employees are eligible for so-called “Top-Hat” benefit plans under ERISA. *See supra* note 5.

43. *See supra* note 20. The current difference between top individual rates and corporate rates is a mere 5.6% for individuals in the top bracket (39.6% versus 34%). I.R.C. §§ 1, 11 (1994). For all other individuals—those earning less than \$250,000 per year in adjusted gross income—the corporate

trust.⁴⁴ The decline in secular trust popularity has resulted in the vastly increased use of rabbi trusts for HCEs.⁴⁵ However, the risk requirements of the rabbi trust⁴⁶ have made benefits available unevenly,⁴⁷ and have lessened the value of deferral under these arrangements to the HCEs involved.⁴⁸ An approved Rabbicular Trust would dramatically reshape the nonqualified deferred compensation landscape, potentially rendering ordinary rabbi trusts obsolete and secular trusts even more unattractive.⁴⁹

Skillful use of financial performance vesting triggers in the design of Rabbicular Trusts should effectively eliminate any real possibility that trust assets would be lost in the event of company insolvency.⁵⁰ Thus, the Rabbicular Trust would boast both the desired deferral of the HCEs income and a high degree of protection for the deferred compensation. All but the most risk averse would thus be provided a significant incentive to utilize

tax rates are lower by only 1% or are greater than the individual rates. *Compare* I.R.C. § 1 (1994) with I.R.C. § 11 (1994).

44. Secular trust monies are taxed at corporate rates, and thus the greater the differential between corporate and individual tax rates, the more attractive the secular trust becomes. *See supra* note 17 and accompanying text.

45. For a discussion of the current trend in executive deferred compensation planning, see generally Hall, *supra* note 6.

46. Treas. Reg. § 1.83-3(e) (1996) (not including in definition of property “unfunded or unsecured promise to pay . . . in the future”). For a discussion of the definition of property in evaluating the tax treatment of deferred compensation, see Karen B. Kotner & David G. Shipp, *Unfunded Deferred Compensation: I.R.S. Provides Model Rabbi Trust and Consolidates Ruling Requirements*, 20 TAX MGMT.: COMPENSATION PLAN J. 215 (1992).

47. Benefits are available unevenly because the risk of loss is dependent on the employment setting. Often large corporations with strong balance sheets present little risk of insolvency. The little risk makes the benefits of the rabbi trust more attractive and valuable to the large corporations’ employees. Most corporate plan sponsors with strong balance sheets and good bond ratings present little actual risk of forfeiture for their rabbi trust holding employee. *But see supra* note 25 (noting the Barings disaster, which demonstrated that even the most secure of firms can become insolvent quickly).

48. The value of future benefits, like those received under a rabbi trust, is a function of the discount rate applied. This is a statement, not of tax law, but of basic principles of present value. The discount rate is further a function of the business risk. *See HARRINGTON & WILSON, supra* note 34, at 63-65. Since riskier companies will require the application of higher discount rates, their employees will value deferral at a lower amount than the employees of more stable companies. *Id.*

49. The secular trust is not likely to go away altogether, because of the bankruptcy risk, *see supra* note 29, and the risk aversion of some employees, *see infra* notes 50-53 and accompanying text.

50. While a complete discussion is beyond the scope of this Recent Development, suffice it to say that short of an instantaneous disaster—such as afflicted Barings, *supra* note 25—skillfully applies financial ratio triggers should be able to detect any decline in the underlying financial condition of the granting employer in plenty of time to allow for vesting of interests. *But see supra* note 29 (noting the one-year requirement of vested interests for protection from Bankruptcy laws).

Rabbicular Trusts in place of secular trusts.⁵¹ Rabbi trust beneficiaries would have even greater incentives to switch instruments,⁵² because the addition of financial vesting triggers to existing plans would provide added benefits in the form of increased asset security.⁵³ In addition, Rabbicular Trusts would virtually eliminate the need for, and would certainly lower the cost of, private insurance for rabbi trust interests.⁵⁴ The Service, perhaps fearing just such a gold rush, has declared that the protections of the Rabbicular Trust do in fact go too far to qualify these interests for deferral of tax liability until actual receipt.

III. IS THE SERVICE'S ANNOUNCED POSITION A PRINCIPLED ADDITION TO THE CURRENT NONQUALIFIED DEFERRED COMPENSATION POLICY?

Given the potential impact of the Rabbicular Trust,⁵⁵ it is nearly certain that challenges to the Service's position will soon follow.⁵⁶ Present Service ruling positions on related issues—private insurance for rabbi trust interests⁵⁷ and a rabbi trust utilizing a net worth financial performance vesting trigger⁵⁸—call into question the ability of the Service to draw the line at Rabbicular Trusts.⁵⁹ However, inconsistent ruling positions are a poor basis for predicting litigation success.⁶⁰ The policy underlying the interpretation of “property” for purposes of I.R.C. § 83(a) indicates that the Rabbicular Trust may not survive the Service's announcement of its demise.⁶¹

51. See *supra* notes 43-48, *infra* note 52 and accompanying text.

52. Actually, adding the desired triggers to the existing instrument would not require a true “switching” of instruments. Modifications of rabbi trusts are permitted under current law. Moreover, the addition of financial vesting triggers would not require the establishment of a new trust but merely a modification to the existing trust. See *supra* note 31 (discussing the financial vesting trigger of the Rabbicular Trust).

53. By definition, the other aspects of the trust would be unchanged. See *supra* note 52 and accompanying text (describing the change from a rabbi trust to a Rabbicular Trust); Rev. Proc. 92-64, *supra* note 27 (establishing a model rabbi trust).

54. Priv. Ltr. Rul. 93-44-038, *supra* note 40.

55. See *supra* Part II.D.

56. In fact, at a seminar sponsored by the St. Louis Bar Association, the holder of the Rabbicular Trust Service Mark indicated, in spoken remarks to Mr. Brisendine, that litigation would be forthcoming on this issue.

57. Priv. Ltr. Rul. 93-44-038, *supra* note 40.

58. Priv. Ltr. Rul. 95-08-014, *supra* note 40.

59. See *supra* note 40.

60. Cf. *Crummy v. Commissioner*, 397 F.2d 82 (9th Cir. 1968) (Service arguing unsuccessfully on behalf of itself and the Tax Court before the Ninth Circuit).

61. In addition, the Service has indicated through the remarks of Thomas Brisendine that it will not rule on Rabbicular Trust plans in the near future. Reilly, *supra* note 1. There has not been any

A. Private Insurance for Rabbi Trust Interests

In Private Letter Ruling (“Priv. Ltr. Rul.”) 93-44-038,⁶² the Service permitted an employee to defer income recognition under a rabbi trust arrangement when the employee had secured, without the assistance of the employer,⁶³ private insurance against the failure of the rabbi trust interest due to the employer’s insolvency.⁶⁴ The Service ruled that so long as the individual, and not the company, procured the insurance, then the assets paid into trust were still available to the firm’s general unsecured creditors.⁶⁵ Because of that inherent possibility of loss, deferral of that employee’s tax liability was appropriate until the benefits were actually received by the employee.⁶⁶ While this ruling has been attacked as unprincipled for arguably removing all actual risk of loss,⁶⁷ the ruling differentiates this case by

direct challenge on this issue. Moreover, the confidential nature of the private letter ruling process makes it all but impossible to determine when this issue will be raised before the Service.

62. *Supra* note 40.

63. It is the lack of a transfer between the employer and the employee that permits this exception to exist at all. Arguably, employer participation would involve just such a transfer, and thus would defeat deferral of tax on the deferred compensation paid to trust.

Another point here is that the employer did not *have* to be involved. This ruling concerned a publicly traded corporation with a Standard and Poor’s bond rating of AA or better. The Service focused on the fact that the information gathered by the insurer was publicly available. This seems to draw a questionable distinction between taxpayers who work for financially sound companies and those who do not. Viewed from the tax policy end, however, this distinction appears to create an insupportable result. Employees who arguably receive deferred compensation that is subject to very little risk, and therefore much closer to property under § 83(a), are allowed to take the next incremental step and secure the income absolutely via insurance, without tax consequences. Were this feat attempted by those actually subject to a substantial risk of forfeiture, that is, those employees whose employers had not obtained this premium bond rating, they would be subject to severe tax consequences. *See* Priv. Ltr. Rul. 93-44-038, *supra* note 40.

64. *Id.* It does not appear that this ruling is limited by when the insurer agrees to pay, or under what circumstances. Rather, it appears that the sole issue is the employer’s involvement in the procurement of the insurance. Thus, if the employer agreed to reimburse the employee subsequent to the purchase of the insurance (which was in fact the case), there is no effect on the deferral decision. *Id.*

65. *Id.*

66. *Id.* This determination focuses only on the transfer of assets from employer to employee. *See infra* notes 69-71 and accompanying text.

67. Priv. Ltr. Rul. 93-44-038, *supra* note 40. The Service found that the insurance arrangement in question did not affect the underlying rabbi trust. It is important to note, however, that this type of insurance guarantees that the employee will receive the deferred income in the future. A principled application of I.R.C. § 83(a) focuses only on whether property has been transferred. *See* I.R.C. § 83(a) (1994); Treas. Reg. § 1.83-3(e) (1996). In making this assessment, the regulations make an allowance for “promise[s] to pay money or property in the future,” not because these are preferred transfers, but because of the quite real problems associated with valuing a promise. Treas. Reg. § 1.83-3(e) (1996). The problem of valuation is wholly eliminated once the substantial uncertainty is removed. The

examining on whom the risk of loss requirement operates under I.R.C. § 83(a).⁶⁸

The Service's position in Priv. Ltr. Rul. 93-44-038 implies that the payor company (the employer) must shoulder the risk of loss.⁶⁹ This position is premised on the I.R.C. § 83(a) language requiring inclusion in gross income of "[p]roperty transferred in connection with [the] performance of services."⁷⁰ So long as the company plays no role in obtaining or purchasing the insurance, then in the event of the company's insolvency, no transfer will have taken place from the company to the employee.⁷¹ Therefore, the contingency precluding inclusion of the rabbi trust interest under the I.R.C. § 83(a) definition of property remains intact.⁷² The fact that the employee is no worse off in cases of the employer's insolvency is not considered in the Service's analysis.⁷³ While the insurance payout to the employee is income under I.R.C. § 61(a),⁷⁴ it was not paid by the company for the performance of services. Instead, the payout is the result of an independent contractual arrangement between the employee and the insurer.⁷⁵ Thus, private insurance secured by the employee against company insolvency meets the technical requirements for deferral of tax on the property until actual receipt.

The Rabbicular Trust fails to divorce two critical elements: company insolvency and payout to the employee. Thus, the Rabbicular Trust does not fit under the narrow exception created by the insurance ruling. While it is true that the result to the employee is the same—receipt of the deferred compensation in the event of insolvency—the payor is different.⁷⁶ Under a

Service's myopia, focusing on the party eliminating the uncertainty rather than on the party receiving the property, leads to a bizarre tax result in this case.

68. Priv. Ltr. Rul. 93-44-038, *supra* note 40. However, I.R.C. § 83(a) (1994) and Treas. Reg. § 1.83-3(e) (1996) do not discuss any such requirement.

69. The inference is based on the Service's distinction between the case of employee-provided security, which is permissible, and employer-provided security, which is not. *See* Priv. Ltr. Rul. 93-44-038, *supra* note 40.

70. I.R.C. § 83(a) (1994); *see supra* note 63.

71. *See supra* notes 63-64, 67, 69.

72. *See* I.R.C. § 83(a) (1994); Treas. Reg. 1.83-3(e) (1996) (excluding "unfunded and unsecured promise[s]").

73. Although, arguably, it should be. *See supra* notes 67, 69.

74. I.R.C. § 61(a) (1994) (including in gross income "income from whatever source derived").

75. *See* I.R.C. § 83 (1994); *supra* notes 67-69.

76. The difference in payor is not a trivial distinction. Under the terms of I.R.C. § 83(a) (1994), it is only transfers of property for the performance of services that are covered. When the insurance company pays, it is merely fulfilling a contractual obligation, the insurance policy, and is not compensating the employee directly for services rendered. *See supra* notes 63-75 and accompanying text.

Rabbicular Trust, the company “transfers property” in connection with the rendering of services by the employee and thus meets the technical inclusion grounds of I.R.C. § 83.⁷⁷ Any argument in support of extending the insurance exception to cover the Rabbicular Trust would therefore be counterproductive.⁷⁸ While the insurance ruling arguably represents an attack on the policy and principles underlying I.R.C. § 83,⁷⁹ it nonetheless supports the conclusion that the Rabbicular Trust is not a viable instrument for tax deferral of income.

B. Net Worth Trigger Discounted

Far more troubling for the Service’s position is the recent ruling in Priv. Ltr. Rul. 95-08-014,⁸⁰ approving a plan that uses model rabbi trust language⁸¹ and a vesting trigger based upon a decline in the net worth of the company.⁸² Nothing distinguishes this plan from the Rabbicular Trust, except for possibly degree.⁸³ Thus, without any technical grounds for distinguishing the net worth trigger from the Rabbicular Trust, the Service appears to attack Rabbicular Trusts in one breath and approve them in the next.⁸⁴ Arguably, the net worth trigger no longer represents the Service’s ruling position and will be unsupported in future ruling requests.⁸⁵ Given the absence of precedential

In the insurance case, the payor is an independent third party, the insurer, who makes the payment to the employee. In the case of a Rabbicular Trust, the payor is always the company that created the trust. By the terms of a Rabbicular Trust, the conversion from a rabbi trust to secular trust occurs at the direction of the company prior to insolvency. *See supra* note 28. There is no third-party contract; thus, the argument for deferral in the insurance context is not present in the Rabbicular Trust context.

77. I.R.C. § 83(a) (1994); *see supra* note 63.

78. This is true since any argument that shifts the focus of the risk of loss requirement, *see supra* note 67, from the employer to the employee would necessarily defeat the fragile exception permitted in the case of third-party insurance, *see supra* notes 67-69 and accompanying text.

79. *See supra* notes 67-68. If § 83 is read as requiring that a contingency exist if the income is to be excluded, the private insurance situation in which all contingency is removed would seem to conflict with § 83.

80. *Supra* note 40.

81. Rev. Proc. 92-64, *supra* note 27.

82. The ruling contains an example of a financial performance vesting trigger, *see supra* note 31, because the event resulting in termination of the rabbi trust interest is independent of the employee and instead dependent on the employer.

83. In a Rabbicular Trust, as envisioned, numerous triggers would be utilized by the employer to reduce default risk, not just one.

84. This ruling issued from Division 4, while Thomas A. Brisendine, the author of the Service’s position, is from Division 1. *See Reilly, supra* note 1.

85. *See supra* note 61 and accompanying text.

value accorded letter rulings,⁸⁶ and given that the Service has recently come out against the Rabbicular Trust,⁸⁷ the existence of the ruling approving a net worth vesting trigger may give hope to proponents of the Rabbicular Trust. However, the ruling probably provides little useful ammunition for the litigation ahead.

IV. A LOOK TOWARDS LITIGATION: THE ARGUMENTS FOR AND AGAINST THE RABBICULAR TRUST

With the Service set to resist employers' efforts to achieve income deferral through the use of Rabbicular Trusts, the final test of the viability of these plans will almost certainly be conducted in the courts.⁸⁸ Proponents of the Rabbicular Trust argue that the existence of *any* risk of forfeiture precludes inclusion of the trust under I.R.C. § 83's definition of property.⁸⁹ These proponents stress that financial ratio triggers merely lessen, but do not eliminate, the potential for plan default due to insolvency.⁹⁰ The Service, on the other hand, argues that the test of I.R.C. § 83 requires a quantifiable measure of risk, not a mere possibility of failure. From a litigation perspective, the Service's argument finds more support in the plain language of the statute, congressional intent, and the policies underlying I.R.C. § 83.⁹¹ Thus, the Service will likely prevail at the litigation stage of this dispute.

The critical chink in the armor of Rabbicular Trust proponents is the language of the regulations covering I.R.C. § 83. Specifically, the problem lies in the language discussing property transferred to the employee for the performance of services.⁹² The Rabbicular Trust side must argue that Rabbicular Trust interests are not "property" for purposes of I.R.C. § 83(a) because, absent employer insolvency, there will not be a transfer to the

86. By law, Private Letter Rulings are valid only as to the taxpayer requesting them, and only on the facts as presented to the Service. I.R.C. § 6110(j)(3) (1994). Many rulings have been abandoned after an initial favorable response. It is difficult to see why this will not also be the case with the net worth trigger ruling if the Service so decides.

87. See *supra* note 1 and accompanying text.

88. The challenge will likely arise through the denial of deferral in a test case, because the Service may well refuse to rule on Rabbicular Trusts specifically.

89. See I.R.C. § 83(a) (1994); Treas. Reg. § 1.83-3(e) (1996).

90. Technically, this is correct. However, the test is *substantial* risk of forfeiture, a point conveniently ignored by the proponents of the Rabbicular Trust. See *supra* note 22.

91. See *supra* notes 67-68 and accompanying text.

92. I.R.C. § 83(a) (1994); see *supra* notes 14, 63.

employee.⁹³ The argument relies on the proposition that the Service must either declare that all interests subject to the slightest contingency of non-payment fall outside the definition of property contained in I.R.C. § 83, or evaluate every Rabbicular Trust plan on the facts of the underlying triggers employed to determine if enough uncertainty exists to warrant deferral of the employees' tax liability until actual payment.⁹⁴ Neither of these positions is likely to gather much support among the judiciary.

The first position is insupportable precisely because the courts have not defined property so narrowly in any other context within the I.R.C.⁹⁵ Under the proponents' theory of property, even secular trusts would qualify for deferral, since the possibility exists that payments will not be made due to embezzlement or some other equally improbable reason. And, while it may well be argued that rabbi trust interests are not all equally subject to default,⁹⁶ it is difficult to conceive of a court excusing willful subversion of congressional intent on the basis that the enacting provisions of the I.R.C. fail to achieve universal fairness.

The second proposition is equally shaky. Under a fact-specific regimen, the Service would be forced to examine every plan to determine whether, given the mix of financial ratio triggers—and the possible combinations border on the infinite—a real possibility of default through insolvency exists.⁹⁷ This is not only administratively unworkable, it is unthinkable that the Service would ever be charged with making such business-specific judgments.⁹⁸ No support exists for the proposition that Congress ever contemplated such a role for the Service, nor is there policy support for

93. See *supra* notes 76-79 and accompanying text.

94. See *supra* note 17.

95. No cases were discovered at the Tax Court or appellate levels giving such a narrow definition of property either for income or estate and gift tax purposes. See, e.g., *Sproull v. Commissioner*, 16 T.C. 244 (1951), *aff'd per curiam*, 194 F.2d 541 (6th Cir. 1952).

96. See *supra* note 47. An example of the possible inequality would be the general preference for a General Motors rabbi trust over a start-up, bio-tech, rabbi trust interest, all else being equal.

97. The Service's evaluation would ostensibly require a specific determination of some allowed amount of default risk (say 20%), which among other things, would result in a contest to determine how close to that standard compensation planners could draft. Equally as difficult would be the articulation and administration of the standard.

98. Any business judgment by the Service would be a direct comment on the management of the underlying firm. A judgment by the Service disallowing a debt-to-equity trigger would imply that the Service did not feel that the firm was viable below that debt-to-equity threshold. The Service is ill-equipped to make such business-specific determinations and, as a matter of policy, should not be placed in that position.

implementing one.⁹⁹ In fact, in an effort to avoid business-specific judgments, the Service has established model approved instruments.¹⁰⁰ Yet, absent such a fact-specific analysis, the Service would be left without any principled basis to distinguish between appropriate and inappropriate uses of financial ratio vesting triggers.

The courts, like the Service, will likely attempt to draw the line at protections written into the plans by their creators, employers.¹⁰¹ This decision will necessarily involve a retreat from the net worth ruling;¹⁰² however, such a distinction between types of protections is fully consistent with the plain language of I.R.C. § 83 and with Congress's intent to tax income from services in the period earned unless presented with a significant uncertainty.

V. CONCLUSION

While it may always be true that clever tax attorneys will stay one step ahead of the Service in exploiting the infirmities of the Internal Revenue Code, this maxim is no guarantee of ultimate success. In the case of the Rabbicular Trust, the simple extension of the vesting trigger concept to encompass financial performance considerations of the issuing company has proven to the Service, and will prove to the courts, that the reported demise of the Rabbicular Trust is by no means greatly exaggerated.

Karl Dickhaus

99. The Service is, supposedly, in the revenue collection business exclusively.

100. See, e.g., Rev. Proc. 92-64, *supra* note 27.

101. See *supra* note 30.

102. Priv. Ltr. Rul. 95-08-014, *supra* note 40.

