

# Designing Deferred Compensation for Maximum Distribution Flexibility – the Automatic Re-deferral System

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## The Distribution Flexibility Problem

Over the last several years deferred compensation plans have increasingly been designed with innovative distribution devices, particularly “haircut” provisions, which increased the flexibility and liquidity of plans. By triggering the haircut provision an employee can access account values at any time as long as he/she is willing to pay a penalty (usually 10%). This access provides substantial comfort to an employee who is concerned that the money might be needed before a scheduled distribution date, or who is concerned about the possibility of losing money in a corporate bankruptcy.

Also, plan sponsors have always derived comfort from the ability to manage financial crises through plan termination. Historically, companies that have envisioned a looming financial crisis and the potential for insolvency have been able terminate a plan and distribute assets to the plan participants. Generally, as long as the plan termination and distribution precede bankruptcy by 12 months, the assets are protected from the claims of corporate creditors.

The rules under new Section 409A, though, are specifically designed to limit participant access to accounts. Specifically, the prohibition on acceleration of benefits has eliminated the haircut provision for deferrals beginning January 1, 2005. Also, after December 31, 2005, a company will be unable to terminate a plan (even a plan that has been grandfathered and whose document allows termination), as the termination will be considered a material modification and the distribution an acceleration of benefits, creating sizable taxes, penalties and interest.

Let’s review the major provisions of 409A. The major impact of Section 409A on traditional deferred compensation can be summarized as impacting plans in four major areas. The first three areas are generally viewed as more restrictive than before, while the fourth is considered a liberalization of the rules:

1. **Deferral Elections:** With limited exceptions for performance-based compensation, deferrals must be made in the year prior to the year in which the compensation is earned.
2. **Distribution Elections:** The time and form of distribution must be determined at the time of deferral.
3. **No Acceleration of Benefits:** Other than a few exceptions, there cannot be any acceleration of the time or schedule of distribution.
4. **Rules Governing “Re-deferrals”:** The time and form of distribution may be delayed (“re-deferred”) as long as the re-deferral election is made at least 12

months before the scheduled distribution, and the subsequent distribution must be for at least an additional 5 years. Significantly, there is *no limit* placed on the number of re-deferrals a participant can make.

How, then, can a plan be designed today that provides the maximum in benefit flexibility and liquidity? How can a company mitigate the loss of security created by the inability to terminate a plan? To design a plan with flexibility we turn to the rules regarding re-deferrals. The key will be to design a plan that allows maximum flexibility to the participant in choosing a distribution date or dates, and then allows for unlimited subsequent re-deferrals. Then, we turn to the administration of the plan to provide an automated system that makes the re-deferral process easy for the participant to manage. The result will be a system in which the participant can always have access to a portion of his/her money within 13 to 23 months. For a more thorough explanation, let's turn to an example.

### **The Automatic Re-deferral System**

Let's say I want to defer \$10,000 of next year's compensation (2006). I will need to make my election to defer by 12/31/05. I will also need to select the date(s) on which the deferred compensation benefit becomes payable to me.

In this case, I will elect to have the \$10,000 automatically split into 5 payments, or *tranches*, of \$2,000 each. The first *tranche* will become payable on January 15, 2008, and the remaining *tranches* will be payable on January 15 of the four years following. This chart represents the result:

Year	Amount Deferred	Scheduled Payment	Payment Date
2006	\$10,000	\$ 0	
2007		\$ 0	
2008		\$2,000	January 15
2009		\$2,000	January 15
2010		\$2,000	January 15
2011		\$2,000	January 15
2012		\$2,000	January 15

No payment is scheduled for 2007 because I will need at least one year to elect a re-deferral of the first *tranche*. That re-deferral election will be made on a date before January 15, 2007. On that date I will elect to re-defer the 2008 payment for 5 years, or until January 15, 2013. The payment thus moves from the "front of the line" to the "back of the line". This chart demonstrates the re-deferral process:

Year	Existing Payment Schedule	Re-deferral	New Payment Schedule
2007			
2008	\$2,000		
2009	\$2,000		\$2,000
2010	\$2,000		\$2,000
2011	\$2,000		\$2,000
2012	\$2,000		\$2,000
2013		\$2,000	\$2,000

This process, then, will be repeated with each subsequent year's deferral. The net result will be that I will always have 20% of my deferred compensation account available over the 5 years that begins 13 to 24 months from the present.

The process is automated, which eliminates my having to keep track of deferrals, re-deferral elections, etc. I simply make a one-time election to use the automated deferral system, and each year's deferral is automatically allocated to the 5-year *tranches*. I also choose to have each year's benefit payment automatically re-deferred at least one year before payment is due, so I don't have to keep track of multiple decisions to re-defer. Then, when I decide to begin taking distributions, I simply turn the system off and I'll begin to receive payments the very next year. Or, I can elect partial re-deferrals so that my income stream is spread over a longer period of time (10 – 15 years).

## Conclusion

Although the automatic re-deferral system is not a direct replacement of haircut provisions, it does give participants the assurance that they will have access to deferred cash on a fairly short-term basis. Additionally, while the automatic re-deferral system does not give the plan sponsor the ability to terminate a plan and distribute assets, the sponsor can freeze the plan and let the natural progression of distributions begin on schedule within 13 – 23 months. By administering plans to allow for the automated scheduling of distributions and an automated system of re-deferrals, companies today can still provide deferred compensation plans with maximum flexibility and liquidity. Among other objectives, the following can be accomplished:

- Long-term tax deferral
- Short-term access to funds
- The ability to manage benefit payments for maximum tax efficiency.
- Increased benefit security

All of this accomplished within the rules of 409A.