

Designing Deferred Compensation for Maximum Distribution Flexibility

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The Need for Distribution Flexibility

In the years before the passage of Section 409A, deferred compensation plans were increasingly designed with innovative distribution devices, particularly “haircut” provisions, which increased the flexibility and liquidity of plans. By triggering the haircut provision an employee could access account values at any time as long as he was willing to pay a penalty (usually 10%). This “anytime access” provided substantial comfort to an employee who anticipated that the money might be needed before a scheduled distribution date, or one was concerned about the possibility of losing money in a corporate bankruptcy.

The rules under new Section 409A, though, are specifically designed to limit participant access to accounts. Specifically, the prohibition on acceleration of benefits eliminated the haircut provision for deferrals after January 1, 2005. For this reason, it was assumed that most plan sponsors after the passage of 409A would “grandfather” plans containing a haircut provision with deferrals made prior to the law’s effective date (January 1, 2005). However, proposed regulations released in October of 2005 have clarified the rules governing subsequent distribution elections (“re-deferrals”), and have given significant flexibility to the design of plans. Thus, many plan sponsors have decided to unify all plans under the rules of 409A.

In-Service Distributions

The first step is to use deferred compensation for pre-retirement events or objectives. RCG has found an approach to short-term distributions that is unique and offers the participant a lot of flexibility. RCG uses an in-service “bucket” approach, whereby a participant has the option to establish from three to five in-service accounts with defined distribution dates (lump sum and/or five annual installments) plus two retirement/termination buckets (lump sum and/or up to 15 annual installments). Each year, a participant will elect to defer income (by source) and then decide how much of the total deferral will be allocated to each in-service and/or retirement account.

Example:

Participant: Age 40 with 2 Children, Ages 13 and 11

Base Salary: \$175,000

Salary Deferral: 12%

Deferral Amount: \$21,000

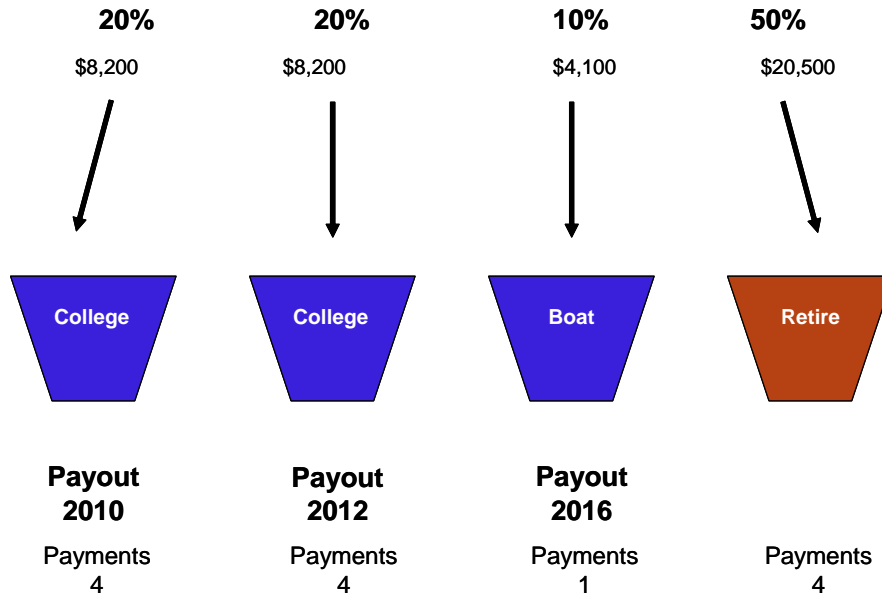
Bonus: \$100,000

Bonus Deferral: 20%

Deferral Amount: \$20,000

Total Deferral: \$41,000

Annual Deferral Allocations



Rules Governing “Re-deferrals”

Next, a participant can provide even more dynamic flexibility to his use of deferred compensation by understanding the rules regarding 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 delayed for at least an additional five years. Significantly, separate re-deferral elections can be made with respect to each future distribution “bucket”, and 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? This type of plan is achieved through wise management of both in-service distributions and re-deferrals.

Maximum Distribution Flexibility Achieved

To design a plan with maximum distribution flexibility RCG turns 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, RCG administers of the plan to provide a system that makes the re-deferral process easy for the participant to manage. The result will be a system in which the participant can balance two important objectives: short-term access and indefinite tax deferral.

Maximum distribution flexibility is achieved when a participant elects a short-term distribution date to preserve access, while planning to repeatedly re-defer those dollars until some future date when the dollars are needed.

For example, a participant wants to defer \$10,000 of next year's compensation (2007). He needs to make his election to defer by 12/31/06. He also needs to select the date(s) on which the deferred compensation benefit becomes payable.

In this case, he elects to split his deferral into five equal, short-term distribution dates. He elects to have the \$10,000 automatically split into five equal buckets of \$2,000 each. The first bucket will become payable in January 2009, and the remaining buckets will be payable in January of the four following years. This chart represents the result:

Year	Amount Deferred	Scheduled Payment	Payment Date
2007	\$10,000	\$ 0	
2008		\$ 0	
2009		\$2,000	January 15
2010		\$2,000	January 15
2011		\$2,000	January 15
2012		\$2,000	January 15
2013		\$2,000	January 15

The next element is the re-deferral of distribution. This works by automatically extending any payments due at least one year and one day before the scheduled payment. That payment is extended by five years. This re-deferral strategy continues until the participant elects to begin to receive benefits.

In the above example, no payment is scheduled for 2008 because I will need at least one year is necessary to elect a re-deferral of the first *bucket*. That re-

deferral election will be made on a date before January 2008. On that date the participant will elect to re-defer the 2009 payment for five years, or until January 2014. 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			
2009	\$2,000		
2010	\$2,000		\$2,000
2011	\$2,000		\$2,000
2012	\$2,000		\$2,000
2013	\$2,000		\$2,000
2014		\$2,000	\$2,000

This process, then, will be repeated with each subsequent year's deferral. The net result will be that the participant will always have 20% of his deferred compensation account available in each of the five years that begin 13 to 24 months from the present.

To ensure complete accuracy and compliance with the re-deferral requirements of Section 409A, this technique requires a robust administration platform that utilizes an “account balance” approach to administration. Ideally, the administrator of the plan will be able to provide an automated system for deferral and re-deferral. In such a system, the participant can simply make a one-time election to use the system, and each year's deferral is automatically allocated to the 5-year buckets. The participant also chooses to have each year's benefit payment automatically re-deferred at least one year before payment is due, so he doesn't have to keep track of multiple decisions to re-defer. Then, when the participant decides to begin taking distributions, he simply turns the system off and begins to receive payments the very next year. Or, he can elect partial re-deferrals so that his income stream is spread over a longer period of time (10 – 15 years). (At least one administrator has built such a system.)

Conclusion

Although the 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. 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
- Ability to manage benefit payments for maximum tax efficiency
- Increased benefit security

All of this is accomplished within the rules of 409A.

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