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The “Silver Lining” of 409A

Planning Opportunities in the Transition Rules

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About This Report



The temporary and proposed regulations under Section 409A, released on September 29, 2005, provide substantial guidance on the operation of nonqualified deferred compensation going forward. With the new rules come important Transition Rules that are scheduled to expire December 31, 2006. Understanding these rules and their benefit to plan sponsors can be important to success in your plans.

This report will discuss how to react to the changes and add more flexibility to your current plans.

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Today's Discussion



- ❑ Nonqualified Plans Under 409A.
- ❑ Transition Rules under the Temporary and Proposed Regulations.
- ❑ The “Silver Lining” of 409A: What are the planning opportunities available to plan sponsors and participants?

Nonqualified Plans After 409A



- ❑ The American Jobs Creation Act created new Code Section 409A, generally effective on January 1, 2005.
- ❑ January 2005, the IRS issued preliminary guidance in Notice 2005-1.
- ❑ September 2005, the IRS issued proposed regulations for Section 409A.
- ❑ Sponsors should now be well underway in the process of assessing the impact of the legislation on their plans and considering the next steps to bring their plans into compliance by December 31, 2006.

Nonqualified Plans After 409A



□ In summary, the Act:

- ◆ Applies broadly to any arrangement that defers compensation.
 - Excludes tax-qualified plans, welfare plans, certain “stock rights”, some severance plans and “short-term deferrals”.
- ◆ Specifies periods for making deferral elections.
- ◆ Restricts flexibility on distribution (no “acceleration of benefits”).
- ◆ Restricts funding options such as certain offshore trusts.
- ◆ Imposes penalties on participants for non-compliance.
- ◆ Requires informational reporting of deferrals on IRS Forms W-2 (employees) and 1099 (independent contractors).

Nonqualified Plans After 409A



Effective Dates

- ❑ The Act applies to amounts deferred after December 31, 2004.
- ❑ Deferred compensation that was earned and vested before January 1, 2005, may be administered under the document in effect on October 3, 2004 as long as the features are not materially modified.
- ❑ Sponsors must keep separate records to administer “old money” accounts subject to the October 3, 2004 plan design and “new money” accounts subject to 409A.
- ❑ Sponsors should analyze costs and benefits of maintaining old and new money accounts. Final decisions on “grandfathering” should be made and implemented by December 31, 2006.

Transition Rules



Reliance and Good Faith Compliance

- ❑ Treasury and IRS intend for final regulations to become effective on January 1, 2007.
- ❑ Sponsors must operate their plans in compliance with 409A prior to January 1, 2007. Compliance with Notice 2005-1 and the proposed regulations are deemed to constitute “good faith” compliance.
- ❑ Plan documents must be adopted and executed by December 31, 2006.

Transition Rules



Qualified Plan Payment Linkage

- ❑ Nonqualified plan payments linked to payment elections under a qualified plan can continue through December 31, 2006.
 - ◆ Typically applies to defined benefit SERPs.

- ❑ Consider how 409A affects SERP design.
 - ◆ SERP offering life annuities only: change in form of life annuity may remain linked to qualified plan.
 - ◆ Any other form of payment (lump sum, installments over specified period) may need to be de-linked by January 1, 2007.

Transition Rules



Discounted Stock Options and SARs

- ❑ A discounted “stock right” (stock option or stock appreciation right) may be replaced with a non-discounted stock right through December 31, 2006.
 - ◆ “Discount” means an exercise price less than fair market value on the grant date.
 - ◆ Replacement stock right is not subject to 409A.
 - ◆ The amount of the “discount” may be preserved in the form of a credit to a deferred compensation plan account.

- ❑ Option or SAR cannot be exercised prior to the replacement.

Transition Rules



Not Extended

- ❑ Other transition rules found in Notice 2005-1 were not extended, for example:
 - ◆ Right to cancel deferrals.
 - ◆ Plan termination (except under new rules).
 - ◆ Expanded initial election period (was March 15, 2005).

Transition Rules



Change in Payment Election

- ❑ Participants may change payment elections (both as to time and form) without resulting in an impermissible subsequent deferral or acceleration through December 31, 2006.
 - ◆ May not delay payments that otherwise would have been received in 2006 or accelerate payments from a future year into 2006.
- ❑ This rule creates substantial planning opportunities for participants as well as sponsors, the “Silver Lining”.

“Silver Lining”



Simplifying a “Class Year” Plan

- ❑ Planned Payment Events,
 - ◆ In-service distribution, and
 - ◆ Retirement.

- ❑ Class-Year Plans (unlimited number of accounts, payment dates and forms of payment) may be simplified.
 - ◆ Each year’s deferral can be allocated to one or several “buckets”.
 - ◆ Re-deferral opportunity (minimum 5 years).

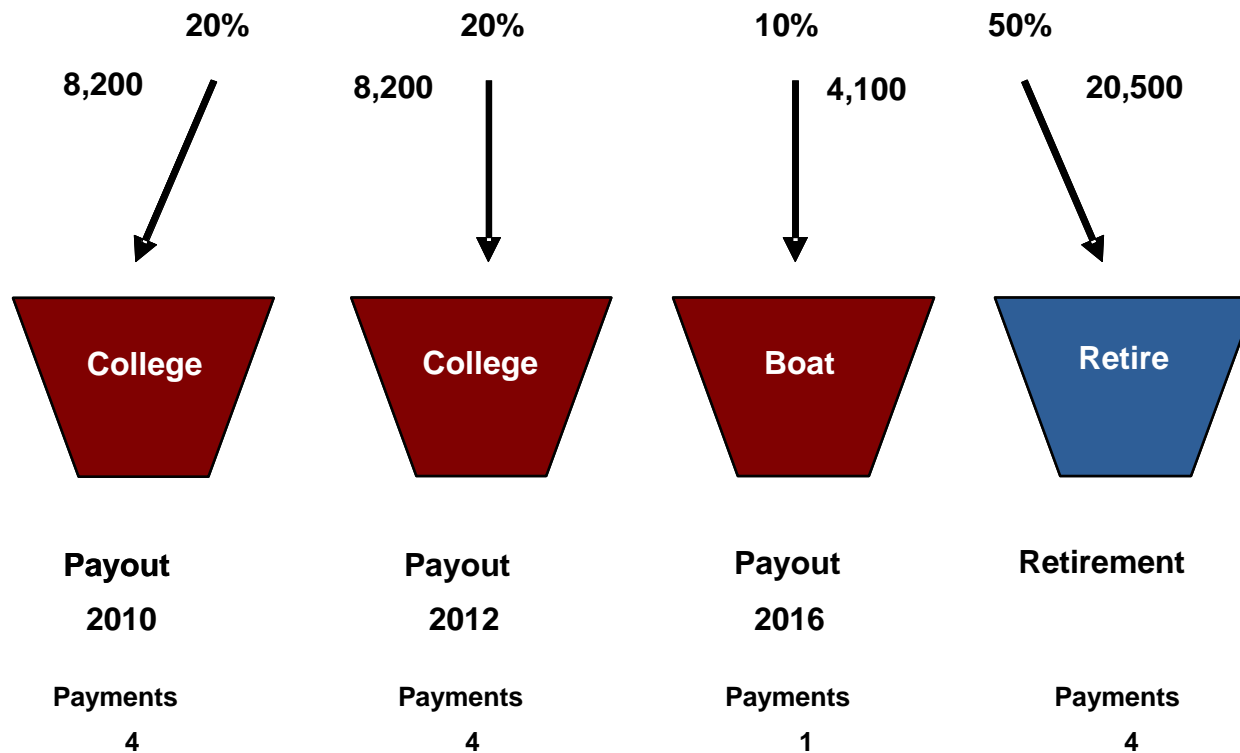
“Silver Lining”



Simplification (continued)

In-Service Distributions

Example:



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Simplification (continued)

□ Re-deferrals:

- ◆ Election to re-defer at least 12 months before scheduled distribution.
- ◆ Subsequent distribution must be delayed for at least an additional 5 years.
- ◆ No limit placed on number of deferrals a participant can make.

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Simplification (continued)

- ❑ Simplification with optimized payment flexibility.

Year	Amount Deferred	Scheduled Payment	Payment Date
2006	\$10,000	\$0	
2007		\$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

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Simplification (continued)

- Simplification with optimized payment flexibility.

Year	Existing Payment Schedule	Re-deferral	New Payment Schedule
2006			
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

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❑ SERP Re-design.

- ◆ Defined benefit formula based on age and service.
- ◆ Grandfathered benefit accruals must be frozen as of December 31, 2004.
- ◆ Post-2004 accruals must comply with 409A.
- ◆ Unless all payment forms for “new” accruals are “annuities” under the 409A regulations, payment election may need to be de-linked from qualified plan.
 - Recordkeeping for two forms of payment, “old” accruals and “new” accruals.
 - Application of tax-qualified offset to “old” and “new” accruals.

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- Solution: Consider conversion of “new” SERP accruals to an annual credit under individual account plan.
 - ◆ Freeze pre-409A SERP accruals as of December 31, 2004.
 - ◆ Estimation of annual accrual for future years, calculated as an annual credit to the participant’s account.
 - ◆ May allow participant investment elections.
 - ◆ Payment upon separation from service, death, disability, change in control, and an unforeseeable emergency.
 - ◆ Elections as to payment form and timing follow individual account plan design.

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- ❑ Post-merger/acquisition planning,
 - ◆ Pre-merger planning, and
 - ◆ Post-merger implementation.

- ❑ Issue: maintain single or multiple plans?
 - ◆ DOL filings,
 - ◆ Securities law compliance (Form S-8 or Reg D analysis for public companies; Rule 701 analysis for private companies),
 - ◆ Trust accounting, separate enrollments, separate recordkeeping, separate communications materials, and grandfathered accounts?

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- ❑ Consider consolidating plans:
 - ◆ Benefit parity, and
 - ◆ Simplified administration.

- ❑ Issue: conforming benefits.

- ❑ Solution: New payment elections through December 31, 2006 to collapse class year accounts to buckets, conform payment elections to single design.

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- ❑ Resolving Split Dollar Issues.

- ❑ Problem: Policies that “straddle” the effective date of split-dollar regulations.
 - ◆ Sarbanes-Oxley issue: whether continued funding of some “grandfathered” split dollar arrangements constitutes an impermissible loan after SOX.
 - ◆ Policy may not be fully paid: e.g., four premium payments made prior to SOX.
 - ◆ Policy may “collapse” without continuing premiums.
 - ◆ Split dollar status under 409A not clear: material modification if changed?

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- Solution: Convert the split dollar policy into an equivalent replacement benefit that conforms to 409A and allow payment elections under transition rules.
 - ◆ Term insurance or company-funded death benefit.
 - ◆ Convert accumulated cash value into deferred compensation credit.
 - ◆ Ongoing “premiums” credited to the deferred compensation plan.
 - May be invested in company-owned insurance to provide replacement death benefit.
 - ◆ Executive allowed to make “investment” elections.
 - ◆ If split-dollar is “deferred compensation” change in structure may lose grandfathering under 409A, but transition rules through 2006 allow new payment elections.

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❑ Severance programs.

- ◆ Severance is “deferred compensation”.
- ◆ Exception for severance paid within 2 years of separation and limited to 2x compensation or 2x compensation limit for tax-qualified plans (whichever amount is less).

❑ Problem: non-safe harbor severance arrangements.

- ◆ Subject to 409A.
- ◆ Must meet deferral rules.
 - Problem: when were services “performed”?
 - Termination for “cause” a sufficient forfeiture risk to allow payment elections?

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- ◆ Must meet payment rules.
 - When is the “initial election”?
 - If no “initial election” all payment elections delay severance payments 5 years.
 - Key employees: six month rule.

□ Solutions:

- ◆ Allow payment elections prior to 2007 to conform to 409A; or
- ◆ Treat the severance as deferred compensation under the deferred compensation plan.
 - Credit to participant’s account.
 - Contingent on involuntary separation, not for “cause”.
 - Allow 409A transition year elections.

Summary



- ❑ You should assess your plan and its operations to ensure “good faith compliance”.
- ❑ Review all plans (SERPs, severance, stock rights, split dollar, employment agreements, etc.) for 2006 transition year election opportunities.
- ❑ Amend plan documents and other deferral agreements (include all transition relief provisions) by December 31, 2006.
- ❑ Under 409A there is more certainty and flexibility during 2006 to design and integrate deferral arrangements in a way that benefits both the sponsor and participants.

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