

***Legislation Changing the  
Deferred Compensation Rules:  
What Should You do Now?***

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**William L. MacDonald**

Chairman, President & Chief Executive Officer

**Phone:** 858.677.5900 ext. 160

**E-mail:** [wmacdonald@retirementcapital.com](mailto:wmacdonald@retirementcapital.com)

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## Section I.



## Legislative Changing the Deferred Compensation Rules

# Legislation Changing the Deferred Compensation Rules

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## Overview of Legislation

### □ Status of Legislation

- ◆ House and Senate have both passed similar bills.
- ◆ Although similar, there were significant differences.
- ◆ American Jobs Creation Act of 2004 was approved by the Senate on October 11, 2004 (following approval by the House of Representatives on October 7) and sent to the President for signature.



# Legislation Changing the Deferred Compensation Rules



## What Type Plans will be Impacted?

- Nonqualified deferral plans
- 401(k) “wrap” plans
- Supplemental Executive Retirement Plan (SERP)
- Excess benefit plans
- Employment agreement with deferral feature
- Tax-exempt and government plans
- Stock Appreciation Rights (SARs)



# Legislation Changing the Deferred Compensation Rules



## What Plans are Excluded or not Addressed?

### The conference report specifically excludes:

- ◆ Incentive stock options
- ◆ Employee stock purchase plans

### Neither the Legislation nor the conference report specifically addresses:

- ◆ Restricted stock
- ◆ Restricted stock units



# Legislation Changing the Deferred Compensation Rules

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## Income Inclusion under Proposed Bills

- ❑ Taxpayer must include deferred compensation in income unless plan satisfies requirements with respect to:
  - ◆ Timing of distribution
  - ◆ Deferral elections
  - ◆ Types of trusts that maybe used to secure benefits



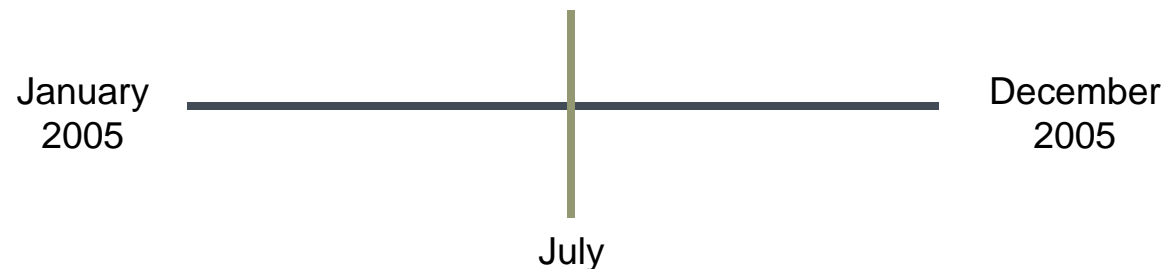


# Legislation Changing the Deferred Compensation Rules



## Deferral Elections

- ❑ Election to defer must be made in year before compensation is earned with two exceptions:
  - ◆ Election can be made within 30 days of date on which employee first becomes eligible to participate to defer compensation earned after election is made.
  - ◆ If the eligible compensation is “based on performance” over a period of at least 12 months (i.e. annual bonus or long-term incentive compensation), the participant has until six months before the end of the performance period to make the election.



# Legislation Changing the Deferred Compensation Rules



## Deferral Elections *(continued)*

- Election to delay distribution dates or change form of distribution permitted only if:
  - ◆ It is made at least 12 months after date of election and 12 months in advance of “scheduled distribution.”
  - ◆ Delay is for at least 5 years.
  - ◆ Legislation does not state that the initial deferral cannot be for less than 5 years.

# Legislation Changing the Deferred Compensation Rules



## Distribution Requirements

### □ Distributions may not be made earlier than:

- ◆ Separation from service (6 months after separation for key employees of public companies)
- ◆ Disability
- ◆ Death
- ◆ A specified time (or pursuant to a fixed schedule) specified under the plan as of the date of deferral
  - Amount could not become payable upon occurrence of specific event (e.g., when child attends college)
- ◆ A severe unforeseen financial hardship – narrowly defined



# Legislation Changing the Deferred Compensation Rules



## Distribution Requirements *(continued)*

- ❑ No acceleration of the specified time (or fixed schedule for making payments) would be permitted.
  - ◆ This would preclude, for example, elections by participants to receive distributions subject to a penalty (so-called “hair-cut distributions”).
  - ◆ The bill allows IRS to issue regulations permitting acceleration in certain cases.
  - ◆ For plans permitting a subsequent election to delay a payment or to change the form of a payment, the election may not take effect for at least 12 months after it is made – generally, the first election may not be made less than 12 months prior to the date of the first scheduled payment – election cannot accelerate payments.



# Legislation Changing the Deferred Compensation Rules



**RCG**  
Retirement Capital Group

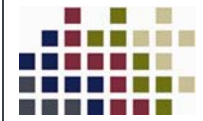
## Investment Options

### □ Some good news from the bill

- ◆ The bill does not apply restrictions on the type of investments available to NQDC participants
  
- ◆ Also omitted are rules prohibiting deferral of stock option gains; plus golden parachute excise – tax treatment



# Legislation Changing the Deferred Compensation Rules



## Other Rules

- ❑ Amounts set aside in off-shore Rabbi Trusts ( and earnings thereon) would be currently taxable
- ❑ Assets (and earnings thereon) would be currently taxable if plan provides that use will be restricted to payment of benefits upon a *change in employer's financial health*
- ❑ Interest on tax on deferred amount (and 20% penalty on deferred amount) when amounts become taxable under above rules
- ❑ IRS authorized to issue regulations to address abuses of constructive receipt rules
- ❑ Deferred compensation will need to be reported on Form W-2 (even if not currently taxable)



# Legislation Changing the Deferred Compensation Rules



## Effective Date

- ❑ Amounts deferred in taxable years beginning after December 31, 2004
  
- ❑ Apply to amounts deferred after December 31, 2004, new rules would also apply to amounts deferred before January 1, 2005 under plans that are materially modified after October 2, 2004
  - ◆ Other than modifications pursuant to treasury guidelines



# Legislation Changing the Deferred Compensation Rules



## Treasury Guidance

- The treasury would be expected to provide certain guidance by regulations, including within 60 days of enactment, guidance allowing, for a limited period, the modification of NQDC plans
  - ◆ To permit plan participants to terminate participation or to cancel outstanding deferral election, or
  - ◆ To conform to the new rules



# Legislation Changing the Deferred Compensation Rules



## Deferral of 2004 Bonuses Uncertain

- ❑ Because new rules would apply to amounts deferred after December 31, 2004, they would apply to the deferral of bonuses earned in 2004 but otherwise payable in 2005
  
- ❑ The Bill does not contain any bonuses earned in 2004
  - ◆ Elections would generally have to have been made before July 1, 2004, under the new performance-based compensation rule or before January 1, 2004 otherwise





## Section II.



What Should You Do Now?

# What Should You Do Now?

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## What Will You Do?

- ❑ **Traditional plans with less flexibility with regard to changes in elections as to timing or form of distributions**
  - ◆ No haircut distributions
  - ◆ Delay distributions to terminated key employees of public companies until 6 months after termination
  - ◆ No security upon change in employer's financial health
  - ◆ No offshore trusts



# What Should You Do Now?

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## What Will You Do? (continued)

### □ Other approaches

- ◆ ISOP®
- ◆ Secular trust
- ◆ Mutual fund options



# What Should You Do Now?



## What Steps Should You Take Now?

- ❑ **Inventory existing plans and identify the features in those plans that will not comply with pending legislation**
  
- ❑ **For elective salary and bonus deferral plans, consider:**
  - ◆ Creating plans that are clones of existing plans with non-compliant features stripped out, and
  - ◆ Communicating the changes to participants when enrolling deferral elections for 2005 compensation, or
  - ◆ Transition relief by the IRS will allow plan participants the ability to either conform to the new statutory rules (apparently the IRS is planning to waive the new timing rules for elections in 2004, at least with respect to bonuses for 2004 that are payable in 2005) or to take their money in 2005 and pay tax on it if they do not wish to comply with those rules.



# What Should You Do Now?

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## Why Should You Consider Taking Action Now?

- **Start to amend existing or adopt new plans**
  - ◆ Every deferred compensation plan subject to new rules will have to be modified
  - ◆ Many features will no longer be permissible
  - ◆ Waiting until 2005 could cause participants to be taxed plus 20% excess tax on their 2005 elections (after transition period)



# What Should You Do Now?



## Plans You Should Review

- Elective deferrals under nonqualified plans
- Section 415 “excess plans”
- Supplemental executive Retirement Plans (SERP)
- 401(k) mirror plans
- Phantom stock units
- Stock appreciation (SARs)
- Deferred compensation and retirement plans for directors and independent contractors
- 457(f) plans (both governmental and nongovernmental)
- 457(b) plans of tax-exempt (non-governmental) organizations



# What Should You Do Now?



## Consider Creating Clone Plans for Elective Deferrals

- Should implement before 2005
  
- Could be easier than re-writing plan with new design
  
- Clone plan would have same design features as existing plans, except for noncompliant features
  
- Process would preserve the tax deferral for participants regardless if legislation passes in 2004 or 2005





**William L. MacDonald**  
**Chairman, President & Chief Executive Officer**



Retirement Capital Group, Inc.  
3636 Nobel Drive, Suite 250 San Diego, CA 92122  
Phone: 858.677.5900 ext. 160  
Fax: 858.677.5915  
Email: [wmacdonald@retirementcapital.com](mailto:wmacdonald@retirementcapital.com)  
[www.retirementcapital.com](http://www.retirementcapital.com)

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