



Highlights of Deferred Compensation Regulations Under 409A

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About This Report



On October 4, 2005, the Treasury Department published proposed regulations pursuant to Section 409A of the Internal Revenue Code of 1986, as amended, governing the design and operation of nonqualified deferred compensation arrangements. The proposed regulations contain some very helpful provisions that will facilitate plan administration as well as the transition from the interim guidance under Notice 2005-1 to the regulations which become effective on January 1, 2007.

This report discusses some of the important provisions of Section 409A and the proposed regulations, and addresses some of the more important issues sponsors will need to address in 2005 and 2006.

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Background

- ❑ Section 409A, passed in October, 2004, ended 26 years of silence by the IRS and Congress regarding deferred compensation.
- ❑ Notice 2005-1, published in January, 2005, provided interim guidance identifying deferred compensation, addressing stock-based plans, and providing guidelines for making deferral and payment elections in 2005.
- ❑ Proposed Treasury Regulations provide first and largest installment of substantive guidance under Section 409A
 - arrangements are covered by Section 409A
 - what constitutes valid deferral and payment elections
 - transition relief in 2005 and 2006 for bringing plans into compliance with Section 409A

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409A applies to “deferrals” on or after January 1, 2005

- Amounts that would have been paid in 2005 but for a deferral election filed on or before March 15, 2005 (Notice 2005-1)
- Amounts deferred prior to 2005 that vest in 2005 and beyond
- Earnings on 409A deferrals.

Example:

Bonus compensation earned in 2004 that would have been paid in 2005 but for a deferral election that was filed prior to payment and no later than March 15, 2005 under Notice 2005-1, and 2005 earnings on the deferrals.

Example:

Company matching contribution made to a deferred compensation plan in 2004 that “cliff” vests on December 31 2007, and the earnings on the amount that vests in 2007.

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Proposed Regulations: Effective Date

- Effective Date: January 1, 2007.

- Sponsors' and participants' reliance on the proposed regulations during 2005 and 2006 constitutes "good faith" compliance with Section 409A.

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Transition Rules Extended through 2006

- ❑ Deferral arrangements must be documented and the terms must comply with Section 409A and the regulations by December 31, 2006.
- ❑ Participants may change payment elections through December 31, 2006.
 - Elections are effective immediately (12-month rule does not apply)
 - Any payment date after 2006 may be selected without regard to the anti-acceleration or five-year rule
 - Plan document must be amended to reflect the administrator's authority to offer new payment elections to participants by December 31, 2006
 - SERP payments that are governed by payment elections under a related tax-qualified plan may change with the tax-qualified plan election through December 31, 2006 (a payment election must have been in place on October 3, 2004)
- ❑ "Discounted" stock rights (options and SARs) may be repriced at fair market value on the grant date. Any deferral component may be converted to restricted stock or deferred cash compensation with an identical vesting schedule.

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Example:

Participant P filed an election in December, 2004 to defer 50% of his 2005 bonus, payable in ten annual installments upon termination from employment. Pursuant to authority granted by the plan administrator, P files a new payment election on February 1, 2006 to change the payment from installments to a lump sum payable on the earlier of termination of employment or January 1, 2015. This election should meet the requirements of the regulations and Notice 2005-1. However, if the Participant terminates employment in 2006, the prior election will govern and the Participant will receive ten annual installments.

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Example:

P also has an option to purchase 5000 shares of employer common stock at \$10 per share. On the date of grant, the underlying shares were worth \$15 per share. The shares vest on January 1, 2008. Pursuant to Notice 2005-1 and the regulations, the employer may substitute the award with an option to purchase 5000 shares at \$15 per share, the FMV on the original grant date. The \$5 per share “deferral component” of the original option may be replaced with an award of restricted stock equal to \$25,000 or a company contribution to a deferred compensation plan of \$25,000 as long as either award vests on January 1, 2008.

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Transition Relief Expiring December 31, 2005

- Ability to change payment elections scheduled to commence in 2006
- No extension of the March 15 deadline for deferral elections
- Ability to substitute “discounted” stock rights (options or SARs) with a repriced stock right at fair market value and a cashout of the “deferral” component
- Ability to suspend, revoke or reduce a deferral election effective during 2005

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What Plans Are Covered?

- Nonqualified deferral plans
 - Elective or non-elective plans
- 401(k) “wrap” plans
- “Excess Plans” (Supplemental Executive Retirement Plans or “SERPs”)
- Employment agreement with deferral feature
- Some Section 457(f) plans (governmental and tax-exempt sponsors)
- Certain severance payments
- Deferred bonus arrangements

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What Plans Are Covered?

- Discounted “stock rights” (options and stock appreciation rights)
- Option gain deferral arrangements
- Non-qualified employee stock purchase plans
- Any bonus plan that actually pays more than 2-1/2 months after taxable year in which the bonus is earned and vested

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What Plans Are Excluded From 409A?

- Qualified plans
- 457(b) plans
- “At the market” stock rights
- Qualified employee stock purchase plans (423 plans)
- Vacation, sick pay, compensatory time, disability pay and death benefit
- Arrangements subject to Section 83 – restricted stock
- “Short-term deferrals” paid within 2 ½ months after end of tax year in which the compensation is earned or vested, whichever is later

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What Are The New Requirements For Deferred Compensation?

- ❑ A nonqualified deferred compensation plan will not result in deferral of taxation unless the plan satisfies all of the following requirements both in form and operation:
 - Deferrals
 - Payments
 - No Acceleration
 - Funding

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What Are The New Requirements For Deferred Compensation? (continued)

□ Participant Deferral Elections

- General Rule: Participants must file deferral elections no later than December 31 of the calendar year preceding the year in which the compensation subject to the election is earned.
- Other deferral opportunities:
 - **Newly Eligible Participants:** 30-day rule
 - **“Performance-based compensation”** based on services performed over a period of at least 12 months. The participant must elect deferrals no later than six months before the end of the service period and before the performance criteria have been substantially met
 - **Fiscal Year Award** provided the compensation is paid after the end of the fiscal year
 - **Short-term deferral** deferred under an election filed no later than twelve months prior to the date the award vests. Payment date must be at least five years after the vesting date.
 - **Forfeitable Rights** such as restricted stock units, may be deferred if an election is filed within 30 days of grant and more than 12 months remain in the service period.

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What Are The New Requirements For Deferred Compensation? (continued)

- Distributions – the plan may not distribute amounts earlier than:
 - Separation from service (six-month delay for “key employees” of public companies);
 - Disability
 - Death
 - A specified date (an event, such a child going to college, is not a specified time)
 - A change in control
 - An unforeseeable emergency
 - Domestic relations orders (similar to “QDROs”)

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What Are The New Requirements For Deferred Compensation? (continued)

Opportunities with Specified Date Elections

- Participant may specify payment upon separation from service, or
- Participant may specify payments from in-service “buckets”; i.e., 2007, 2009, 2014, etc



Timmy's
College
Account



Mary's
College
Account



Boat
Purchase
Account

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What Are The New Requirements For Deferred Compensation? (continued)

Modifying Payment Elections

- A plan may allow “subsequent elections” by participants to delay a payment or change the form of payment (but in no event accelerate the payment) if the plan provides that
 - (i) the election does not become effective for at least twelve months;
 - (ii) the additional deferral must be for at least 5 years;
 - (iii) legislation does not prohibit multiple “subsequent elections”.

Example

Participant P specifies an in-service payment in the form of ten annual installments commencing on January 1 2010. P may elect to change the payment to a lump sum commencing on January 1, 2015. The lump sum is not considered an acceleration of the previous installment schedule. The election to change the payment to a lump sum must be filed with the plan administrator no later than December 31, 2008.

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What Are The New Requirements For Deferred Compensation? (continued)

Funding

- Offshore Trust subject to immediate tax.
- Rabbi Trust will become most prevalent
- “Retention Trust” survived 409A

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Pleasant Surprises Under 409A!

- ❑ Mid-Year Deferrals, Fiscal Year Deferrals
- ❑ Significant flexibility is given in payment elections and second elections (“cascade deferrals”).
- ❑ Stock Appreciation Rights are permissible for privately-owned companies (but, valuation challenges remain).
- ❑ Discretionary termination of plans is allowed under certain circumstances.
- ❑ “Evergreen” deferral elections OK.
- ❑ Significant flexibility in design of 401(k) “wrap” and “sweep” plans (subject to 402(g) guidelines).

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What Are The Consequences Of Failing To Comply With The New Rules?

- Defective deferrals subject the individual to retroactive taxation (assessed at the underpayment rate plus 1%) plus a 20% penalty.
- Defective deferral generally does not disqualify the plan; the penalty is on the individual.
- Exercise of administrative discretion may affect all participants e.g., decision to accelerate payment to one participant may affect all
- No consequences to the employer under 409A, but employee relations issues may lead to gross-ups for participants' tax liability

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What Issues Are Companies Likely To Face?

- ❑ **W-2s** – The new law will require annual reporting on Form W-2 of the amounts deferred.
 - Employers should be considering how to measure and track the amounts that they must report
 - The purpose behind the reporting is not clear. Information gathering? Enforcement?
 - If enforcement, should reporting be limited to vested deferrals since those amounts would be subject to taxation under 409A?
 - “Best guess” for 2005. Expect assumptions and reported numbers to vary among companies until Treasury or IRS issue future guidance
 - It is also possible that companies will need to report deferrals in their annual executive compensation disclosures in proxy statements and form 10K.

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What Should Companies Do Now?

- Enroll salary and calendar year bonus during annual fall enrollment
- Amend plans to authorize 2005 transition elections by December 31, 2005
 - March 15, 2005 deferral elections
 - Suspension, reduction, revocation elections
 - Revised payment election
- Confirm the decision to “grandfather” plans by December 31, 2005
- Plan for reporting of 2005 (vested) deferrals and earnings on IRS Form W-2 and 1099-MISC for independent contractors

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What Should Companies Do Now? (continued)

- Plan for compliance initiatives in 2006
 - Review bonus programs during 2006
 - Plan documentation
 - Change in Control planning, coordination with rabbi trust
- Participant communications (transition rules, 2007 requirements)
- Review administrative platform for 409A capabilities



William L. MacDonald
Chairman, President & Chief Executive Officer

Retirement Capital Group, Inc.
12340 El Camino Real, Suite 400
San Diego, CA 92130
Toll-Free: **866.RCG.4TRS (724.4877)**
Phone: **858-677-5900**
Fax: **858-677-5915**
E-mail: wmacdonald@retirementcapital.com
Website: www.retirementcapital.com

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