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Assessing Nonqualified Plans After 409A

Today's Presenters: William L. MacDonald
Chairman, President and CEO, *RCG*

Samuel Brkich
Vice President and Chief Counsel, *Newport Group, Inc.*

RCG
Retirement Capital Group

About This Report



The American Jobs Creation Act of 2004 (the Act) contained a number of provisions related to restructuring of business taxes. One of the major concerns among the changes impacts the tax treatment of nonqualified deferred compensation plans.

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

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- ❑ The Act added a new section 409A to the Internal Revenue Code.
- ❑ Effective January 1, 2005, nonqualified deferred compensation sponsors must comply “in operation” with the Act on a “good faith basis”, although their plan documents need not be amended until December 31, 2005.

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- ❑ January 2005, the IRS issued preliminary guidance in Notice 2005-1.
- ❑ Although plan sponsors should wait until all guidance has been issued before amending their plans, they should now be well underway in the process of assessing the impact of the legislation on their plans.

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□ In summary, the Act

- ◆ Defines nonqualified deferred compensation and notes the key exclusions.
- ◆ Establishes effective dates, including grandfathering of previous plans and the impact of “material modifications”.
- ◆ Defines the timing of elections.
- ◆ Restricts flexibility on distribution.

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- In summary, the Act (continued)
 - ◆ Restricts funding options such as certain offshore trusts.
 - ◆ Imposes severe penalties on participants for failure of a plan to achieve compliance.
 - ◆ Outlines withholding and reporting requirements.

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Effective Dates

- ❑ The Act applies to amounts deferred after December 31, 2004.
- ❑ Deferred compensation that was earned and vested before January 1, 2005, will be “grandfathered”.
- ❑ In effect, previous plans can be frozen and new plans started with “old” money grandfathered and new money subject to new rules.

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New Money, Old Money

- ❑ Exception to new/old money rule.
 - ◆ If the old plan or arrangement is “materially modified”, i.e., additional benefits, rights, or feature an acceleration of vesting after October 3, 2004, the amounts deferred and vested will lose grandfathering.

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Deferral Elections

Deferrals

- ◆ No later than the end of the taxable year that precedes the year in which they perform the services for which the deferred compensation would be paid.
- ◆ Exception: Newly eligible employees can make their deferral election within 30 days after becoming eligible.

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Deferral Elections (continued)

- Another exception relates to deferral of performance-based compensation for services provided over at least a 12-month period.

- The deferral election must be made at least six months before the end of the service period.

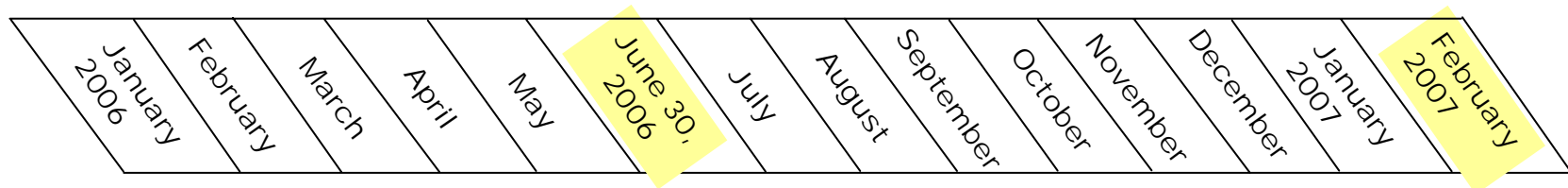
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Deferral Elections (continued)

- ❑ Companies that allow employees to defer bonuses earned annually, or over a multi-year period, will be very interested in these rules.

Example:



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Distribution

- ❑ Plans must include provisions related to the timing and form of distribution.
- ❑ Six ways to get your money:
 1. Participant's death
 2. Participant's disability
 3. Separation from service*
 4. Change in ownership of company
 5. Unforeseeable emergency
 6. Specified time on fixed schedule

*Restrictions for key employees

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Distribution (continued)

- ❑ Section 409A restricts “key employees” of publicly-traded companies from receiving a distribution for at least six months after departure.
- ❑ A key employee is defined as an officer with at least \$135,000 (for 2005) in annual compensation, a five percent (5%) owner, or a one percent (1%) owner with more than \$150,000 in annual compensation.
- ❑ Will require employers to keep track of “who a key employee” in a particular year is.
- ❑ IRS will be issuing additional guidance as to what constitutes a “separation from service” that triggers the six month rule for key employees.

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Distribution (continued)

Distribution Flexibility

- ◆ In-service distribution
- ◆ Retirement
- ◆ Re-deferral opportunity (minimum 5 years)

Maximum Flexibility

- ◆ Opportunity to carve up deferrals into different “buckets”

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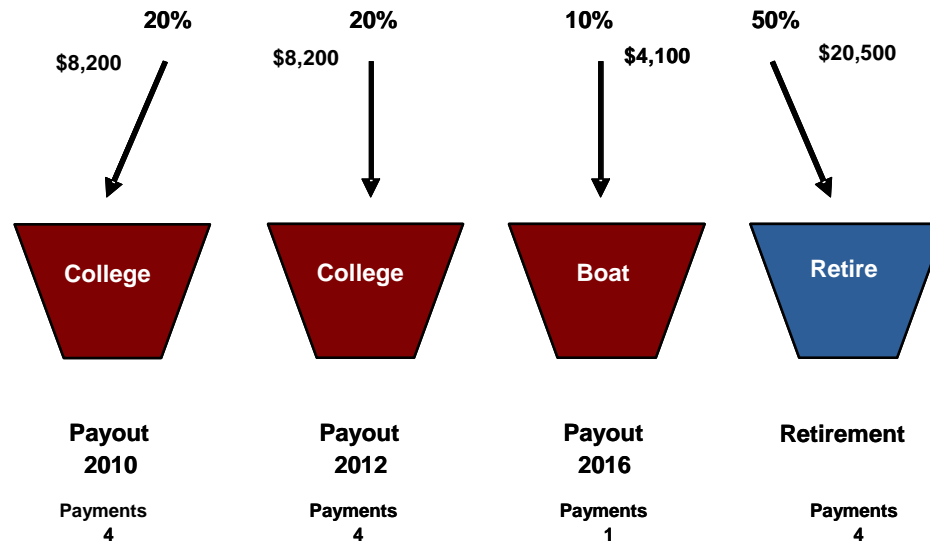
Distribution (continued)

☐ In-Service Distributions

Example:

Participant: Age 40 - 2 Children, Ages 13 & 11

| | | | | | |
|--------------|-----------|------------------|-----|------------------|-----------------|
| Base Salary: | \$175,000 | Salary Deferral: | 12% | Deferral Amount: | \$21,000 |
| Bonus: | \$100,000 | Bonus Deferral: | 20% | Deferral Amount: | <u>\$20,000</u> |
| | | | | Total Deferral: | \$41,000 |



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Distribution (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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Distribution (continued)

- Maximum distribution flexibility achieved

| 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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Distribution (continued)

- Maximum distribution flexibility achieved

| 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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Funding

- Section 409A specifies funding restrictions related to “offshore” or foreign Rabbi Trust and trust that become protected from creditors or distribute assets to participants based on a change in the employer’s financial health.
- 409A “blessed” domestic Rabbi Trust.
- Not a material change to restructure funding.

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Reporting and Withholding

- ❑ Amounts that are deferred, whether included in the employee's wages or not, must be reflected on the employee's form W-2.



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Trends in Nonqualified Plans

- With the changes in 409A, many companies are stepping back to analyze their plans to:
 - ◆ Lower funding cost
 - ◆ Offer more flexibility
 - ◆ Increase investment funds to participants
 - ◆ Provide greater security
 - ◆ Improve administration

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Summary

- ❑ 409A will effect nearly all deferred compensation arrangements.
- ❑ Because of the severity of penalties, it's important to conform.
- ❑ There is more certainty and in many ways more flexibility.



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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