

The Impact of Recent Tax Law and Accounting Changes on Deferred Compensation and Equity-Based Compensation



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Karr Barth

Sales: Karr Barth Associates

- Our Corporate Division is a national leader in design, implementation, and funding of corporate non-qualified benefit plans. We have helped install almost 200 plans at over a hundred companies throughout the country since ERISA was enacted in 1974.
- Our principal focus since 1993 has been on “Self-Directed” Pension and Deferral Plans, which we believe are today’s fastest growing executive benefit.

Service: Karr Barth Administrators

- Our corporate benefit services organization administers plans with over \$250 million in annual premiums and directs the allocation of over \$3.5 billion in assets under management.
- Through its Executive Benefits website, over 7,000 plan participants from over 75 companies have daily access to “self-directed” accounts. Their deferrals are projected to exceed \$150 million in 2005.



Advantages of Deferring Compensation

- Deferring compensation brings distinct advantages to retirement savings efforts:
 - Commitment to set aside savings for retirement is made in advance.
 - Changes between investment funds are not taxable events.
 - Pre-tax compounding retains significant advantages, even under the new tax law.

Pre-Tax Deferral vs. After-Tax Investment

Tax Rates (Federal/State Blend)

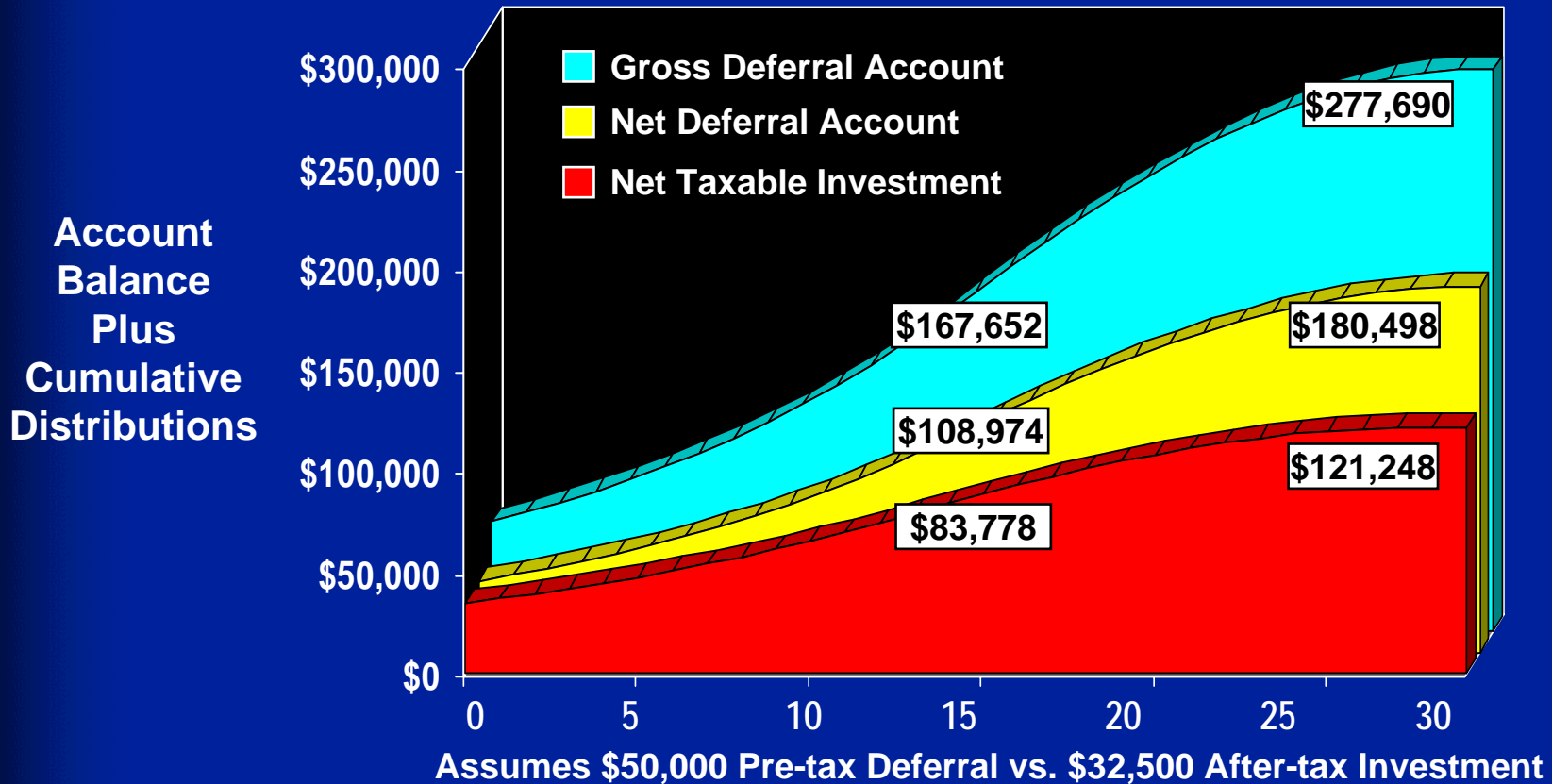
Current Tax Law

Ordinary Income	35%
Long Term Capital Gains	17%
Dividends	17%

Assumptions

Pre-tax Deferral / After-tax Investment	\$50,000 / \$32,500
Stock / Bond Allocation Percentages	60% / 40%
Stock / Bond Annual Investment Return	10% / 6%
Components of Stock Return	2% Div.; 4% LT Cap Gain; 4% ST Cap Gain
Investment Holding Period	15 Years
Payout Period	15 Years

Pre-Tax Deferral vs. After-Tax Investment



Annual Distribution (Years 16 - 30):

■ \$8,083
 ■ \$12,033 (+ 49%)
 ■ \$18,513

Funding Considerations

Funding Conundrum

- Qualified plans receive stock market returns in a tax-free environment, but the tax code caps employee contributions at \$14,000 per year.
- The design feature most attractive to executives – stock market appreciation of pre-tax deferrals – also poses the greatest challenge to the assets of sponsoring companies.

Three Possible Approaches to Informal Funding of Non-Qualified Plans

- Invest deferrals in the company itself, keep notational accounts of sums due, and hope the company's after-tax return on assets keeps up with the pre-tax stock market appreciation experienced by plan participants.
- Invest deferrals in mutual funds, understanding these are taxable transactions:
 - Hedge directly by buying same funds offered as “deemed investment” options, or
 - Hedge indirectly by buying tax-managed, index fund, or Exchange Traded Funds.
- Deposit deferrals in life insurance, harnessing investment selection, hedging potential, and tax-advantages of Variable Universal Life (VUL).

New Legislation

- Section 409A, enacted October 22, 2004, provides statutory basis for all non-qualified deferral plans; broad definition of deferred compensation
- Future deferrals will be taxed unless plans meet specific criteria:
 - Distributions can be triggered by only six events:
 - Separation
 - Death
 - Disability
 - Fixed Schedule
 - Change of Control
 - Unforeseeable Financial Emergency
 - Time and form of distribution must be specified at time of deferral
 - Acceleration disallowed; limited re-deferral (at least five years)
- Treasury guidance issued December 20, 2004; Regulations expected in mid-2005.

The Good News

- **Broad grandfathering for accumulated accrued benefits**
 - New law generally effective for amounts deferred after 2004
 - Scope of grandfather provision
 - “Old Money” vs. “New Money”
 - “Material Modification” after October 3, 2004 convert Old Money to New Money, or worse
- **Re-deferral elections blessed for the future**

More Good News – Serious Proposals That Did Not Survive

- No restriction of access to special investment funds or above-market rates of return
- No restriction on deferral of incentive compensation earned over more than one year

The Bad News

- **Quasi-qualification approach**
- **Severe consequences for attempted but failed deferrals**
- **Demise of the haircut**
- **Reporting of the amount deferred (particularly problematic for Pennsylvania taxpayers)**
- **New SEC reporting and exchange listing rules may result in additional disclosure and shareholder approval burdens**

More Bad News

- **Breadth of coverage**
 - **IRC 409A(d)(1): “nonqualified deferred compensation plan means any plan that provides for the deferral of compensation, other than –**
 - **A qualified employer plan, and**
 - **Any bona fide vacation leave, sick leave, compensatory time, disability pay or death benefit plan”**
 - **Stock appreciation rights**
 - **Discount stock options**
 - **SERPS (e.g., non-elective or employer-funded deferral arrangements)**
 - **Some severance programs?**

Key Thoughts for Deferral Plans

- Essential Attractiveness Preserved
- Effective Dates
- Clone vs. Plan Amendment
- Distribution Options

Five Bucket Ferris WheelSM

- Always defer/re-defer for minimum time allowed by plan:
 - For initial deferrals, this may be two years
 - For re-deferrals, this will be five years
- Re-deferrals will come around again, eventually forming a Five Bucket Ferris Wheel:
 - Thirteen months before each payment, decide whether and how much to redefer for another five years
 - Process can be repeated indefinitely
- Participant will never be more than one year from 20% of deferral balance, but full payout will require five years

Impact on Other Benefit Plans

Deferral option can be preserved in amended plans:

- Excess Pension Plans
- SARs and RSUs
- Severance Plans

Most attractive choice may be “paid out over five years, beginning thirteen months after triggering event” to facilitate re-deferral option

Possible 2005 Communication/Decision Time Line

- January/February--informational mailing to plan participants
- March 15—last day for new '05 salary deferrals (limited use)
- June 30—Last day for '05 bonus deferrals (wide use)
- Third Quarter—Expected release of Treasury's 409A Regulations, enabling finalization of all non-qualified benefit changes

Possible 2005 Communication/Decision Time Line

(continued)

- Fall Enrollment/Re-Enrollment Meetings
 - Describe plan revisions, offer '06 salary deferrals
 - Allow retroactive reversals of '05 deferrals
 - Finalize distribution decisions for '05/'06 deferrals
 - Describe revisions and offer deferral options for:
 - Excess Pension Plan ('05 balances forward)
 - Anticipated SAR/RSU Grants
 - Severance Plans