



News & Resources on legal issues that impact Employee Benefits Management

AUGUST 2007

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Last Call for Deferred
Compensation

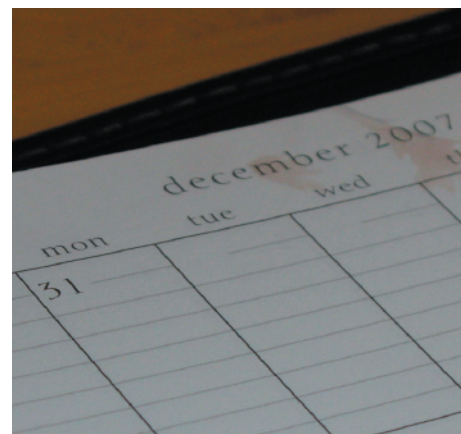
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Supercharging
Retirement Benefits

LAST CALL FOR DEFERRED COMPENSATION

A deferral of compensation exists where a participant has a legally binding right to receive a payment of compensation that *is* or *may be* paid in a later year. This is a very broad definition, encompassing a variety of “arrangements.” Non-qualified deferred compensation plans must be brought into written compliance with the final regulations issued under Internal Revenue Code 409A by December 31, 2007. The transition relief and good faith compliance under which deferred compensation plans have been operating since Section 409A was enacted in 2004 does not extend beyond the end of this year. Non-compliant deferred compensation results in harsh tax penalties for the plan participant: the compensation is immediately included in income (unless subject to a substantial risk of forfeiture), a 20% penalty tax is assessed on the amount included in income, and interest and penalties running from the vesting date may be imposed. The purpose of this article is to bring your attention to the places deferred compensation subject to Section 409A are found—some of which are less than obvious.

Deferred compensation is paid by a service recipient to a service provider. Typically, the service recipient is an employer and the service provider is an employee. Service



providers may also include independent contractors and directors. Outside of the employment context, service recipients and providers may be found in many common business transactions. In this context, a service recipient/service provider may include a seller/buyer or a partnership/partner. It is important to take an expansive view of the “compensation” paid by the recipient to the provider.

Deferred compensation plans may cover a group of participants or as few as one individual participant. Deferred compensation is found not only in traditional nonqualified deferred compensation plans, wrap plans, supplemental executive retirement plans (SERPs), but may also be found in severance plans/agreements, employment agreements, employment offer letters, change in control agreements, various types of equity compensation, split dollar agreements, excess benefit plans, bonus programs, incentive programs, retention agreements, post-retirement benefits, Code Section

Last Call for Deferred Compensation

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457(f) plans, buy-sell agreements, and earn outs. This is not an exclusive list of the types of arrangements that may provide deferred compensation, but should alert you to forms of compensation that you may have assumed were not subject to 409A. It is very important that all types of compensation and promises of compensation be reviewed now in order to identify all plans or arrangements that are potentially subject to 409A.

Despite the broad definition of deferred compensation, there are a number of exceptions to Section 409A. The obvious exceptions are qualified plans, 403(b) plans, 457(b) plans, bona fide vacation and sick leave plans, disability and death benefit plans, statutory stock options, and non-taxable medical reimbursement plans (traditional health plans)—assuming, of course, that the tax requirements for these types of plans are met. Other compensation arrangements may or may not be subject to Section 409A depending on the specific design of the benefit, therefore should be carefully analyzed for Section 409A compliance. The downside for guessing wrong can be very costly to employees.

Once the potential plans of deferred compensation are identified, those subject to Section 409A must be determined. It may be necessary to prepare amendments to bring these plans into written compliance with the law and regulations no later than December 31, 2007. Compliance issues are most often related to the timing of the deferral, and the timing of and



reasons for the payment of compensation. The Burr & Forman Employee Benefits Practice Group is experienced in identifying deferred compensation and finding solutions to compliance with Section 409A. Please call on us to assist you with this important issue—time is running out! [fb](#)

SUPERCHARGING RETIREMENT BENEFITS

Would you like to provide increased qualified retirement benefits to your key employees in a manner that does not significantly increase the cost of providing benefits to all other employees?

As you are probably aware, contributions to a defined contribution plan (profit sharing plans, 401(k) plans, and money purchase pension plans) for any participant are capped at an annual maximum for 2007 of \$45,000 or, in the case of a 401(k) plan, \$50,000 for a participant who will be age 50 or older by the end of the year. A technique that we have used to provide increased contributions and benefits for participants who are affected by this maximum amount is the cash balance pension plan. A cash balance pension plan is a defined benefit plan that more closely resembles a defined contribution plan. A typical plan design is to provide for an annual contribution equal to a specified

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Supercharging Retirement Benefits

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percentage of each participant's compensation. This contribution, along with interest at a rate specified in the plan, is allocated to an account for the participant. The plan can provide for different contribution percentages for specified groups of participants. For example, owner participants can receive an allocation equal to 12% of their compensation while all other participants might receive an allocation equal to 2% of their compensation. The interest rate might be tied to the 30-year Treasury rate. At retirement, the participant receives a benefit (usually in the form of a lump sum) equal to the contributions made for his benefit increased by the specified interest rate.

With the [cash balance pension] plan design described above, contributions are largely predictable and, with careful investing, the possibility of underfunding is slight.

A major disadvantage of the traditional defined benefit plan is the possibility of underfunding and the unpredictability of the amount required to be contributed each year. With the plan design described above, contributions are largely predictable and, with careful investing, the possibility of underfunding is slight.

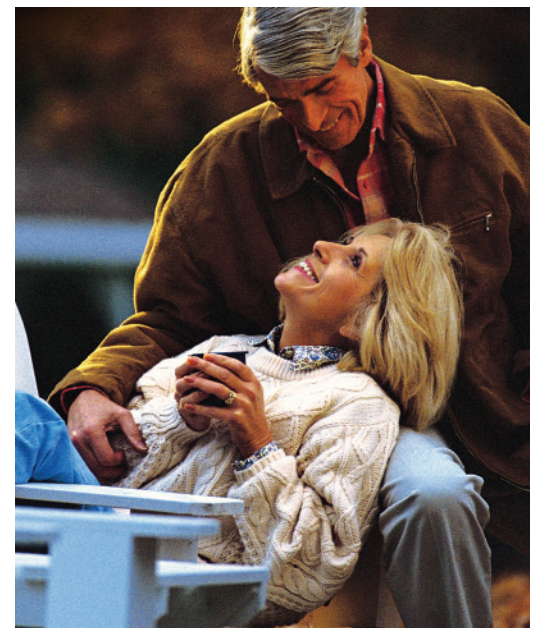
Why does this work? Unlike the limits that apply to defined contribution plans, the amounts that can be contributed to a defined benefit plan are based on the amount required to fund a maximum benefit. For 2007, the maximum benefit at retirement is \$180,000. The employer can contribute the amount required to fund this maximum benefit, and this can be done while continuing to make contributions to the profit sharing or 401(k) plan.

Another situation that we see is the employer who would like to contribute

\$45,000 for its key employees, but cannot do so without significantly increasing the contributions to be made on behalf of all other employees. There is a solution to this problem—the “new comparability” or “cross-tested” plan. With this type of plan, the participants are divided into two or more groups and provide for contributions equal to a different percentage of compensation for each group. For example, a contribution equal to 13.11% of compensation might be made for the group comprised of owner participants with 4.5% being contributed for the group consisting of all other participants. If the plan provides for 401(k) contributions, and if the safe harbor design is used, key employees can max out at \$45,000 or \$50,000.

Why does this type of plan work? When evaluated based on the contributions being made, the plan is clearly discriminatory. IRS regulations, however, permit a defined contribution plan to be tested for discrimination based on the benefits generated by the contributions. In other words, we convert the contributions into benefits at age 65 and then determine whether those benefits are discriminatory. If the key employees are older than the other employees, this approach can work.

If you have an interest in increasing contributions on behalf of key employees, the Burr & Forman Employee Benefits Practice Group would like to help. [🌐](#)



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