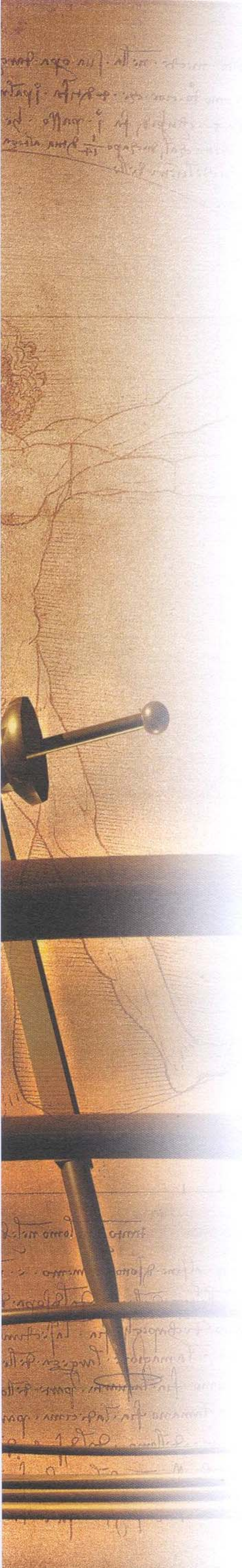

Volume 7, No. 3 – Q3/2009

Nolan Financial Report

A Challenge for The Times
Managing Your Nonqualified Plans in a Difficult Economy

A Disciplined Approach

These Uncertain Times

The word we want to use is "Angst"! The Encarta Dictionary defines angst as a feeling of dread arising from an awareness of free choice. Angst is not necessarily bad; it just needs to be managed in the same way that we should manage all of our various emotions. The American Jobs Creation Act of 2004 created IRC Section 409A, which has a broad impact on nonqualified deferred compensation plans. In the times we are living through now, many of the provisions of section 409A are having a significant impact on the way companies need to manage their nonqualified plans. These include 457(f) plans as well as the more familiar deferred compensation and SERP plans. This is creating for some a strong feeling of angst as they try to determine what they and their company should do to manage these nonqualified plan assets in light of the provisions of 409A that deal specifically with the limitations on an employer's ability to terminate and liquidate such arrangements.

Why Terminate

Perhaps one of the first questions to ask is why terminate? It is easy to get caught up in the economic environment we are in and to quickly forget why these nonqualified plans were designed, funded and are currently being administered today. These plans serve a very useful and practical purpose and the presence of a Bear Market does not change the real impact that these plans have on the participating executives and their company.

If you have been a reader of earlier Nolan Financial Reports, then you are aware that we have discussed often the impact of what we call "Reverse Discrimination" faced by highly compensated executives. The severe impact of reverse discrimination is that executives are faced with significant retirement income shortfalls through their qualified plan options and their ability to elect to defer on a pre-tax basis their own income to subsidize their retirement or for other major liabilities they may incur throughout their business career.

In addition and perhaps even more importantly, the employer and their boards are now faced with the decision of whether to undo the nonqualified plans they adopted to attract and retain the very executives they need to lead them back to the profitability and growth they desire.

People seem to have forgotten that Bear Markets are unfortunately part of the business cycle that we have experienced in our free market society. As has often been quoted – "This too shall pass". When this downturn has passed and the employer and its board start to see these same executives willing to accept other offers of employment, they will wonder why they made the decision to terminate these very important pieces of their executives' compensation plan. They will have undone the very same handcuffs they worked so hard to implement. The executive would have received their distribution of any vested compensation and would have no further reason to turn down any offer of employment. For public companies, there is the added problem of underwater options. What was once considered the vehicle of choice to retain executives has now lost its retentive powers. For many companies the decision to re-price options or seek additional options at the cost of further dilution are not well-received by many shareholders as they have seen their own wealth evaporate. So now the CEO and the Compensation Committee see themselves at a decision cross road that they did not envision when these nonqualified plans were first developed and introduced. In addition under Section 409A, the decision to terminate a deferred compensation plan or a nonqualified SERP is no longer as easy as doing just that. We will discuss in a moment some of the more stringent parts of Section 409A that deal with the termination of a nonqualified plan.

Limitations on Terminating

A recent edition of AALU Washington Report [1] did a very thorough analysis on the limitations of terminating or otherwise changing nonqualified deferred compensation arrangements subject to Code Section 409A. This report goes on to say that in many, if not most, cases there may be no viable options for terminating and liquidating a 409A arrangement either: (i) because the parties cannot or do not want to satisfy all of the requirements (e.g. terminating all arrangements of the same type) or (ii) because of the uncertainty about whether all of the conditions can actually be satisfied (e.g., whether a termination or liquidation is not proximate to a downturn in the financial health of the employer). This report continues to say that if all of the conditions are not satisfied, any liquidating distributions would be in violation of 409A and all arrangements that are required to be aggregated would be treated as violating 409A, which generally would result in significant adverse tax consequences to the participants.

Code Section 409A addresses three new requirements that are relevant to this discussion and that must be satisfied both in form and operation: (1) election restrictions, (2) distribution restrictions, (3) acceleration restrictions. The AALU report addresses these restrictions and their impact in some detail. There are significant adverse tax consequences if the new requirements are not satisfied. What is important to understand and is often misunderstood by most is that the decision to terminate one deferred compensation plan affects all like designed plans such as SERPS and any other post-409A nonqualified compensation plan. Note that split-dollar arrangements are a separate type of plan for purposes of the 409A plan aggregation rules.

Another onerous requirement within the final regulations of 409A requires that there be a 3-year wait before a new nonqualified plan of the same type may be enacted. Lastly on the subject of liquidation distributions mentioned above, there is also debate on whether the financial health of the organization at the time of distribution is equally as important as at the time the decision was made to terminate the plan. The crux of this report is that with the exception of certain limited circumstances identified for liquidations (i.e. certain corporate dissolutions and changes in control), there may be no viable option for terminating and liquidating 409A arrangements without triggering adverse tax consequences.

[1] AALU Washington Report April 21, 2009

Alternatives to Termination

The decision to terminate a nonqualified plan should not be taken lightly nor should it be considered as the only option a company has when faced with the economic environment we have today.

We would encourage the CEO, the CFO, the Head of Human Resources and the Compensation Committee of the Board to consider a thorough review and analysis of their current nonqualified plans and consider alternatives to their current design rather than complete termination.

There are many options available that the company could consider that would greatly mitigate the financial impact to both the employer as well as the participating executive without outright termination of the plans.

The employer must realize that terminating their nonqualified plans may require that they pay the deferred compensation obligation out of general assets earlier than expected and at a time when cash flow may be significantly reduced. Furthermore, an outright termination of the plans would result in non-recoverable costs previously incurred for legal counsel, plan implementation, administration, initial product charges, sales loads on funding vehicles, etc. Even if the employer has an intention to reinstate new nonqualified plans in the future, it would essentially mean doubling the costs associated with the implementation, administration and funding of the plans.

We would proffer that the employer has many more viable options than the onerous route of plan termination. If the existing plan documents were properly designed, then there would be sufficient flexibility to allow the plan administrator to make certain changes in the way the plan is currently being administered. To illustrate one example of an alternative that may be utilized, if the plan has been administered with a company match, the company can simply decide to suspend the match until the profitability goals of the company are reached. If the employer is currently funding a SERP, the compensation Committee could similarly decide to not fund the obligation for some period of time. Depending upon the time of the year, the Compensation Committee of the Board could decide to freeze the existing population at the end of a plan year and reduce the number of participating executives going forward.

There are other scenarios that could be developed depending again on the existing plan documents. The






employer should definitely seek the counsel of an attorney who is well-versed in the intricacies of Section 409A as well as a consulting group who would have the practical knowledge of how to best administer these types of plan changes.

The employer should also not lose focus on the overriding rationale that formulated these plans. The attraction and retention of executives, especially the retention of executives in a bear market economy, is critical to the future success of the company.

Perhaps most importantly, it is in times of stress and duress that the executives and employees along with shareholders and other interested parties want to see how the leadership of the company will lead their company through this stressful time. Has the leadership been able to retain the executives it needs to lead it through this recessionary time? Has it been able to recruit the caliber of new talent it needs to continue its growth?

In addition to the employer related issues discussed above, it is also important that the company realize that terminating these plans could have a severe tax consequence on the participating executives. It is widely accepted that some personal tax rates will be going up under the current administration. For the participating executive this means that the company has eliminated one of the major sources of pre-tax sheltering of income and the elimination of one of the major tools used by financial planners to help their clients do tax planning, manage their current income and plan for retirement.

For the participating executive who has 20 or 25 years until retirement, the termination of these plans and the likelihood of this same employer designing new plans in three years will appear very unlikely. For this reason alone, this executive may be motivated to find an employer who does not share this same sentiment towards nonqualified retirement plans.

Lastly, and perhaps another underlying concern is that the executive will probably not take the distribution from their nonqualified plan and purchase annuities, but will more than likely spend it. This will only exacerbate the problem and the executives will find themselves at retirement without a suitable retirement nest egg.

If you have any questions or concerns about how your company may want to address these issues, please contact:

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