DESIGNING DEFERRED COMPENSATION PLANS

FOR TAX-EXEMPT ORGANIZATIONS ©

A Discussion Draft

Section 457(b) Eligible Plans
Section 457 (f) Ineligible Plans
Alternative Plan Approaches

Note: these materials do not reflect concerns potentially raised by the post-Enron / Sarbannes Oxley corporate culture. New laws and best practices in light of these events should be considered when approaching deferred compensation agreements. Additionally, schools should not fail to comply with intermediate sanctions guidelines.

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CONFIDENTIALITY AND LEGAL ISSUES

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AN OVERVIEW OF THE DEFERRED COMPENSATION MARKETPLACE

For many years the "unfunded" non-qualified deferral arrangements have been an important component of the compensation program for selected key employees of the organization. However, with the passage of the Internal Revenue Code Section 457, these types of compensation arrangements have been dramatically restricted within the tax-exempt organizations.

Specifically, the Internal Revenue Code Section 457 regulations apply: "to any compensation arrangement that is deferred plus income attributable to the deferral under an arrangement between a state or local government, a non-church organization, or non governmental tax-exempt organization and an individual who performs services for such an entity". {IRC Notice 87-13, 1987-1 CB 432, 444}. Therefore, both qualified and non-qualified arrangements must comply with Code Section 457.

The Tax Reform Act of 1986 imposed a new and unique set of regulations for deferred compensation arrangements within tax-exempt and governmental organizations. The Section 457 regulations are more restrictive than those applicable to taxable entities. As a result, Section 457 plans have been significantly limited as to their usefulness for deferred compensation arrangement for the highly paid employees within a tax-exempt organization.

In 2001, Congress passed the Economic Growth and Tax Relief Reconciliation Act. Although the centerpiece of the Act was the phase in reduction in personal income tax rates, the Act contains a number of significant changes affecting employee benefit plans especially regarding elective deferral plans, especially 403(b), 401(k) and 457(b) plans. The Act provided for the following changes:

A. **Elective Contributions Limit** increased for 401k, 403b, and 457(b) plans to:

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<tr>
<th>Year</th>
<th>Max. Deferral</th>
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<tr>
<td>2002</td>
<td>$11,000</td>
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<td>2003</td>
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<td>$15,000</td>
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<tr>
<td>2007</td>
<td>$15,000 (indexed*)</td>
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* Thereafter adjusted pursuant to section 457(e)(15)(B) of the Code.

B. **Age 50 Plus Supplemental Contribution added**

Special supplemental elective contributions limit increased for 403b and 401(k) plans to:

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<th>Year</th>
<th>Max. Deferral</th>
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<td>2001</td>
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<tr>
<td>2006</td>
<td>$5,000 (indexed*)</td>
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C. **Special Catch-up Rule within Three (3) Years of Normal Retirement Age** - For the three years prior to Normal retirement Age, the primary limit is computed based upon twice the otherwise applicable dollar limit as provided under section 457(b)(3)(A), as amended up the IRC section 415 annual limits on contributions ($40,000 for 2002

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D. **Non-Coordination of 453(b), 401(k) and 457(b)** - the Act eliminated the coordination of contributions by participants into 401k, 403b, and elective deferrals qualified plans and as such no longer count against the dollar limit applicable to 457(b) plans. That is, 457(b) plans do not have to coordinate benefits under Code section 402(g). This will create a significant deferral opportunity for selected key employees.

Although the deferred compensation arrangements have been curtailed for the highly compensated employees, the current rules still continue to make it possible to provide a low-level deferral arrangement that is still relatively favorable for the rank-and-file employees. This is especially true within those governmental organizations that cannot qualify for the 403(b) type arrangements.

In summary, the Section 457 regulations are broad and restrictive in the area of Section 457(f) plans {known as “Ineligible Plans”}; but the use of Section 457(b) plans {“Eligible Plans”} should dramatically increase.
AN OVERVIEW OF
INTERNAL REVENUE CODE SECTION 457

Code Section 457 was enacted as a provision under the Revenue Act of 1978 to apply to government entities. Later, as part of the Tax Reform Act of 1986, the regulations of Code Section 457 were extended to private tax-exempt organizations.

APPLYING OF CODE

Currently, Code Section 457 applies: "to any compensation arrangement that is deferred plus income attributable to the deferral under an arrangement between a state or local government, a non-church organization, or non governmental tax-exempt organization and an individual who performs services for such an entity." (IRC Notice 87-13, 1987-1 CB 432, 444).

Code Section 457 does not apply to certain deferral arrangements sponsored by the employer. Specifically,

- A plan described in Code Section 401(a) that includes a trust exempt from tax under Code Section 501(a), that is a tax qualified retirement plan such as a defined benefit pension plan, defined contribution pension plan or profit sharing plan.

- Any annuity plan or contract as described in Code Section 403 - tax sheltered annuity plan.

- That portion of any plan that consists of a property transfer described in Code Section 83, e.g. life insurance arrangements between employer and employee.

- That part of a plan that consist of a trust to which Code Section 402 (b) applies, e.g. non-qualified trust.
AN OVERVIEW OF
INTERNAL REVENUE CODE SECTION 457

TYPES OF PLANS

There are two individual deferred compensation arrangements covered under Code Section 457. They are "Eligible" and "Ineligible" deferred compensation plans.

I. "Eligible Deferred Compensation Plans" – Code Section 457(b)

The "Eligible" deferred compensation plans are known as “quasi-qualified” supplemental retirement plans and must meet the specific requirements contained in Code Section 457(b). If these requirements are met, the participants may defer taxes on their elective deferrals and any employer contributions under the plan until which time the amounts are paid or made available to the participant.

Section 457(b) Eligible Plan is a deferred compensation plan that is maintained by an eligible employer and that also meets the statutory requirements of the regulations. The mandatory provisions are as follows:

a. The sponsor must be a state or local government or a non-church, non-governmental tax-exempt organization.

b. The plan must provide that compensation is to be deferred for any calendar month only if an agreement providing for such deferral has been entered into before the first day of the month.

c. The plan document must specify the current IRS deferral ceiling.

d. The plan assets must remain employer assets until distributed to the employee.

e. The plan must specify a fixed or determinable time of payments of benefits by reference to the occurrence of a triggering event (retirement, voluntary/involuntary termination of employment, death, disability). The plan may provide the participant the right to elect when payments are to be made as long as the first payment is not deferred beyond participant’s age 70 ½.

Elective deferrals

Elective Salary Deferral contributions limit increased to:

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<th>Year</th>
<th>Max. Deferral</th>
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<td>2002</td>
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<td>$14,000</td>
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<tr>
<td>2006</td>
<td>$15,000 (indexed)</td>
</tr>
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</table>
**catch-up provision**

The Act eliminated the old "catch-up provision within three years of retirement and replaced it with the following:

**Within Three Years of Retirement**

For the three years prior to Normal retirement Age, the primary limit is computed based upon twice the otherwise applicable dollar limit as provided under section 457(b)(3)(A), as amended up to the 415 annual limits ($40,000 for 2002 indexed)

**457(b) Limitation Test and elimination of coordination of benefit for elective salary deferrals -**

The act increases the annual contribution limit for 457(b) Eligible Plans to the lesser of the dollar limits discussed above or 100% of compensation, effective in 2002. Also, and probably the most unique addition, contributions by participants to other plans (401k, 403b, and elective deferrals qualified plans) no longer count against the dollar limit applicable to 457(b) plans. (No longer have to coordination benefits with Code section 402(g)). This will create a significant deferral opportunity for executives in tax-exempt entities.

**"Eligible" PLANS QUALIFY FOR THE TOP-HAT EXEMPTION**

Most "eligible" deferred compensation plans are structure as "Top-Hat" plans. A "Top-Hat" plan is a non-tax-qualified retirement or deferred compensation plan maintained "primarily for the purpose of providing deferred compensation for a select group of management or highly compensated employees" [ERISA Sections 202(2), 301(a)(3), 401(a)(1)]. It is important to note that the “Top Hat” provisions generally do not apply to government sponsored plans.

**Elective deferrals do not reduce eligible compensation for determining benefits under qualified plan**

Elective deferrals up to the then current applicable maximum under the "Eligible" deferred compensation plan do not reduce the eligible compensation under the qualified plan as with elective deferrals into the In-Eligible section 457(f) plan.

**FUNDING OF THE PLAN**

"Eligible" deferred compensation plan must be "unfunded", that is, the investments are the sole property of the plan sponsor and must be subject to the claims of creditors. {Treasury Regulations Section 1.457-1(b)(1), Private Letter Rulings: 90-03-021, October 20,1989 and 89-46-019, August 17, 1989}. The participant, though, may be allowed to choose among various investment options under the plan.
II. "Ineligible Deferred Compensation Plans" - Code Section 457(f)

"Ineligible" deferred compensation plans are a non-qualified plan sponsored by tax-exempt and governmental employers. These arrangements have a much broader application for deferrals than the "eligible" deferred compensation plan. Moreover, these types of arrangements are designed to be more flexible in contributions and benefits. Moreover, "ineligible" deferred compensation plans have a broader utility because of the fact that:

(a) The amounts deferred under such plans are not limited.

(b) Such amounts deferred are not offset by amounts that a participant may defer under any other plan that involves a limitation such as a Code Section 403(b) tax sheltered annuity plan.

(c) Because of the lack of contribution limitation and potential benefits to the participant, these arrangements have been utilized generally to supplement other elective and non-elective type plans as well as to provide enhancements to other benefit programs offered to the participant (i.e., survivor’s death benefit).

"Ineligible" deferred compensation plans by design do not have satisfied the eligibility requirements imposed by Code Section 457(b). Moreover, the tax treatment of amounts deferred as well as non-elective contributions on the behalf of the participant are taxed under the provisions of Code Section 457(f).

CODE SECTION 457 (f)

Code Section 457(f)(1)(A) requires that amounts deferred under an "ineligible" deferred compensation plan must be subject to "substantial risk of forfeiture". The rights of a participant’s to compensation are "subject to a substantial risk forfeiture if such participant’s rights to such compensation are conditioned upon future performance of services by the participant as a condition of the deferral"{Code Section 457(f)(3)(B)}. Consequently, deferred amounts are considered to be no longer subject to "substantial risk of forfeiture" if the participant may receive the amounts deferred (elective/non-elective) under the plan in the event of a voluntary termination of employment with the sponsoring employer. If this event were to occur, the full amount of the deferral whether elective or non-elective as well as the earnings would be taxable in the calendar year (i.e. tax inclusion rule under Code Section 1.457-3(a)(2) and Code Section 72 would apply).

- OBSERVATION/COMMENTARY -

The forfeiture provisions of the "ineligible" plan form the important exemption from taxation under Code Section 457(f). Too many, the forfeiture provision seems harsh; yet, such a provision is needed to maintain the tax-deferred nature of the plan.

A number of plan provisions and the awareness of the tax inclusion rule have reduced the relative harshness of the forfeiture provisions. These plan provisions are structured in such a way to cause "vesting of amounts deferred under to plan to coincide with the participant’s desired date of the receipt of the benefits under the plan and/or permit vesting of earnings on deferred amounts, which are not taxed to the participant until received by the participant." {Private Letter Ruling 92-12-011, Dec 19, 1991}
If vesting and therefore taxation does not coincide with the participant's desired date of receipt of benefits under the plan, the following results may occur:

1. In the case of "vesting" prior to the desired date of receipt of benefits under the plan, taxation to the participant might occur. This event would most likely result in a substantial liquidity problem (tax due of vested benefits) for the participant.

2. In the case of voluntary termination prior to the participant's vesting date, the participant may likely experience a forfeiture of non-vested deferred compensation amounts under the plan.

"INELIGIBLE" PLANS QUALIFY FOR THE TOP-HAT EXEMPTION

Most "ineligible" deferred compensation plans are structure as "Top-Hat" plans. A "Top-Hat" plan is a non-tax-qualified retirement or deferred compensation plan maintained "primarily for the purpose of providing deferred compensation for a select group of management or highly compensated employees" [ERISA Sections 202(2), 301(a)(3), 401(a)(1)]. As such, "Top-Hat" plans are not subject to the very rigid design structures and ERISA compliance regulation imposed upon tax-qualified retirement plans. Thus, "ineligible" plans are extremely flexible, largely contractual in nature, and may be designed to serve a wide range of organizational objectives. The organizational objectives may be:

1. To attract and retain qualified key employees.
2. To permit key employees to achieve maximum income tax deferral/savings opportunities;
3. To bring parity to key employees with all other employees percentage of actual salary; and
4. To prevent competition by employees after termination.

Elective deferrals into "In-Eligible" plan reduce eligible compensation for determining benefits under qualified plan

Excess elective deferrals above that contributed into the 403(b) and "Eligible" 457(b) plans which are contributed into the “In-Eligible” 457(f) plan will reduce the participant’s eligible compensation for determining benefits under the qualified plan on a dollar for dollar basis. To mitigate this occurrence, most plan sponsors incorporate a “pension offset” provision to accommodate for this reduction in qualified plan contributions due to excess elective deferrals beyond the 403(b) and 457(b) limits.

FUNDING OF THE PLAN

"Ineligible" deferred compensation plan must be "unfunded", that is, like the "eligible" plan investments are the sole property of the plan sponsor and must be subject to the claims of creditors. {Treasury Regulations Section 1.457-1(b)(1), Private Letter Rulings: 90-03-021, October 20,1989 and 89-46-019, August 17, 1989}. The participant, though, may be allowed to choose among various investment options under the plan.

TRANSFERS BETWEEN INELIGIBLE PLANS

The Code does allow for transfers from one "ineligible" plan to another "ineligible" plan without requiring the participant to include any portion of the amount transferred in income as long as the participant prior to the transfer does not constructively receive the transfers. {IRC Section 457(e)(10); Private Letter Ruling 89-46-019, August 17, 1989}.

In addition, the Code does not permit a rollover to an IRA from an "ineligible" plan. Such a transfer
would be a taxable distribution and a non-permissible IRA contribution. (IRC Section 457(a); Treasury Regulation Section 1.457-1(a)(1); Revenue Ruling 86-103, 1986-2 CB 62; Technical Advice Memorandum 91-21-004, Jan 30, 1991)

**LUMP SUM DISTRIBUTION FOR INCOME AVERAGING TREATMENT**

Distributions from “ineligible” plans do not qualify for income averaging treatment under Code Section 402, lump sum distributions.
Since the advent of Code Section 457 in 1986, deferred compensation arrangements for employees of tax-exempt organizations have become subject to restrictive tax rules that are strikingly different from those applicable to taxable entities. The effect of Code Section 457 is that the design of deferral plans (elective and non-elective) for tax-exempt organizations were changed and, as a result, the use of Section 457 "eligible" and "ineligible" plans has been reduced.

The advent of the Economic Growth and Tax Relief Reconciliation Tax Act of 2001 has changed the possible use of these arrangements. Although the centerpiece of the Act was the phase in reduction in personal income tax rates, the Act contains a number of significant, and exciting, changes affecting employee benefit plans such as elective deferral plans. The new rules increased deferral limits for 403(b), 401(k) and 457(b) "eligible" plan. Moreover, and the most innovative addition the Act, is the elimination of the coordination of benefit rules associated with 40(b) and 410(k) plans. This should result in be an substantial increased use of Section 457(b) plans.

Most practitioners are suggesting that in the retirement plan (i.e. elective/non-elective) area, that the tax-exempt organizations structure their programs around the following list of preferences. They are:

<table>
<thead>
<tr>
<th>Preference</th>
<th>Arrangement</th>
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<tbody>
<tr>
<td>(1)</td>
<td>Qualified Plan – Defined Benefit; Defined Contribution Retirement Plans</td>
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<tr>
<td>(2)</td>
<td>Section 403 (b) Plans</td>
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<td>(3)</td>
<td>Section 457(b) – known as &quot;403(b)-Look-A-Like or Mirror Plans&quot;</td>
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<td>(4)</td>
<td>Bona Fide Severance Plan under Section 457(e)(11)</td>
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<td>(5)</td>
<td>Section 457 &quot;Ineligible&quot; Plans.</td>
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<td>(6)</td>
<td>Section 162 Bonus Plan</td>
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**NOTE**

Recent passage of the Economic Growth and Tax Relief Reconciliation Act has eliminated the 457(b) limitation and coordination test should have dramatic impact on the increased use of Section 457(b) Plan.

Although split dollar plans have been used as an additional means to provide post-retirement supplemental income benefits of a tax-leveraged basis, the IRS Notice-2001-10 may have a substantial negative impact on these types of arrangements in the future when the final regulations have been promulgated.
RETIREMENT ADEQUACY GOALS

The standard measurement of retirement income adequacy is based on the premise that an employee should be able to enjoy the same standard of living after retirement as before. Income needs in retirement reflect changes in payroll and income taxes, and in expenses. As a result, they vary by pre-retirement income level.

Our model as developed by the President’s Council on Retirement Adequacy in 1981 and as illustrated by the table on the following page, equates disposable income before and after retirement. The table illustrates adequacy goals for a single employee at various income levels, assuming retirement at age 65. Most employees will need a replacement ratio between 65% and 75% of their pre-retirement income in order to maintain the same standard of living in retirement (Refer to exhibit sections for two articles on retirement replacement ratios).

The adequacy goal for pre-retirement income in excess of $500,000 is similar to that shown for $500,000.

ADEQUACY GOALS FOR SINGLE EMPLOYEES

<table>
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<th>Replacement Ratio's</th>
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<th>70K</th>
<th>80K</th>
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SECURITIZATION CONSIDERATIONS

Since almost all non-qualified deferred compensation plans are unfunded in the formal sense, participants initiating deferred compensation arrangements are likely to seek ways to increase the benefit security. The following approaches are commonly used:

**Reserve Account Maintained by Employer**

The employer maintains an actual account invested in various types of securities. There is no trust and the funds are fully accessible to the employer and its creditors. A variation of this theme is to allow the participant to "direct" (select) investments in the reserve account. The right must be limited to choice of broad types of investments (i.e., equity, bonds, and mutual funds) because the ability to choose specific investments may lead to constructive receipt by the participant.

**Rabbi Trust**

A Rabbi trust is a grantor trust established to hold property used for financing the emerging liability of the non-qualified deferred compensation plan. The fund set aside in the rabbi trust is still subject to the claims of creditors.

**Third Party Guarantees**

Under this arrangement, the employer obtains a guarantee from a third party to pay the participant if the employer defaults. The guarantor may be an individual, a related corporation, or a letter of credit from a bank.

**Haircut Provision**

The "Haircut Provision" is a provision within the contract, not the trust arrangement, to protect the accrued value of the participant's vested non-qualified account balances. Under the wording of the provision, the participant (active as well as retired) is allowed a one (1)-time opportunity to elect the acceleration of the benefit and have it paid out under a discounted lump sum arrangement. This provision assures that upon the signs of insolvency with the employer the participant has the opportunity to protect the accrued values in the account and be paid this amount.
A Review of Pre-August 16, 1986 Deferred Compensation

Regarding Pre-August 16, 1986 deferred compensation plans, it is important to determine the "grandfathered" provisions under Code Section 457 and its effect. The following will review our summary findings.

If an entity is subject to Code Section 457(f) (i.e. a governmental employer or a non-church, tax-exempt employer) maintains a written non qualified arrangement on August 16, 1986, the participant in the plan as of August 16, 1986 are taxed under the rules applicable to the non qualified deferred compensation arrangements of for profit entities so long as they do not modify their deferred compensation formulae after August 16, 1986. {Tax Reform Act Section 1107(c)(2)-(5), as amended by Private Letter Ruling 100-647, Section 1101(e)(6)-(7)}

In order words, in order to enjoy the grandfather rule, the participants in grand-fathered plans must be sure not to make any changes to the formulae used to determine the amounts of compensation that regularly are deferred under the plan. For instance, if the plan provides for deferred compensation equal to a fixed percentage of total pay, that percentage should not be altered. Similarly, if the plan provides for a fixed dollar amount of deferred compensation, that dollar amount should not be altered.

Although there is no guidance to date under these grandfather rules, the IRS has stated informally, and with some frequency, that a decision by a grand-fathered plan participant to reduce his or her deferral rate from August 16, 1986 to or zero would not have the effect of eliminating the grand-fathered treatment of the amounts deferred to date of the reduction.

**Situation -**

1. **A reduction of the August 16, 1986 deferral rate** to a number greater than zero, or an increase of the August 16, 1986 deferral rate, would cause the grandfathered plan to lose the grandfathered status.
   - The IRS undoubtedly would conclude that a reduction of the August 16, 1986 rate to zero, followed by a subsequent increase of the deferral rate from zero to the August 16, 1986 rate would cause at least subsequent deferrals to fail to enjoy the grand-fathered plan status.

2. **An increase in the August 16, 1986 deferral rate** to a number greater than prior August 16, 1986 deferral rate would cause the grandfathered plan to lose the grandfathered status.
Summary of the Alternative Deferred Compensation Arrangements

“If you don’t know where you are going, any path will take you there.”
- Sioux Proverb

The Alternatives...
A description, the rub, pros and cons as well as the ideal organization.

I. Section 457(b) – Quasi Qualified Supplemental Plans

II. Supplemental Executive Retirement Plan Funded with a Rabbi Trust

III. Severance Pay Plan Funded by a Rabbi Trust

IV. Supplemental Executive Retirement Plan Funded with an Ordinary Trust

V. Severance Pay Plan Funded by an Ordinary Trust

VI. Split Dollar Life Insurance Arrangement

VII. Professional Corporation Executive Retirement Plan Funded by a Rabbi Trust

VIII. Tax-Exempt Entity Non Qualified Discounted Stock Option Plan

IX. Tax-Exempt Entity Partnership Interest Plan – Partner in Profits of Real Estate or Property Transaction
Summary of the Alternative Deferred Compensation Arrangements

Section 457(B) Supplemental Retirement Plan - NEW opportunity as of January 1, 2001

Description: Tax-exempt entity allows the executive to defer a percentage of the participant’s compensation (limited in amount) to the plan. Earning of the plan accrue free of tax. Elective deferrals to the plan are taxed to the participant at a triggering event (defined as voluntary or involuntary termination of employment, retirement, disability or death). The participant’s deferrals are 100% vested in the participant at all times. The participant may elect to receive the benefit in either a lump sum payout or in a series of installments. Distributions must begin by age 70 ½.

The “Rub”: A risk of loss, which requires that the Entity’s bankruptcy and insolvency creditors have access to the plan assets until such assets, are distributed to the participant.

PROS

- Maximum tax deferral benefits.
- Maximum potential investment performance.
- No coordination of deferrals with other elective salary deferral plans such as 403(b) or 401(k) plans.
- Discriminatory as to participation and benefits payable.
- In-service distributions are permitted.
- ERISA generally inapplicable (Compliance Statement to DOL only Reporting Requirement)
- Administratively simple and inexpensive.

CONS

- Unsuitable for itinerant participant.
- Bankruptcy risk makes plan unsuitable for Entities that are bankruptcy risks.
**Summary of the Alternative Deferred Compensation Arrangements**

Supplemental Executive Retirement Plan Funded with A Rabbi Trust -

**Description:**
Tax-exempt entity and the executive (usually just the entity) contribute a percentage of the participant's compensation (unlimited in amount) to a rabbi trust. Earnings of the rabbi trust accrue free of tax. Contributions to the rabbi trust are taxed to the participant at the date contribution's vest in the participant (i.e., the date as of which the participant can voluntarily terminate employment and nevertheless receive the benefits). Contributions are not deemed vested merely because they are payable upon involuntary termination of employment, death or disability. Earnings on contributions may be vested without taxation until distribution, at which time earnings are taxed. In-service distributions are permitted.

**The "Rub":**
A risk of loss (i.e., forfeiture) must exits to defer taxes. The vesting event ideally should coincide with the year of termination of employment. This is achieved by permitting the participant to elect his/her own vesting schedule and continually elect to defer the vesting event prior to its occurrence. Also, the rabbi trust form requires that the Entity’s bankruptcy and insolvency creditors have access to the rabbi trust assets until such assets are distributed to the participant.

**PROS**
- Maximum tax deferral benefits.
- Maximum potential investment performance.
- Risk of forfeiture has golden-handcuff effect.
- Discriminatory as to participation and benefits payable.
- In-service distributions are permitted.
- ERISA generally inapplicable (Compliance Statement to DOL only Reporting Requirement)
- Administratively simple and inexpensive.

**CONS**
- Risk of forfeiture makes the plan unsuitable for itinerant participant.
- Bankruptcy risk makes plan unsuitable for Entities that are bankruptcy risks.
Summary of the Alternative Deferred Compensation Arrangements

Severance Pay Plan Funded by A Rabbi Trust –

Description: Tax-exempt entity and the executive (usually just the executive) contribute a percentage of compensation (usually through salary reduction or bonus deferral) to a rabbi trust. Earnings of the rabbi trust accrue free of tax. The total contributions plus earnings may not exceed 200% of the participant’s final annual cash and non-cash earnings. Amounts are taxed only when paid to the participant at termination of employment. Amounts can be vested at all times without resulting in current taxation to the participant.

The "Rub": Some IRS representatives take the informal position that full vesting of benefit is not permitted. However, existing law supports full vesting. Also, the rabbi trust form requires that the Entity’s bankruptcy and insolvency creditors have access to the rabbi trust assets until such assets are distributed to the participant.

PROS

• Fully vested benefit.
• Maximum tax deferral benefits.
• Maximum potential investment performance.
• Risk of forfeiture has golden-handcuff effect.
• Discriminatory as to participation and benefits payable.
• ERISA generally inapplicable.
• Administratively simple and inexpensive.

CONS

• IRS position makes longevity of the plan questionable and however unlikely, could theoretically result in premature taxation to participant.
• No golden handcuff effect.
• Bankruptcy risk makes plan unsuitable for Entities that are bankruptcy risks.
Summary of the Alternative Deferred Compensation Arrangements

Supplemental Executive Retirement Plan Funded with an Ordinary Trust

**Description:** Tax-exempt entity contributes a percentage of the participant’s compensation (unlimited in amount) to an ordinary trust. Earnings of the trust are taxed to the trust as earnings are realized. Contributions to the trust and earnings are taxed to the participant at the date contribution vest to the participant (i.e., the date as of which the participant can voluntarily terminate employment and nevertheless receive the benefits). Contributions are not deemed vested merely because they are payable upon involuntary termination of employment, death or disability. Because of the use of an ordinary trust, assets of the trust are not subject to the claims of the entity’s creditors, even in bankruptcy.

**The “Rub”:** A risk of loss (i.e., forfeiture) must exits to defer taxes. The vesting event ideally should coincide with the year of termination of employment. This is achieved by permitting the participant to elect his/her own vesting schedule and continually elect to defer the vesting event prior to its occurrence. However, the existence of the trust causes ERISA’s vesting standards (and its other rules) to be applicable. This generally limits the maximum tax deferral period to five years commencing on the first day of participation. Also, the trust form used to protect assets from the entity’s bankruptcy and insolvency creditors, results in tax on earnings, then tax again on earnings when the vested benefit is distributed. Investing in trust assets in some tax-efficient investment medium, such as whole life, universal or variable life insurance contract may mitigate this.

**PROS**

- Creditor protection
- Some limited economic advantage (e.g., deferred tax on principal amount for up to five years).
- Risk of forfeiture has golden-handcuff effect.
- Discriminatory as to participation and benefits payable.

**CONS**

- Double taxation adversely affects investment yield (vs. use of rabbi trust)
- ERISA applies, resulting in increased administrative complexity, liability exposure and cost
- Trust causes existence of a separate taxpayer, further increasing administrative complexity and cost
Summary of the Alternative Deferred Compensation Arrangements

Severance Pay Plan Funded with A Ordinary Trust -

Description: Tax-exempt entity contributes a percentage of compensation (usually through salary reduction or bonus deferral) to a rabbi trust. Earnings of the trust are taxed to the trust as earnings are realized. Contributions to the trust and earnings are taxed to the participant at the date contribution vest to the participant (i.e., the date as of which the participant can voluntarily terminate employment and nevertheless receive the benefits). Contributions are not deemed vested merely because they are payable upon involuntary termination of employment, death or disability. Because of the use of an ordinary trust, assets of the trust are not subject to the claims of the entity's creditors, even in bankruptcy. The total accrued benefit (i.e., contributions plus earnings) may not exceed 200% of the participant's final annual cash and non-cash earnings. Amounts are taxed only when paid to the participant at termination of employment. Amounts are taxed when paid to the participant at termination of employment, or earlier when such amounts become vested.

The "Rub": A risk of loss (i.e., forfeiture) must exist to defer taxes on contributions. The vesting event ideally should coincide with the year of termination of employment. This is achieved by permitting the participant to elect his/her own vesting schedule and continually to elect to defer the vesting event prior to its occurrence. Also, the trust form, used to protect the assets from the entity's bankruptcy and insolvency creditors, results in tax on earnings, then tax again on earnings when vested or distributed. Investing in trust assets in some tax-efficient investment medium, such as whole life, universal or variable life insurance contract may mitigate this. The trust causes ERISA to apply. The application of ERISA forbids the deferral of the vesting event beyond five years unless the plan is structured as a severance pay plan, rather than a pension plan, thus requiring the two times compensation limitation.

PROS

- Creditor protection
- Deferred tax on principal (amount until such amount vests)
- Risk of forfeiture has golden handcuff effect
- Discriminatory as to participant and benefits payable

CONS

- Risk of forfeiture makes the plan unsuitable for itinerant participant.
- Double taxation adversely affects investment yield (vs. use of rabbi trust)
- ERISA applies, resulting in increased administrative complexity, liability exposure and cost
Summary of the Alternative Deferred Compensation Arrangements

Split-Dollar Life Insurance Plan

**NOTE**-IRS Notice 2001-10 has had impact on use of this arrangement going forward as of January 1, 2002

**Description:** The executive and the tax-exempt enter into an agreement where the tax-exempt entity agrees to advance on a permanent life insurance policy. The entity pays the entire premium and the executive reports the "imputed income (pure term cost) of the net death benefit. The executive, at death or termination of the agreement, the sum of the entity’s advances. The policy cash value in excess of the premiums advanced by the entity inures to the executive. At termination, the excess cash over the amount reimbursed to the entity results in "tax-deferred" compensation to the executive in retirement. Moreover, depending upon how the proceeds are withdrawn, the executive can continue to defer the tax on any income received.

The "Rub": Because of the internal economic dynamics of the permanent life insurance (i.e., premiums exceed cash value during the policy’s) and because of the insurability of the participant is an issue, split dollar life insurance arrangements generally are considered feasible only for younger participants with substantial periods of employment ahead of them (e.g., 10 to 16 years). The cash build-up (which represents the deferred compensation component) may not compare favorably to the economic performance of other available vehicles (e.g., rabbi trust funded with investments). Some IRS representatives take the position that a vested interest of the participant in split dollar policy cash build-up (i.e., cash value minus tax-exempt entity outlay) results in current taxation on cash value build-up.

**PROS**
- Insurance protection (Tax-free treatment of insurance proceeds).
- Potential for substantial cash value build up over the long period combined with creditor protection (i.e., because the participant is the beneficial owner of the policy)
- Discriminatory as to participant and benefits payable
- Tax-exempt entity receives its premium advances back; thus the entity’s cost is the time value of money only (assuming complete recovery of premium advances occurs)
- ERISA generally inapplicable

**CONS**
- Insurability of participant as well as the cost structures of the policy may be unsuitable for older participant (above age 55).
- Yield of retirement benefit is less efficient than other forms.
- Tax risk if the participant’s interest in the cash value is not subject to substantial risk of forfeiture.
**Summary of the Alternative Deferred Compensation Arrangements**

**Section 162 Bonus Plan Funded with Life Insurance and Interest-Free Demand Loan -**

**Description:**
Tax-exempt entity pays the premium on a permanent life insurance policy and bonuses the premium and the tax cost associated with the bonus. The entity retains an interest-free demand loan for the after-tax cost of the bonus. The executive owns the policy and the beneficial interest of the policy (e.g., entire death benefit and cash value). At termination, the executive repays the entity’s interest-free demand loan either from cash or from the policy’s cash value. The cash over the amount reimbursed to the entity results in “tax-deferred” compensation to the executive in retirement. Moreover, depending upon how the proceeds are withdrawn, the executive can continue to defer the tax on any income received.

**The “Rub”:**
Because of the internal economic dynamics of the permanent life insurance (i.e., premiums exceed cash value during the policy’s) and because of the insurability of the participant is an issue, split dollar life insurance arrangements generally are considered feasible only for younger participants with substantial periods of employment ahead of them (e.g., 10 to 16 years). The cash build-up (which represents the deferred compensation component) may not compare favorably to the economic performance of other available vehicles (e.g., rabbi trust funded with investments). Some commentators take the position that an interest-free demand loan may results in current taxation on cash value build-up.

**PROS**
- Life insurance protection (favorable tax treatment of life insurance proceeds-tax free).
- Potential for substantial cash value build up over the long period combined with creditor protection (i.e., because the participant is the beneficial owner of the policy)
- Discriminatory as to participant and benefits payable
- Tax-exempt recovers the interest-free demand loan; the entity’s cost is the time value of money only.
- ERISA generally inapplicable

**CONS**
- Insurability of participant as well as the cost structures of the policy may be unsuitable for older participant (above age 55).
- Yield of retirement benefit is less efficient than other forms.
- Tax risk if the participant’s interest in the cash value is not subject to substantial risk of forfeiture.
Summary of the Alternative Deferred Compensation Arrangements

Tax-Exempt Entity Discounted Stock Option Plan –
ALERT – 5/10/02 IRS RULED ADVERSELY ON THIS APPROACH AND IS LIKELY TO BE ELIMINATED IN 2002-

Description: A innovative strategy under which a tax-exempt entity grants an executive an option to purchase securities or mutual funds owned by the entity. When the securities or mutual funds appreciate to a certain level, it is expected that, the executive would exercise his/her option to purchase the securities or mutual funds from the entity at the exercise price set in the option is substantially less than the value of the security or mutual fund share held by the entity. Proponents argue that this arrangement is not “deferred compensation” and thus not subject to the “taxed when vested rule” under IRC Section 457(f). Rather, the arrangement is in nature of an employee stock option that is, under certain tax principles, arguably not treated as deferred compensation.

The “Rub”: The law supporting the conclusion that no tax occurs at the grant date of the option has developed exclusively in situations where the option is one to purchase shares of the employing entity, not shares of a stranger entity or mutual fund merely owned, subject to the option with the employing entity. The occurrence of the tax-entity’s ultimate sale of the security to the executive pursuant to the exercise of the option for less than the security’s fair market value on the date of exercise raises concerns under the private inurement prohibitions applicable to the entity. Further, the offering by the entity of an option to an executive is the issuance by the entity of a “security” causes the application of various, and very complex, federal and state securities laws. Practically not evidence exists on how the IRS or the courts might view these arrangements on federal income tax, private inurement and securities laws. Moreover, some practitioners view the expensive transactional costs of implementing such an arrangement coupled with the tax risks and potential of the arrangement not generating any economic return (e.g., the underlying securities/mutual funds depreciate in value), as advising against such an arrangement’s adoption at this time.

PROS

• Fully vested
• Discriminatory as to participant and benefits payable.
• Deferred taxation on “spread” between option price and fair market value of the underlying security. on principal (amount until such amount vests)
• ERISA inapplicable

CONS

• Tax position not firmly grounded
• No golden handcuff effect
• Bankruptcy risk makes it unsuitable for entities that are bankruptcy risks
Summary of the Alternative Deferred Compensation Arrangements (cont.)

Tax-Exempt Entity Stock Option Plan - (cont.)

CONS

- Puts entity in unfamiliar and highly sensitive position of offering "securities" for sale.
- Legal/accountancy/administrative costs very high due to complex structure and application of federal and state securities laws.
- Cannot change underlying investment (i.e., mutual fund subject to option) without taxable event occurring.
Summary of the Alternative Deferred Compensation Arrangements

Tax-Exempt Entity Partnership interest Plan –

Description: A recently innovative strategy under which a tax-exempt entity forms a limited partnership, which purchases real property. The tax-exempt entity initially owns all of the interest in the partnership. The tax-exempt then transfers to eligible employees (as designated by the Board of Trustees/Directors) special interest ("Partnership Units") in the appreciation in the value of the real property held by the partnership, measured from the date of the grant to the executive. The Board of Trustees/Directors determines, in its sole discretion, the time at which a participant’s Partnership Unit(s) will become vested. If the participant terminates employment before his or her vesting date, the Partnership Unit generally will be forfeited. Each participant will have the right to “put” his or her vested Partnership Unit back to the tax-exempt entity, which must purchase those Partnership Units for their fair market value on the put date (the Partnership Unit may not be put back to the tax-exempt entity until the earlier of the attainment of age 65 or termination of employment. The tax-exempt entity, in its discretion, may satisfy its repurchase obligation in either a lump sum or by giving the participant a promissory note, payable over a period up to 15 years with an appropriate interest rate of interest.

The “Rub”: Although the concept is well known in the real estate industry, the concept is new to the tax-exempt industry. Moreover, such an arrangement requires that the organization be acquiring commercial real estate property that can be used within this arrangement.

PROS
- Can be fully vested
- Discriminatory as to participant and benefits payable.
- Deferred taxation on the appreciation in the value of the real property until the “triggering event” (retirement or termination of employment)
- ERISA inapplicable

CONS
- Tax position not firmly grounded
- Nominal golden handcuff effect
- Transaction may puts entity in unfamiliar and highly sensitive position.
- Legal/accountancy/administrative costs very high due to complex structure and application of federal and state securities laws.
- Cannot change underlying investment (i.e., real property subject to option) without taxable event occurring.