409A - The Sky Isn’t Falling

Nonqualified deferred compensation is alive and well - that is unless you’re one of those Enronesque, limit pushing, rule bending, excessively greedy plan sponsors (or participants) - in which case, the sky is falling, and NQDC is dead! However, for thousands of companies and hundreds of thousands of plan participants who have been operating well within the limits of the old rules, the new rules should not be problematic. Notice 2005-1 provides the first wave of guidance and provides the following answer to companies nervous about amending their pre-2005 plans: “A plan adopted before December 31, 2005 will not be treated as violating 409A(a)(2), (3) or (4) only, if (i) the plan is operated in good faith compliance with the provisions of 409A during the calendar year 2005, and (ii) is amended on or before December 31, 2005...” Generally speaking, if you tighten up some definitions for items such as disability, hardship, and distribution dates for certain key employees, and eliminate items such as offshore rabbi trusts, accelerated payments, on of disability, hardship withdrawals, distribution dates for “eligible employees’ and haircut provisions, and put some constraints on re-deferral options, old plans should be fairly easy to bring into compliance. More specific guidance will be forthcoming, but if you operate your old plan based on the new rules, you have until 12-31-05 to make actual plan amendments. For old plans that would still be in compliance with the new rules, the transition should be even easier. However, It is important to remember two things: First, all plans (new and old) are now subject to new W-2 or 1099-MISC reporting requirements; and Second, the stakes for non-compliance have been raised dramatically. If a plan fails to meet all of the requirements or is not operated in accordance with those requirements, all of the compensation for the taxable year and all preceding years is includible in gross income and assessed an interest penalty as well as an additional flat tax of 20%! Every new and existing NQDC plan needs to be carefully reviewed, but for many the transition to a new playing field may be fairly easy.

OCC 2004-56 ... NEW EMPHASIS ON RISK

On December 7, 2004 OCC Bulletin 2004-56 “Interagency Statement on the Purchase and Risk Management of Life Insurance” was issued to “remind financial institutions that the purchase and risk management of BOLI must be consistent with safe and sound banking practices.” While reaffirming that BOLI can be a useful product to recover employee benefit costs, the regulators have also become “concerned that some institutions have invested a significant amount of capital in BOLI without an adequate understanding of the full array of risks it poses.” The regulating agencies expect institutions to implement appropriate risk management processes including meaningful risk limits before implementing or adding to a BOLI program.

The statement provides new guidelines regarding supervisory expectations for both pre-purchase analysis as well as on-going risk management practices. New pre-purchase guidelines apply to all BOLI contracts entered into after December 7, 2004 whereas new guidance for the on-going risk management of BOLI applies to all holdings of life insurance regardless of when purchased. The new guidelines are quite specific about the need for management to better understand the unique characteristics of BOLI products, especially as they vary by carrier and product type.

And finally, a specific warning: “An institution should be aware that the vendor’s financial benefit from the sale of insurance may provide the vendor with an incentive to emphasize the benefits of a BOLI purchase to the institution without a commensurate explanation of the associated risks. Therefore, reliance solely upon pre-packaged, vendor-supplied compliance information does not demonstrate prudence with respect to the purchase of insurance.” In the future, examiners will be evaluating the effectiveness of the pre-purchase analysis as well as the framework for risk management.
Max. Annual Funding Limit - $42,000
EE 401(k) Max Contribution - $14,000
HCE Minimum Earnings - $95,000
Comp Limit for DC Contribs - $210,000
DB Maximum Annual Benefit - $170,000

DECLINE IN 401(K) PARTICIPATION:
According to the Profit Sharing Council of America, fewer employees participated in their 401(k) plans last year. In 2003, 76.4% of eligible employees had balances in their plans, a dip from 80.3% in 2002.

HEALTH COSTS TOP CONCERN:
According to the Business Roundtable’s quarterly survey of CEOs, the heads of the largest U.S. companies view rising health care costs as the greatest threat to economic growth.

BROKERS ARE PROVIDERS OF CHOICE:
Based on the 2004 EBN-Genworth Small to Midsize Employer Benefit Survey, 76% of respondents reported that they purchase their benefits from brokers as opposed to buying directly from carriers (16%), from a consultant (3%), or through a business group (3%).

Worthy Web Sites

Refresher Course on Funds
www.mutualfunds.about.com

More on Sarbanes-Oxley
www.revenuerecognition.com

Prospecting Tool
www.melissadata.com

Business Valuation Info
www.bvresources.com

Lessons in Loopholes
www.taxloopholes.com

Planning Briefs

COST OF LIVING ADJUSTMENTS:
The following increases have been announced effective January 1, 2005:
DB Maximum Annual Benefit - $170,000
Comp Limit for DC Contribs - $210,000
HCE Minimum Earnings - $95,000
EE 401(k) Max Contribution - $14,000
Max. Annual Funding Limit - $42,000
Social Security Wage Base - $90,000

DBS OUTPERFORMED 401(K)S:
According to Watson Wyatt analysts, during the three-year stock slump of 2000-2002, rates of return for 401(k)s dropped progressively from minus 4.28% in 2000 to minus 12.26% in 2002. Meanwhile, DB plans remained flat in 2000 and then dropped as low as 8.43% in 2002. The average difference in median rates of return between the two types of plans was 3.8%.

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Retirement Readiness:
According to Financial E-News, the following facts should help strengthen your desire to help your clients with their retirement plans:
➤ Average life spans are increasing - Once a married couple reaches the age of 65, there is a 97% chance that one of them will live to 75 and a 72% chance that one will live to 85.
➤ Poor national savings rates - 50% of all workers and 34% of those over 55 report their total savings including the value of their homes are less than $50,000.
➤ Unrealistic expectations for Social Security - 90% of older Americans expect Social Security to be their top source of retirement income, yet in 2001, Social Security supplied only 34% of retirement income to individuals 65 or older.
➤ Decline of employer sponsored plans - The number of individuals covered solely by defined benefit plans has decreased from 58% in 1981 to 12.5% in 2001.
➤ No plans for retirement income - 71% of workers do not have a plan to transform their savings into income.

More on Sarbanes-Oxley
www.revenuerecognition.com

Prospecting Tool
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Business Valuation Info
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Lessons in Loopholes
www.taxloopholes.com

INTERESTING RATES

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(Rates which fluctuate daily are shown on or about the 1st day of the month)