

THE EXECUTIVE BRIEFING SERIES

The Future is Now: Time to Align Executive Compensation & Benefits

CLARK CONSULTINGTM

PM | Pearl Meyer & Partners
& | *A Clark Consulting Practice*

New Legislation & Regs Create Opportunity

- » **Both 409A of the Tax Code and the new SEC disclosure rules are forcing all public companies to examine their executive compensation and benefits programs**
 - Unique opportunity to strategically review the purpose your various executive compensation and benefit plans play in your organization's overall executive compensation philosophy

Time to Act = Opportunity

» **Section 409A is effective NOW**

- The proposed regulations issued September 2005 gave us breathing room and included some transition rules
- While it is possible the IRS may slightly postpone some of the plan drafting deadlines, there is no indication that any further effective date postponements will occur
- You must act NOW

» **Disclosure rules go into effect for 2007 proxy season**

- You will have to act SOON

» **The time is NOW to review your total executive remuneration**

Opportunity to Step Back

- Step 1: Connecting Executive Benefits & Total Rewards**
- Step 2: Plan Design & Drafting**
- Step 3: Plan Funding**
- Step 4: Plan Communication & Administration**

1: Connect Executive Benefits & Rewards

» **Executive Benefits ↔ Executive Compensation**

- Review executive compensation philosophy
- How do your current executive benefit plans fit into overall remuneration strategy?
- Time to redesign these plans to fit into the total executive compensation philosophy?

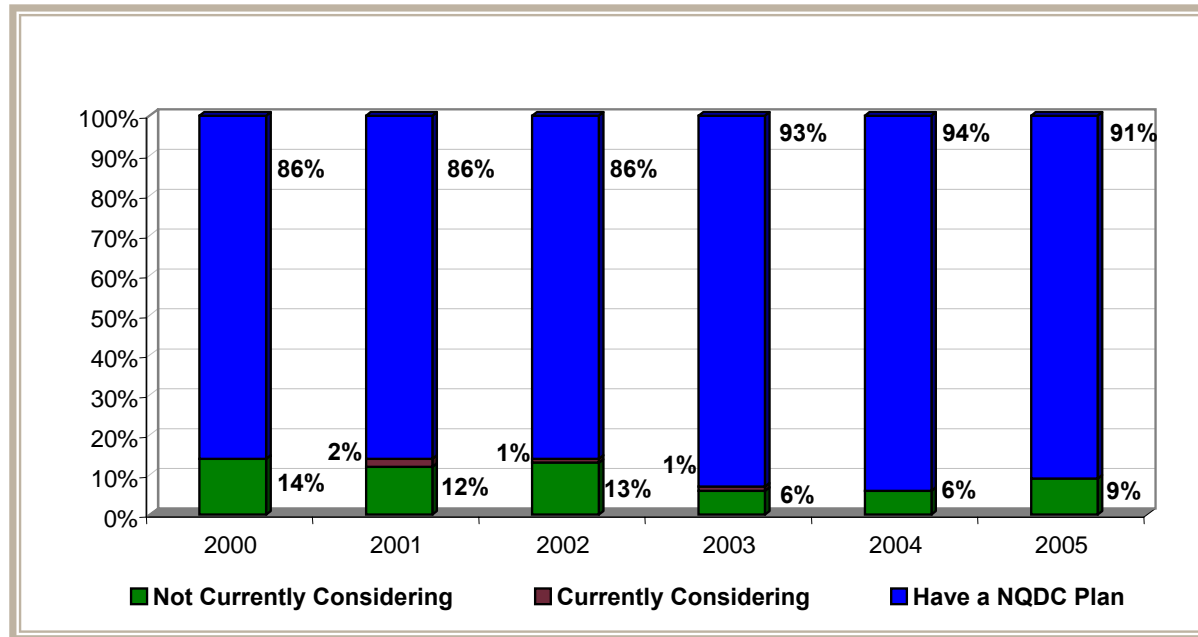
Why have a Deferred Compensation Plan?

- » **Do your executives need a tool to further plan for retirement?**
- » **Does your Company need a tool to help attract or retain key talent?**
- » **Who is / could be using the Plan?**

Why have a Deferred Compensation Plan?

- » **Other than recent legislation and disclosure requirements, the greatest “change” to deferred compensation plans will be the need to extend these plans to more highly compensated employees due to a variety of factors, including:**
 - Expected shortfalls in Social Security
 - Increasing healthcare expenses
 - Lack of other tax-advantaged savings
 - Increasing life expectancies

DCP Prevalence



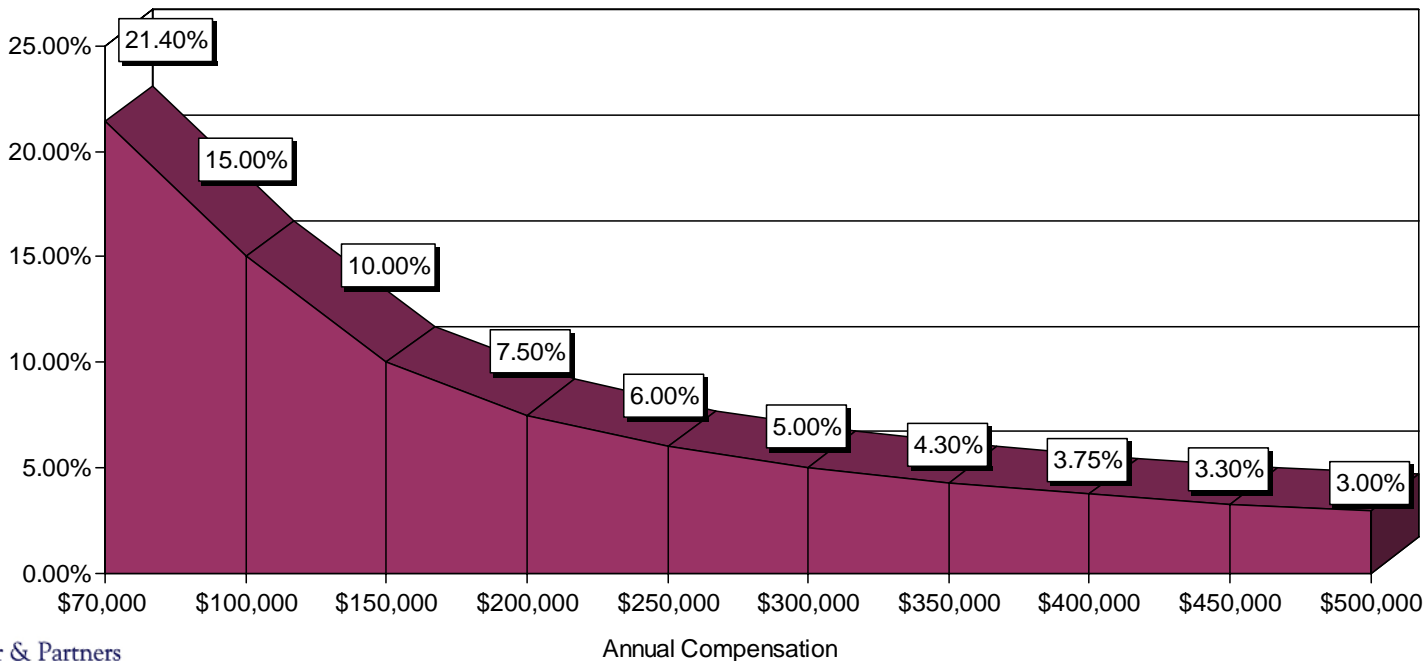
» Participant Demographics:

- Data provided on 225 nonqualified deferred compensation plans across the country,² reveals:
 - 70% of participants earn less than \$150,000
 - ½ of 1% of participants earn more than \$500,000

DCP Prevalence (Cont.)

- » **Highly compensated employees can not count on qualified plans to provide retirement income**
- » **Declining percentage of compensation deferrable under 401(k) as income increases**

Maximum Pretax Deferral (\$15,000 in 2006)
as a Percentage of Compensation



2: Plan Design & Drafting

- » **After determining the appropriate fit for your DCP, the next step is to begin designing and drafting**
- » **While 409A has given us a “boilerplate”, there are a number of substantive decisions that an organization must make**

Plan Design & Drafting

Three Key Concepts (enforced by 20% excise tax)

» **Concept 1 – Distributions can only start upon**

- Separation from service, with a six-month delay for key employees
- Death or disability
- Specified time or schedule specified at date of deferral (“specified time” is not something like a child going to college or an IPO; must be specific)
- Change in control, or
- Unforeseeable emergency

Plan Design & Drafting (cont.)

- » **Concept 2 – No acceleration (haircut provision is gone)**
- » **Concept 3 – Advance election**
 - Generally, before close of preceding year
 - 30 days after first eligible
 - 6 months before end of period if performance based compensation
 - Subsequent delay allowed if:
 - Election 12 months in advance of first payment (not effective for 12 months), and
 - 5 year delay in payments

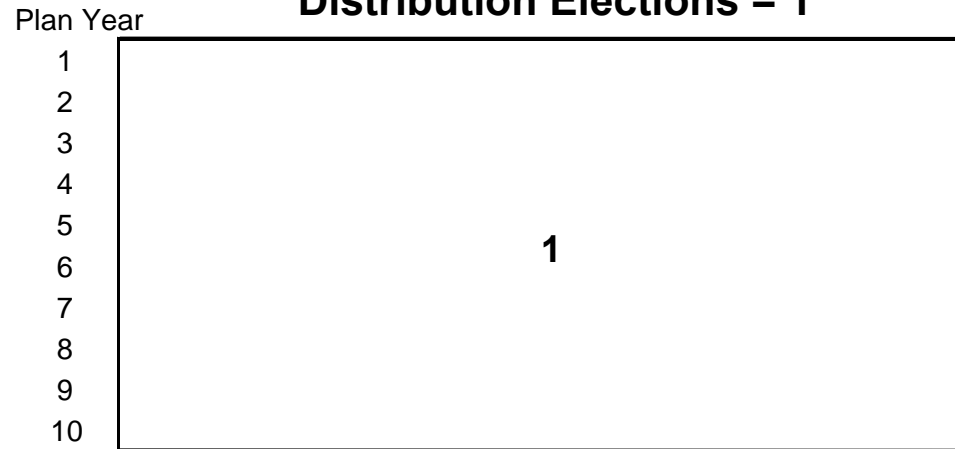
Plan Design & Drafting (cont.)

» **Decision Points**

- Has the prior Plan been “grandfathered” with a successor Plan effective 1/1/2005?
- Will all participants be treated as “key employees” for distribution purposes?
- Are there 401(k) integration issues?
- Do class year deferrals make sense?
- Installments as single payments versus separate payments?

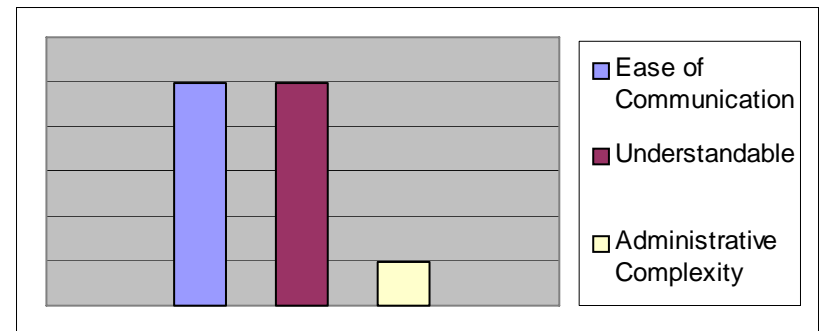
Plan Level - Single Payment Installments

Participant Buckets to Manage = 1
Distribution Elections = 1



» Advantages:

- Easy to communicate to participants
- Easy for participants to understand and anticipate relative size of payment
- Facilitates earliest receipt of lump sum payment following election change (participant can obtain cash ahead)



» Disadvantages:

- Distribution election for entire account must be made upon enrollment in the plan
- Election change impacts entire account balance

Class Year - Single Payment Installments

Participant Buckets to Manage = 10 Distribution Elections = 10

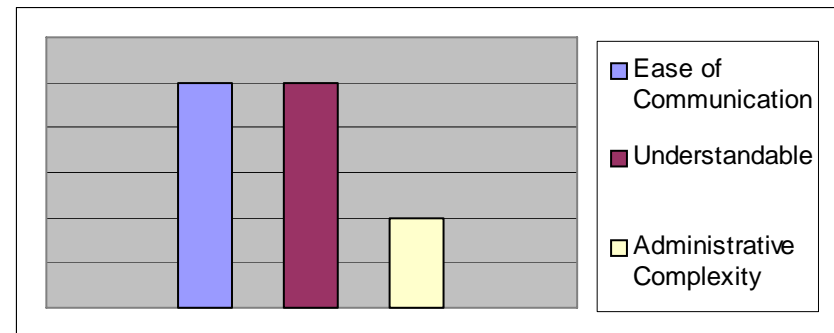
Plan Year	
1	1 - 10 year installment
2	2 - 10 year installment
3	3 - 10 year installment
4	4 - 10 year installment
5	5 - 10 year installment
6	6 - 10 year installment
7	7 - 10 year installment
8	8 - 10 year installment
9	9 - 10 year installment
10	10 - 10 year installment

» Advantages:

- Easy to communicate to participants
- Easy for participants to understand
- Participants can make a separate distribution election every year
- Facilitates earliest receipt of lump sum payment of a bucket following election changes

» Disadvantages:

- Potential for uneven payments
- Must make separate election to change each installment



Plan Level - Separate Payment Installments*

Participant Buckets to Manage = 10
Distribution Elections = 1

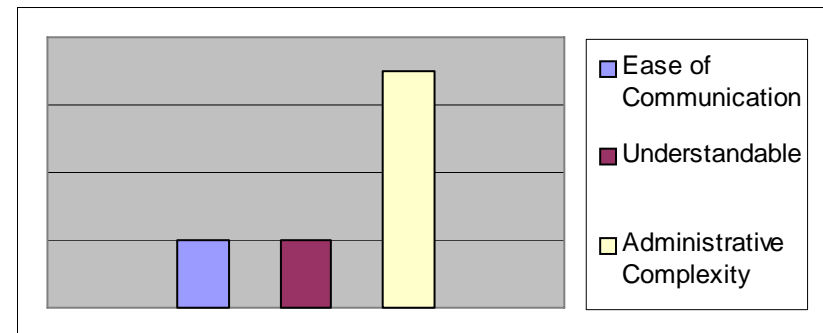
Plan Year	1	2	3	4	5	6	7	8	9	10
1										
2										
3										
4										
5	1	2	3	4	5	6	7	8	9	10
6										
7										
8										
9										
10										

» Advantages:

- Increased control of distribution stream
- Can postpone any installment

» Disadvantages:

- Difficult to communicate to participants
- Hard for participants/plan sponsors to understand
- Must make a separate election to change each installment and 5-year delay applies to each (cannot obtain cash ahead)
- Distribution election for entire account must be made upon enrollment in the plan



Class Year - Separate Payment Installments*

Participant Buckets to Manage = 100
Distribution Elections = 10

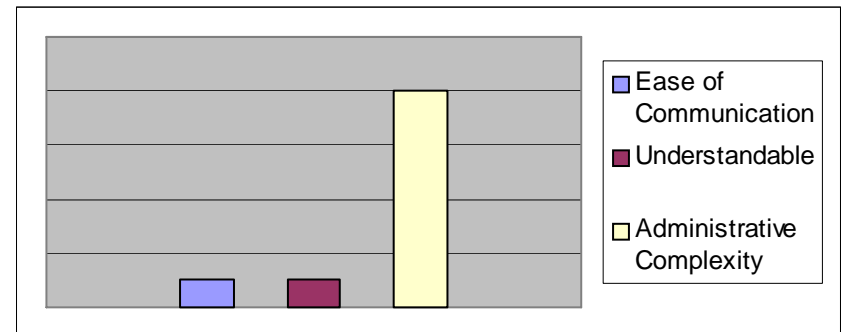
Plan Year	1	2	3	4	5	6	7	8	9	10
1	1	2	3	4	5	6	7	8	9	10
2	11	12	13	14	15	16	17	18	19	20
3	21	22	23	24	25	26	27	28	29	30
4	31	32	33	33	33	33	33	33	33	33
5	41	42	43	44	45	46	47	48	49	50
6	51	52	53	54	55	56	57	58	59	60
7	61	62	63	64	65	66	67	68	69	70
8	71	72	73	74	75	76	77	78	79	80
9	81	82	83	84	85	86	87	88	89	90
10	91	92	93	94	95	96	97	98	99	100

» Advantages:

- Increased control of distribution stream
- Can postpone any installment

» Disadvantages:

- Extremely difficult to communicate
- Hard for participants to understand
- Must make separate election to change each installment and 5-year delay applies to each (cannot obtain cash ahead)



3: Plan Funding

» **409A permits:**

- Domestic trusts
- Direct ownership of assets by employer

» **409A does NOT permit:**

- Foreign-situs trusts
 - Even if the underlying plan otherwise conforms to 409A requirements, holding assets in a foreign trust results in immediate taxation and penalties unless the exception applies

Plan Funding (cont.)

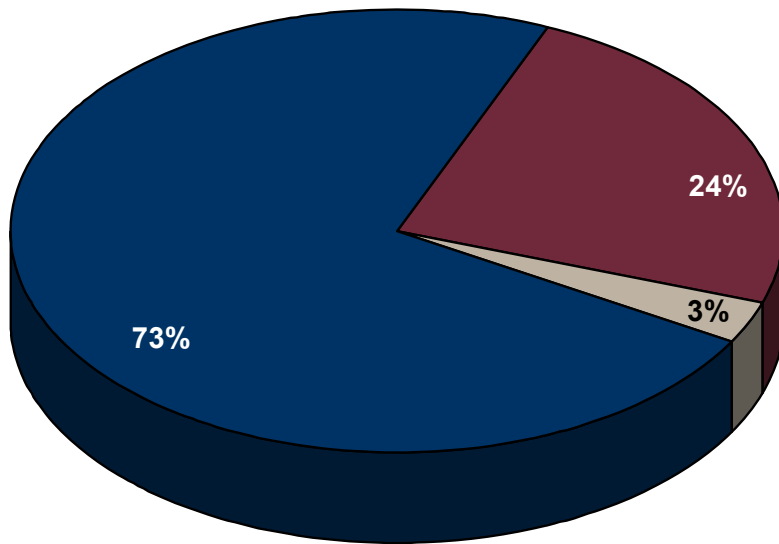
» Why do companies informally fund their plans?

- Current Fiduciary Responsibility. Current allocation of dollars removes the financial burden from successor management
 - Benefit costs for the currently accruing liability will not impact successor management's profits, bonus and benefits -- avoiding the "social security syndrome"
- Consistent with Funding of Qualified Retirement Plans. Dollars can be contributed today to a trust just as they would otherwise be contributed to a qualified pension plan trust if IRS guidelines allowed
- Hedging liabilities—if participants given investment choices, avoids financial statement surprise if assets perform well
- Tax-Advantaged Funding Available. Similar to the qualified plan, the trust and its funding can be designed to allow for a non-taxable accumulation of assets

Plan Funding (cont.)

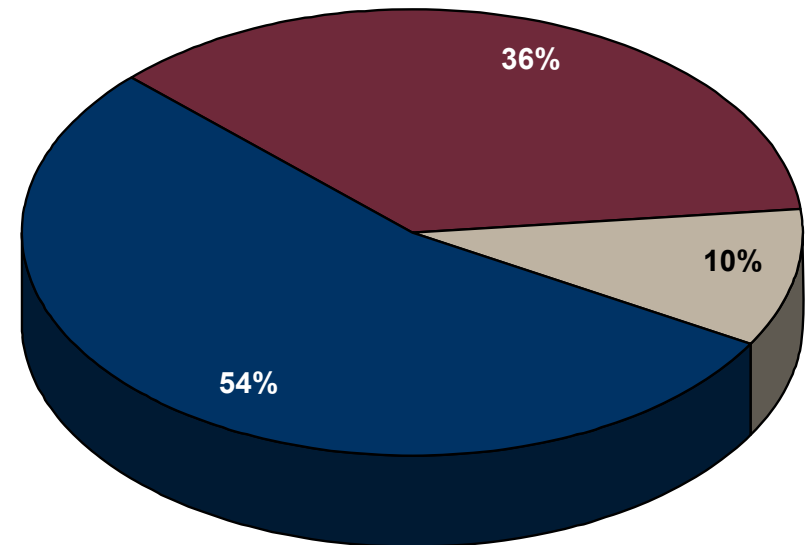
» Prevalence of informal funding for DCPs and SERPs

DCP Informal Funding Prevalence



■ Informally Funded ■ Unfunded ■ Considering

SERP Informal Funding Prevalence



■ Informally Funded ■ Unfunded ■ Considering

4: Plan Admin & Communication

- » **Plan administration**
- » **Payroll reporting**
- » **Top-hat notice for new plans**
- » **For public companies**
 - 8-K reporting for amendments of plans and agreements
 - 10-K attachments
 - Proxy statement disclosure of executive compensation
- » **Communication of new disclosure rules and 409A regulations must be done in conjunction with annual executive compensation changes**
 - Use to reinforce your compensation philosophy

THE EXECUTIVE BRIEFING SERIES

Good Governance in the Era of Enhanced Disclosure

*Creating Competitive, Value-Driven
Executive Rewards*