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A Report of Legal Trends

Susan Ward Harris, Editor

**John
Fitzpatrick
Named
Top
Up
and
Coming
Arizona
Attorney**

John Fitzpatrick, a partner of the firm, was honored in bizAZ Magazine as a top “Up and Coming Arizona Attorney” – those attorneys most likely to make a splash in the state’s legal scene. John’s practice focuses on commercial and estate litigation, including real estate, probate and trust disputes, corporate and commercial transactions and real estate law. John has earned an AV* rating from Martindale-Hubbell. This rating is awarded to only those attorneys who demonstrate the highest ethical standards and legal abilities.

John is a former Justice of the Peace Pro Tem and a Judge Pro Tem of the Maricopa County Superior Court. He graduated in 1987 from Notre Dame Law School, and has been with the firm since 1990. John, his wife, Rebecca, and their two children live in Phoenix. You can contact John at jfitzpatrick@frgaglaw.com or 602.277-2010.



John Fitzpatrick
Attorney at Law

*AV, BV and CV are registered certification marks of Reed Elsevier Properties Inc., used in accordance with Martindale-Hubbell certification procedure’s standards and policies.

**Law
Change
Requires
Life
Insurance
Review**

by
James W. Ryan
*Certified Trust and
Estate Law Specialist*

The Arizona Legislature recently passed House Bill 2633 which effectively exempts all cash value in life insurance policies from creditor claims of the owner of the policy under certain limited circumstances. In order to qualify for this protection from creditors, certain conditions must exist, including who is the named beneficiary of the life insurance policy. If your revocable trust is the beneficiary of your cash value life insurance policy, this protection is not available. We, as well as most estate planning lawyers, have for years recommended that the clients’ personally owned life insurance be made payable to their revocable trusts. That advice is no

longer universally true, given the provisions of the new law. If you are an insured life on a policy of insurance owned by an irrevocable trust, this new law does not affect that structure.

If you have not had your estate plan reviewed recently, we strongly suggest that you schedule a conference with your estate planning attorney to review your insurance ownership and beneficiary designation provisions in light of this new law, as well as the potential impact of the increased exemption from estate taxes which goes into effect January 1st.

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Employment Law Seminar Series

by
Amy Gittler
Attorney at Law

We are pleased to announce we will once again be conducting a series of seminars focusing on issues relevant to today's employers. Back by popular demand, these seminars will provide employers with information to deal effectively with the myriad of workplace legal issues. There is no charge for these seminars.



PLACE
Phoenix Country Club
2901 North 7th Street
At the intersection of 7th Street and Thomas

DATES TOPICS
February 2, 2006 *The Americans With Disabilities Act: What Every Employer Should Know*
Registration 3:45 p.m.; Seminar 4:00 – 5:00 p.m.; Hosted Cocktails 5:00 p.m.

March 2, 2006 *Conducting In-House Investigations in Response to Employee Complaints*
Registration & Continental Breakfast 7:30 a.m.; Seminar 7:45 – 8:45 a.m.

April 6, 2006 *Key Considerations in Drafting Handbooks and Policies and Applying Them in the Workplace*
Registration 3:45 p.m.; Seminar 4:00 – 5:00 p.m.; Hosted Cocktails 5:00 p.m.

Space is limited, so please RSVP at least one week prior to each seminar. To RSVP, please contact Dawn at 602.277.2010 or receptionist@frgaglaw.com. We hope you can attend.

For more information regarding the seminars or employment law related issues, please contact Amy Gittler at 602.200.7390 or agittler@frgaglaw.com.

New Rules Govern Deferred Compensation Plans

by
Susan Ward Harris
*Certified Tax Law
Specialist*

Congress changed the long-standing rules governing various types of deferred compensation plans when it enacted Section 409A of the Internal Revenue Code of 1986, as amended, as part of the American Jobs Creation Act. Under the new law, a taxpayer can potentially become liable for taxes, interest and a 20% penalty on compensation long before the taxpayer actually receives any cash.

Compensation plans affected by the new law run the gamut from basic bonuses paid to an employee the year after the employee earns the money, to severance packages, to more sophisticated types of plans involving stock options and phantom stock. A "plan" for purposes of the regulations can arise out of an arrangement with a single employee or with independent consultants. The Act, signed into law by President Bush at the end of 2004, however, left many of the details on the new law to be resolved by the regulations. The IRS has now issued proposed regulations which will set the rules that differentiate between those deferred compensation plans that permit the taxpayer to only pay tax when the taxpayer receives the cash under the deferred compensation plan and those plans that will penalize the taxpayer.

Deferred compensation plans not covered by the new law include plans that provide only for a short-term deferral of compensation. Short term deferral occurs when the plan requires the payment to be made by the later of 2 1/2 months after the end of either the employee's or the employer's taxable year in which the right to the payment is not subject to a substantial risk of forfeiture. For example, if an employer offered a compensation plan to the employees in which the employee's

right to payment became 100% vested in Year 2 and the employer paid the compensation within 2 1/2 months after the end of Year 2, the new law would not apply to that plan.

Unless a deferred compensation plan qualifies for one of the few exemptions from the law, the plan must comply with the new law. Under the proposed regulations, the deadline by which existing plans must be brought into compliance with the law has been extended to December 31, 2006. The new law focuses on three basic areas:

- A. Elections;
- B. Distributions; and
- C. Acceleration of Payment

Elections to defer receipt of compensation generally must be made the year before the service is performed that will generate the compensation. To qualify under the new law, neither the employee nor the employer can have any ongoing discretion under the terms of the plan to change the form or timing of payment. The proposed regulations do cite a short list of exceptions to the rule that prohibits delay in the payment. For example, a plan will not run afoul of the new law if the employer reserves the right to delay payment under the plan if the payment will result in a violation of a loan covenant. The plan must set the time and form of payment no later than the time the employee obtains a legally binding right to be paid the deferred compensation. The proposed regulations clarify that the new law will even apply to plans that give the employee no right to make any election as to the time or form of payment.

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The plan must require the timing of distributions to be tied to specific events. Those events include a fixed schedule included in the plan, an employee's separation from service, death or disability, change in ownership of the employer and unforeseen emergencies. The restrictions on the timing of distributions are further reinforced by the rules that prohibit the acceleration of any payment under the plan. With very few exceptions, a deferred compensation plan cannot

permit the advance payment of any amount due under the deferred compensation plan or any acceleration of scheduled payments under the plan.

If you have any deferred compensation arrangements in place or are considering entering into one, either as an employer or as a new employee, call us to discuss the implications of the new regulations. ■

**What
Impact
do
the
Proposed
Regulations
have
on
Nonqualified
Plans
that
are
linked
to
Qualified
Plans?**

by
Charles W. Whetstone
*Certified Tax Law
Specialist*

A common plan design is to link both a nonqualified plan and a 401(k) plan to allow highly compensated employees or "HCEs" (employees in 2006 who earn more than \$95,000 in 2005) to defer the maximum 401(k) dollar limit (\$15,000 in 2006). Depending on the average rate of deferrals by nonhighly compensated employees or "NHCEs" under a 401(k) plan, the HCEs' contributions under the 401(k) plan could be restricted under a formula contained in tax laws. For example, if the NHCEs only contributed, on average, 2% of their compensation to the 401(k) plan, then the HCEs, on average, could only contribute 4% of their compensation to the 401(k) plan. If an HCE earned \$150,000 in 2006, the contribution limitation would be \$6,000 (\$150,000 x 4%), which is well below the \$15,000 limit for 2006.

To respond to this restriction, some employers have adopted a "wrap" arrangement between a 401(k) plan and a nonqualified deferred compensation plan. Under this wrap arrangement, an employee could make an election at the beginning of the plan year to transfer to the nonqualified plan any amounts contributed to the 401(k) plan in excess of the dollar limit allowed to the HCE.

When Section 409A was initially acted by Congress and prior to the issuance of the proposed regulations, practitioners and plan sponsors were concerned that this wrap arrangement would no longer be permitted. However, in response to many comments by the benefits community, the proposed regulations allow wrap arrangements to continue, although amendments to the nonqualified plan to conform to the proposed regulations may be necessary. Operationally, the nonqualified plan needs to operate under the new rules immediately, and the amendments would need to be made by December 31, 2006, effective retroactively to January 1, 2005.

Under the proposed regulations, a wrap arrangement permits a participant in a nonqualified deferred compensation plan to make an election to contribute to the plan under the normal election rules (such as an irrevocable election prior to the beginning of the plan

year). The wrap around arrangement may then provide that upon the completion of the testing for the 401(k) plan within an "administratively practicable" period following the close of the calendar year, the nonqualified deferred compensation plan may transfer to the 401(k) plan an amount not exceeding the dollar cap for that year.

For example, assume that Mary will earn \$200,000 in 2006 and wants to contribute 10% of her salary to a combination of the 401(k) plan and the nonqualified deferred compensation plan. Prior to December 31, 2005, Mary could make an irrevocable election to defer 10% of her salary, or \$20,000, to the nonqualified deferred compensation plan. Assume that prior to March 15, 2007, Mary's employer determines that the maximum that Mary, as an HCE, could have contributed to the 401(k) plan during 2006 would have been 6% of her compensation, or \$12,000. The nonqualified deferred compensation plan could transfer \$12,000 to the 401(k) plan. This transfer is permissible under the proposed regulations and is not treated as a change to Mary's 2006 election or as an accelerating distributing event since the amount transferred (\$12,000) does not exceed the dollar cap for 2006 (\$15,000).

Employers and practitioners welcome this guidance from the IRS. The proposed regulations will allow HCEs to continue to defer compensation under nonqualified deferred compensation plans, without losing the extra benefits of making contributions to the 401(k) plans, such as tax-free rollovers following termination of employment and security from the employer's general creditors. Any wrap arrangements must be reviewed to make sure the arrangements comply with the requirements of the proposed regulations. Additionally, plans may need to be amended by December 31, 2006 to comply with the proposed regulations.

Please call us to review your plan to determine if these proposed regulations impact you. ■

Please call us at 602.277.2010 if you have questions or concerns about your compensation plan.

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