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Life Income Strategy

A New Concept In Executive Compensation Planning

Companies have long known that to attract talented executives to their businesses, they need to offer specialized retirement benefits. Once these key executives are on board, nonqualified deferred compensation (NQDC) can help motivate, reward and retain them.

Corporations have gravitated to traditional NQDC arrangements because they offer a flexible design, allowing enough variation within a single plan to meet the needs of a number of individuals while, at the same time, providing a selective fringe benefit. They enable management to single out specific executives for unique treatment.

Traditional NQDC plans are funded with corporate-owned life insurance. Earnings on the cash value within the policy aren't subject to current taxes and thus grow on a pretax compounded basis. In addition, the cash value may be accessed on a tax-free cash-flow basis by borrowing against the policy in future years to fund the company's retirement obligation. Moreover, in the event of a participant's early death, the policy provides a current death benefit that lets the company meet its obligations and potentially recover the costs of the plan.

Traditional NQDC arrangements have numerous drawbacks, however. From a corporation's perspective, they're quite expensive. Although the business, as owner of the life insurance policy, will eventually receive the death benefit when the key employee dies, it still has to fund the NQDC plan in a non-tax-deductible manner and then wait for a key employee to die—which could take 30 years or more—before being repaid.

Let's say, for example, that the corporation is putting $100,000 a year into a traditional NQDC plan's life insurance policy, which it owns. Each year, the company loses $35,000 (in the 35 percent corporate tax bracket) due to its inability to deduct that premium payment.

The drawbacks to traditional NQDC plans notwithstanding, they have been hugely successful—principally due to the lack of meaningful alternatives.

The landscape changed on October 22, 2004, when President Bush signed the American Jobs Creation Act, which put in place IRC Rule 409A. The legislation made dramatic changes in the tax rules that affect all NQDC arrangements for amounts deferred on or after January 1, 2005. However, IRC Rule 409A also led to some ingenious new alternatives to the traditional NQDC.

First, let's look at the changes. In a sweeping fashion, the legislation made all deferrals of compensation of any sort taxable if the terms of a plan, under which deferrals were made, did not comply with the new

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guidelines. In particular, the law limited payout elections and placed greater restrictions on such events as death, disability, termination and hardship.

Significantly, the legislation prohibited the ability to accelerate benefits as follows:

- ✔ No "haircut" or penalty provision permitting early withdrawal.
- ✔ No petitions for early distributions.
- ✔ No contract renegotiations or benefits restructurings.
- ✔ No plan terminations or liquidations.

NQDCs were affected in a number of other ways by the legislation, including the timing of deferral elections, the rules affecting changes in the time and form of payout, the elimination of offshore trusts, the elimination of financial and health triggers and, of course, an increase in IRS reporting requirements.

On December 20, 2004, the Treasury Department and the IRS issued Notice 2005-1, providing guidance with respect to the transition of existing NQDC plans, including "freezing" or terminating such plans. Although the legislation generally was effective for contributions made on or after January 1, 2005, Notice 2005-1 extended the deadline for bringing existing NQDC plans into compliance to December 31, 2005.

In other words, employers had until the end of the year to terminate an existing plan without inadvertently triggering the penalties prescribed by the Jobs Creation Act. The extension provided a great opportunity for executive benefits advisors to assist clients in evaluating their deferred compensation options through end of year 2005.

Employers that were currently providing traditional NQDC arrangements struggled to determine how to proceed. While the law contemplated an ability to grandfather an existing plan, doing so generally required freezing the current plan, thus prohibiting any future contributions. Under such a circumstance, an employer could choose to terminate an existing plan, not form a new plan, and instead leave retirement planning up to the key executive.

Now, let's talk about the ingenious new alternative plans that don't have the limitations, restrictions and costs associated with NQDC, **such as one of the following:**

- **Rule 162 Double Bonus Plan (DBP):** This plan is favored by executives because its funding is deductible to the company as a Rule 162 business deduction. A Rule 162 plan is quite simple. The corporation

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pays a deductible bonus to the key executive and the executive takes that bonus and invests the money into a cash-building life insurance policy that will serve as a supplemental retirement vehicle via tax-free loans from the policy. Because the executive takes the bonus as income, the employer awards the executive a second (double) bonus to cover the costs of income taxes on the first bonus.

The executive owns the insurance policy in the double bonus plan with a restrictive endorsement. Therefore, the employer typically will tie the double bonuses to the continued future employment of the executive. By requesting an agreement to repay the bonus in the event a key executive does not fulfill the employment contract, the employer can protect against funding a DBP and then having the key executive quit shortly afterward.

The appeal of a Rule 162 DBP is its simplicity and deductibility. Because the participant is paying taxes on the bonus, the plan operates outside the rules and regulations otherwise applicable to traditional NQDC and, in particular, the Jobs Creation Act.

The primary drawback of the Rule 162 DBP is the cash flow cost to the employer. Because the employer must "gross up" the bonus to cover taxes, the plan is expensive and inefficient, from a tax perspective. For this reason, many employers historically have preferred to establish traditional NQDC arrangements if they offer a plan at all. Passage of the Jobs Creation Act spurred companies to give the Rule 162 DBP another look.

• **Rule 162 with the Life Income Strategy (LIS):** The LIS has been around for only a short period of time since it was created to fill the void in the NQDC world following the passage of the 2004 Jobs Creation Act.

In an LIS, the employer still makes two outlays, with the initial bonus payment made directly to the executive just as in the DBP. The executive is still liable for income taxes on that first bonus, but instead of looking to the employer to cover those taxes, the executive borrows the necessary funds in a pre-arranged agreement with the insurance carrier.

In an LIS, the employer's second bonus—much smaller than that in a DBP—covers only the interest on that borrowed money. Typically, this second bonus is tied to an employment agreement between the employer and the key employee. The loan is a non-recourse loan to the executive which is secured with a life insurance policy that will repay the loan at the executive's death.

An LIS is essentially an individually owned executive-benefits program that's funded with high quality universal life insurance where a portion of the premium is funded through a loan made internally by the insurance company.

Employers prefer LIS to traditional NQDC plans because an LIS isn't subject to deferred-compensation-related regulation or the restrictions of the Jobs Creation Act. Consequently, LIS allows an employer to maintain a flexible and selective fringe benefit for a key executive without the administrative burden and long term liability of a traditional plan. Most importantly, under current guidelines, the LIS is deductible for corporations, while substantially reducing their overall cash flow cost.

Executives like the LIS because they own the retirement plan outright and are no longer subject to the general credit risk of the employer for their future retirement cash flow. Moreover, unlike traditional NQDC plans, the future retirement benefits are tax-free if the insurance policy is held until death. Last, LIS-type plans provide a current death benefit and may be designed to provide asset protection and/or estate tax planning flexibility.

A participant in an LIS should expect to keep the program in place a minimum of 10 years so there is sufficient cash buildup within the insurance policy to provide an adequate tax-advantaged income stream at retirement.

The insurance carrier will only lend on a universal life insurance policy, which has a guaranteed minimum crediting rate and a higher current crediting rate. Since the policy uses the S&P 500 index to generate its rate of return, it has a positive crediting rate and reduced volatility. Also, the employer is carrying the interest cost of the loan; thus, it's generally not possible for a participant to lose value in the retirement plan because of market conditions or interest rate fluctuations. Since an employee's income taxes are reimbursed through the internal loan, he has 100-cent dollars at work from inception along with a tax-free net death benefit available to his beneficiaries.

The essential fact is that the American Jobs Creation Act of 2004 established a new set of rules and regulations governing the operation of every deferred-compensation arrangement in the United States. The early consequences of the law have been to take the wind out of the sails of traditional NQDC plans, creating a problem for any employer who has one—and a tremendous marketing opportunity for those who are familiar with the best new alternatives.