Winning strategy

The American Jobs Creation Act took the wind out of the sails of traditional nonqualified deferred comp 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.

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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 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 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

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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. For one thing, 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 a 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% tax bracket) due to its inability to deduct that premium payment.

Legislation redraws the map

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The NQDC landscape changed in October 2004, with enactment of the American Jobs Creation Act, which put in place Code Section 409A. The legislation made dramatic changes in the tax rules that affect all NQDC arrangements for amounts deferred on or after Jan. 1, 2005. However, Section 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 taxable if the terms of the plan under which deferrals were made did not comply with the new 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 acceleration of benefits in numerous ways:

- no "haircut" or penalty provision permitting early withdrawal
- no petitions for early distributions
- no contract renegotiations or benefits restructuring
- 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 payment, the elimination of financial and health triggers and an increase in IRS reporting requirements.

On Dec. 20, 2004, the Treasury Department and 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 was generally effective for contributions made on or after Jan. 1, 2005, Notice 2005-1 extended the deadline for bringing existing NQDC plans into compliance to Dec. 31, 2005.

In other words, employers had until the end of that 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 benefit advisers to help their clients evaluate their deferred compensation options through the end of 2005. Employers that were providing traditional NQDC arrangements at the time struggled to decide 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 and not form a new one, leaving its key executives to do their own retirement planning without the company's assistance.

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Maximizing retirement plan value

Qualified pension plans — those that meet certain legal requirements — have advantages for employees and employers alike. The biggest advantage is favorable tax treatment. Money going into the plan during your working years — whether it comes from you or your employer — is not taxed until you take it out. This tax subsidy generates much of the funding that will be there to pay benefits when you eventually retire. In addition, qualified pension plan assets are held in a trust and can only be used to pay retirement benefits to plan participants, even if your employer later declares bankruptcy.

Today, most employers offer defined contribution plans, and nearly all employers allow employees to make pre-tax contributions to a qualified DC plan. 401(k) plans, 403(b) plans, Keogh plans, IRAs, SEPs and money purchase pension plans are all examples of DC pension

plans. (Technically, a 403(b) is not a qualified pension plan, but it behaves like a one in most respects.)

These plans have several advantages for employees:

• You can never lose your own contributions, and your employer's contributions vest quickly. (DC plans require employer contributions to either be fully vested after three years, or begin vesting after two years and be fully vested at the end of the sixth year.)

• Many plans allow you to decide how your account will be invested.

• You can take your account with you if you change jobs.

• Your account may be inherited by your spouse, your children, your favorite charity, or anyone else you name as a beneficiary.

Benefits of lifetime income strategy plans

- no sponsoring organization insolvency risk — no substantial risk of forfeiture
- internal earnings accumulate tax-deferred — distributions are income tax-free
- no contribution limits
- life insurance death benefit protection
- diversifies both portfolio and pre-tax vs. after-tax retirement income resources
- employee may take distributions when wanted, and not subject to distribution rules or penalties
- protects against fluctuating tax rates
- predictable control of balance sheet liability
- no benefit performance liability
- no actuarial fees
- optional employer contributions (no limitations or caps)

Problems with qualified plans

Since 1986, the law has placed limits on the effectiveness of qualified plans for high-income employees. For example, qualified pension plans are required to ignore pay over $245,000 in calculating benefits. The most you may contribute to a 401(k) or 403(b) plan is $16,500 a year unless you are 50 or older, in which case you may contribute an extra $5,500. The most that may be contributed to a DC plan on your behalf from all sources is $49,000 per year.

Most executives have a 401(k) with a profit sharing feature that is funded from three sources:

• personal contributions up to the 401(k) plan limit of $16,500

• an employer match, typically 3.5% to 4.0% of pay (but counting only the first $245,000)

• a profit sharing contribution that goes into the plan at year end based on the profits of the business

All three sources of funding must fall within the $49,000 limit on total contributions in a single year. Extra contributions for employees age 50 and older are not required to fit within this limit.

These limits on 401(k) plan contributions are a significant obstacle for executives who are trying to fund retirement benefits. But there is another obstacle for employers: ERISA, which does not allow a qualified pension plan to provide greater benefits to highly compensated employees than it provides to other employees.

This means that profit sharing contributions must be based on a formula that treats all employees, including owners, the same way. Distributing profits so that the executives reach the $49,000 limit is an expensive proposition, because it means giving non-executive employees an unusually rich retirement benefit.

High-income executives will find it almost impossible to fund an adequate level of retirement income through qualified pension plans alone. And business owners may object to the cost of funding rich profit sharing formulas for non-owners. As a result, high-income executives need a better option for accumulating enough personal savings to fund a comfortable retirement.

New alternatives

Now, let's talk about the ingenious new alternative plans that don't have the limitations, restrictions and costs associated with NQDC. They include:

• **Section 162 double bonus plan**: This plan is favored by executives because its funding is deductible to the company as a Code Section 162 business deduction. A Section 162 plan is quite simple. The corporation 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 the income taxes on the first bonus.

The executive owns the insurance policy in the double bonus plan with a restrictive endorsement. Therefore, the em-

ployer typically ties 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 Section 162 DBP is its simplicity and deductibility. Because the participant is paying taxes on the bonus, the plan operates outside the rules and regulations that apply to traditional NQDC, particularly the Jobs Creation Act rules.

The primary drawback of the Section 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 Acts spurred companies to give the Section 162 DBP another look.

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• **Section 162 plan with life income strategy**: The "life income strategy" was was created to fill the void in the NQDC world following enactment of the Jobs Creation Act in 2004.

In the life income strategy approach, 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 funds needed under a pre-arranged agreement with the insurance carrier.

The employer's second bonus — much smaller than the 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, secured with a life insurance policy that will replay the loan upon the executive's death. This is why a life insurance policy is used in order to utilize the death benefit account while allowing the cash value account to accumulate with full-value dollars, free from income taxes, to provide a retirement income to the executive.

Thus, the life income strategy 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 the life income strategy to traditional NQDC plans because it isn't subject to DC plan regulations or the restrictions of the Jobs Creation Act. Consequently, it 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, contributions to an LIS arrangement are deductible as wages for corporations, and substantially reduce the overall cash flow cost.

Executives like LIS arrangements 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.

And lastly, LIS 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 arrangement 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 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 the executive's income taxes are reimbursed through the internal loan, he or she has full-value dollars at work from inception along with a tax-free net death benefit available to beneficiaries. **EBA**

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