Deferred Judgment

Changes in the tax laws have made compensating key employees more complex—but potentially more rewarding.

By Roccy DeFrancesco and Timothy Trankina

COMPANIES HAVE LONG KNOWN THAT TO attract talented executives to their businesses, they need to offer specialized retirement benefits. Once these key employees are on board, nonqualified deferred compensation (NQDC) can help motivate, reward, and retain them. Companies 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 company's perspective, they're quite expensive. Although the company, 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 company 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% 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. But now, the landscape has changed. On Oct. 22, 2004, however, President Bush signed the American Jobs Creation Act of 2004, which put in place a new tax code section, IRC Rule 409A. That rule has led to some ingenious new alternatives to the traditional NQDC.

This new law makes dramatic changes to the tax rules that affect virtually all NQDC arrangements for all amounts deferred on or after Jan. 1, 2005. In a sweeping fashion, the legislation says that all current and prior deferrals of compensation of any sort,

by anyone, will be taxed if the terms of the plan under which the deferrals were made do not comply with the new rules. In particular, the new law limits payout elections as well as placing greater restrictions on events of death, disability, termination, and hardship.

Significantly, the legislation prohibits 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; and no plan terminations or liquidations. The new law affects NQDC in a number of other ways, 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 Dec. 20, 2004, the Treasury Department and the IRS issued Notice 2005-1 providing guidance with respect to the transition of existing NQDC plans, including the "freezing" or termination of such plans. Although the new legislation generally is effective for contributions made on or after Jan. 1, 2005, Notice 2005-1 extends to Dec. 31 the deadline for bringing existing NQDC plans into compliance.

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

Companies that currently provide traditional NQDC arrangements are struggling to determine how to proceed. While the new law contemplates an ability to grandfather an existing plan, doing so will generally require freezing the current plan, thus prohibiting any future contributions. Under such a circumstance, a company is faced with either not offering a plan going forward or developing a new plan that complies with the new legislation.

Alternatively, a company may choose to terminate an existing plan, not form a new plan, and instead leave retirement planning up to the key employees. Better yet, it could find an alternative plan that doesn't come with 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 employers because its funding is deductible to the company as a Rule 162 business deduction. A Rule 162 plan is very simple: The employer pays a deductible bonus to the key employee. The employee 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 employee takes the bonus as income, the company awards the employee a second (double) bonus to cover the costs of income taxes on the first bonus.

New rules governing deferred compensation have created a problem for any employer with a traditional plan and a tremendous marketing opportunity for those familiar with the alternatives.

The employee does not own the insurance policy in the Double Bonus Plan. Therefore, the company typically will tie the double bonuses to the continued future employment of the key employee. By requesting an agreement to repay the bonus in the event a key employee does not fulfill the employment contract, the employer can protect against funding a Double Bonus Plan and then having the key employee quit shortly afterward.

The appeal of a Rule 162 Double Bonus Plan 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 Double Bonus Plan 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 Double Bonus Plan another look.

Rule 162 Leveraged Bonus Plan (LBP): The LBP 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 LBP, the employer still makes two outlays, with the initial bonus payment made directly to the employee, just as in the Double Bonus Plan. The employee is still liable for income taxes on that first bonus, but instead of looking to the employer to cover those taxes, the employee goes out and borrows the necessary funds. In an LBP, the employer's second bonus—much smaller than that in a DBP—covers only the interest on that borrowed money. The loan is a non-recourse loan to the employee, which is secured with a life insurance policy that will repay the loan at the employee's death.

An LBP is essentially an individually owned executive-benefits program that's funded with universal life insurance. A portion of the premium is funded through a loan made by a third-party finance company. Employers prefer LBPs to traditional NQDC

plans because an LBP isn't subject to deferred-compensation-related regulation or the restrictions of the Jobs Creation Act. Consequently, LBPs allow an employer to maintain a flexible and selective fringe benefit for key executives without the administrative burden and long-term liability of a traditional plan. Most importantly, under current guidelines, LBPs are deductible for companies, while substantially reducing their overall cash-flow cost.

Employees like LBPs because they own the retirement plan outright and are no longer subject to the general credit risk of the company 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, LBP-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 LBP should expect to be offered a written commitment from the finance company to make a minimum of five annual loans. Typically, the loan term is 10 years with automatic annual renewals, and repayment is expected at the end of the tenth year from the cash value buildup within the policy.

The lender will likely only lend on a universal life insurance policy, which has a guaranteed minimum crediting rate and a higher current crediting rate. Since the policy has a positive crediting rate and the employer is carrying the interest cost of the loan, it's generally not possible for a participant to lose value in the retirement plan because of market conditions or interest-rate fluctuations.

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 consequence of the law has been to take the wind out of the sails of traditional NQDC plans, creating a problem for any employer that has one—and a tremendous marketing opportunity for those who are familiar with the best new alternative, the Leveraged Bonus Plan. **FP**

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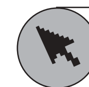

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