Non-Qualified Deferred Compensation

Leverage Bonus Plan

CWPP™ Educational Module

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Non-Qualified Deferred Compensation (NQDC)

- Executive compensation has historically outpaced the deferral limitations set forth in qualified retirement arrangements like 401(k) plans and individual retirement accounts (IRAs).
- Consequently, companies have had to look to other options to fund the retirement income expected by their highly compensated key employees.
- To meet this need, non-qualified deferred compensation ("NQDC") arrangements have become a staple at most public companies, as well as many privately held businesses.
- Companies that traditionally do not use NQDC are small closely held business that are traditionally S-corporations.

Executive Benefit Basics

- Companies have long known that in order to *attract* talented executives to their businesses, competition required the offering of specialized retirement benefits.
- Once on board, these benefits are used to *motivate, reward and retain* the key employees of the company.
- Companies have gravitated to traditional NQDC arrangements because such plans offer a *flexible design*, allowing a enough variability within a single plan to meet the needs of a number of individuals while at the same time provide a *selective fringe benefit* – that is, management may single-out specific executives and treat them uniquely.

Typical NQDC plan

- Typically, these plans are funded with corporate-owned life insurance. The most common form of these plans calls for the participant to voluntarily defer a percentage of his or her income each year.
- For example, a person making $500,000 per year might choose to defer 20% or $100,000. Rather than paying the person the compensation, the company will use the $100,000 to pay the premium on a life insurance policy owned by the company insuring the life of the participant.
- The company's obligation to provide future retirement benefits to the participant is memorialized in a contract and the company will look to the cash build up in the policy to meet its future payment obligations.

Life Insurance

- LI is the vehicle of choice because the cash can grow tax free and be taken out tax free via policy loans.
- Plus in the old NQDC situation, the life insurance was an asset on the books of the company and the company would receive the DB when the employee died (some of which would be used to pay deferred comp. to the EE’s estate).

Drawbacks to traditions NQDC

- From a company perspective, a traditional NQDC arrangement is quite expensive. While this type of plan has historically been sold on a "cost recovery basis." (the life insurance investment is not deductible). Plus the company might wait 30+ years to be repaid while they wait for the EE to die.
- In the example above, the company forgoes the opportunity to deduct $100,000 in compensation. At a 40% tax rate, the company loses $40,000 in current deductions. Moreover, the company is unable to redeploy the $40,000 back into the business. Over a 10-year period, the cost is substantial.

	Deferred Compensation Plan			
Year	Executive Deferral	Plan Funding	Lost Tax Deduction at 40%	**Incremental Annual Outlay**
	[1]	[2]	[3]	**[4]=[1]+[2]+[3]**
1	$100,000	($100,000)	($40,000)	**($40,000)**
2	100,000	(100,000)	(40,000)	**(40,000)**
3	100,000	(100,000)	(40,000)	**(40,000)**
4	100,000	(100,000)	(40,000)	**(40,000)**
5	100,000	(100,000)	(40,000)	**(40,000)**
6	100,000	(100,000)	(40,000)	**(40,000)**
7	100,000	(100,000)	(40,000)	**(40,000)**
8	100,000	(100,000)	(40,000)	**(40,000)**
9	100,000	(100,000)	(40,000)	**(40,000)**
10	100,000	(100,000)	(40,000)	**(40,000)**

Totals:	**($400,000)**
Net Present Value at 6%:	**($312,068)**

Downside continued

- The participant, on the other hand, also accepts some downside in the traditional NQDC arrangement.
- The single most significant risk factor for the participant is that of “creditor risk”.
- While the company may have purchased an insurance policy to help it meet the future obligation, this policy is an asset of the company and may be liquidated by other priority creditors of the company.
- The **participant is a general, unsecured creditor of the company** whose risk of nonpayment exists until the last retirement dollar is paid.
- High profile business failures, such as the Enron collapse, underscore this significant risk to participants in traditional NQDC arrangements.

American Jobs Creation Act of 2004

- On October 22, 2004, the President signed the American Jobs Creation Act of 2004 (P.L. 108-357).
- This new law makes *dramatic* changes to the tax rules impacting virtually all NQDC arrangements for all amounts deferred there under on or after January 1, 2005.
- The new law is generally viewed as "tightening the noose" on traditional NQDC arrangements.

Continued

- The Act created a new tax code section, IRC §409A.
- In sweeping fashion, the new law provides that all current and prior deferrals of compensation of any sort by anyone will be taxed if the terms of such plan under which the deferrals were made do not comply with the terms of the new rules.
- In particular, the new law creates limitations on payout elections, as well as creating greater restrictions in event of death, disability, termination and hardship.

Continued

- Significantly, the new law 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 restructures
  - No plan terminations or liquidations
- The bottom line is that few companies and executives will want to use traditional NQDC going forward.
- Further, companies have until 2005 to freeze or terminate their current plans unless they want to run the risk of the negative tax implications of the new laws.

Failure to comply

- 1) Accelerated inclusion of the income by the employee.
- 2) a 20% excise tax.
- 3) A payment of an interest penalty (at the AFR) looking back to the time of deferral.

Reaction to the Act

- Employers do not like it. They see the following problem areas:
  - Our NQDC Plan is no longer attractive to key executives
  - Increased IRS and SEC reporting requirements
  - Increased shareholder scrutiny
  - Increased Director and Officer potential liability
  - No ability to terminate plan until the last participant's retirement is paid
- Many executives are expressing concern over the following:
  - Long-term financial security of their employer
  - Change in heart of management to continue the plan given the law change
  - Change in control of company no longer represents a "trigger event"
  - Retirement planning flexibility has been substantially reduced
  - Possible need for early access is no longer an option

Looking for Alternatives

- <u>**§162 Double Bonus Plan**</u>
- The first alternative is the so-called §162 Double Bonus Plan.
- This plan provides that a payment, in this case a simple out right bonus, <u>is deductible as an ordinary and necessary business</u> expense to the extent it is reasonable.
- This arrangement is a fundamental shift away from the traditional NQDC structure and contemplates that the <u>executive will purchase a life insurance policy</u> to fund his or her own future retirement needs.
- Consequently, the <u>company is not the owner</u> of the policy and, accordingly, the policy <u>is not subject to the claims of the company's creditors</u>. To enable the executive to purchase the policy, the company agrees to make an annual bonus sized on an after-tax amount necessary to pay the premium.

The double bonus

- Not only does the company bonus the employee so a life policy can be purchased as an investment, but the company makes a “double bonus” to cover the taxes the employee must pay on the first bonus.
- The appeal of a §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 Act.
- From a participant perspective, this type of plan eliminates the creditor risk present in traditional NQDC arrangements (because the EE owns the policy).

Problem with the double bonus

- The primary drawback for use of the §162 Double Bonus Plan is the cash flow cost for the employer. Because the employer is expected to "gross up" the bonus to cover taxes, the plan is expensive and inefficient, from a tax perspective.

Plan Bonus	**(100,000)**
Tax Deduction	**40,000**
Net Cost of Bonus	**(60,000)**
Double Bonus	**(66,667)**
Tax Deduction	**26,667**
Net Cost of Double Bonus	**(40,000)**
Gross Cost:	**($166,667)**
After-Tax Cost:	**($100,000)**

The Leverage Bonus Plan

- A §162 Leveraged Bonus Plan ("LBP") is a viable option employers should look to as an alternative to the double bonus plan.
- A LBP works like a §162 Double Bonus Plan except that with LBP, rather than the company making a second bonus to cover the entire cost of taxes on the first bonus, the company makes a much smaller second bonus to cover the **interest cost of borrowing** an amount that replaces the taxes lost on the first bonus.
- That is, the participant borrows an amount equal to the tax paid on the first bonus (the participant may borrow an amount equal to a multiple of the taxes paid in order to create greater leverage and better performance of the retirement arrangement).

	§162 Bonus	LBP	LBP Savings
Plan Bonus	(100,000)	(100,000)	0
Tax Deduction	40,000	40,000	0
Net Cost of Bonus	(60,000)	(60,000)	0
Double Bonus	(66,667)	(4,000)	62,667
Tax Deduction	26,667	1,600	
Net Cost of Double Bonus	(40,000)	(2,400)	37,600
Gross Cost:	($166,667)	($104,000)	$62,667
After-Tax Cost:	($100,000)	($62,400)	$37,600

Why use the LBP

- Employers like LBP over traditional NQDC because LBP is not subject to deferred compensation-related regulation or the Act. Consequently, LBP allows an employer to maintain a flexible and selective fringe benefit for key executives without the administrative burden and long-term liability.
- **Most importantly, LBP is deductible to companies currently while substantially reducing the overall cash flow cost to the company**.
- Keep in mind that the ER will <u>not be paid back</u> its bonus from the executive life policy since it is owned by the EE.

Continued

- Employees like LBP 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, the future retirement benefits are paid tax-free if the policy is held until death.
- Lastly, LBP plans provide a current death benefit and may be designed to provide asset protection and/or estate tax planning flexibility (ILIT).

How does the loan work?

- The loan should be non-recourse relying solely on the underlying insurance policy as collateral.
- A participant should expect to be offered a written commitment from the finance company to make a minimum of 5 annual loans.
- **Typically, the loan term is 10 years with automatic annual renewals and repayment is expected at the end of the 10th year from the cash value buildup within the policy**. (The lender will likely only lend on a universal life ("UL") insurance policy).
- Since the policy has a positive crediting rate and the employer is carrying the interest cost of the loan, it is generally not possible for a participant to lose value in the retirement plan due to market conditions or interest rate fluctuations).

Summary on deferred compensation

- If you are not helping your clients reduce their income taxes, you are missing out on a opportunity to grow your practice and benefit your clients.
- If you have clients that make in excess of $250,000 a year and are owners in closely held business that are cash based, bringing the unique and simple WBA to a client will bring a smile to their face and yours.
- Don’t forget that WBA also works for any client, even an individual, who makes 1099 income.

Continued

- If you have current clients with NQDC plans, you now know that they need to freeze or terminate those plans by the end of 2005.
- By dealing with the unique and simple Leveraged Bonus Plan, you can help current clients implement the best NQDC plan in the marketplace.
- By dealing with the LBP, you should be able to cultivate new clients who’s advisors are not aware of the best alternative in the NQDC market place, e.g., the LBP.

Questions?

For more information, please e-mail info@thewpi.org or call

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