



# NONQUALIFIED DEFERRED COMPENSATION ARRANGEMENT

Providing additional benefits to owner-employees, key executives, and other skilled and highly compensated employees is something all businesses must address to attract and retain top talent. The increasing regulation of qualified retirement plans and high costs to administer them has made nonqualified deferred compensation arrangements increasingly attractive for businesses and their employees. These arrangements allow the business to identify and select highly compensated employees to participate in creating financial security in retirement, upon death, or disability.

## Flexibility

- Nonqualified deferred compensation arrangements allow a business to be selective among “top-level” employees without concerns about ERISA regulations like anti-discrimination rules or minimum funding requirements, which are required for qualified retirement plans.
- A business can provide different benefit levels for different employees.
- No government-mandated vesting rules apply.
- Deferred compensation can be customized to suit individual situations.
- Paperwork and administrative costs are reduced as compared to qualified plans.

## Funded vs. Unfunded Arrangements

Unfunded nonqualified deferred compensation arrangements are when the business does not set aside or earmark specific funds to cover the contractual obligation. If the business has an optional funding reserve established, it is still considered an asset of the business and subject to claims from creditors of the business. The employee does not have a beneficial right to the reserve assets.

Funded nonqualified deferred compensation arrangements have specific funds set aside in a reserve to meet the future contractual obligation. These reserves are not part of the business’s assets and are not subject to the claims of creditors. However, a funded agreement means the deferred amounts are included in the employee’s taxable income once there is no longer a substantial risk of forfeiture.

## Rabbi Trust

A rabbi trust is an irrevocable trust designed to hold the assets outside of the business or possible future successors. The IRS has provided guidance on rabbi trusts and even has issued a model rabbi trust agreement.\* The trust does provide protection from the business accessing the reserves, but it does not fully protect the reserves from the general creditors of the business if it goes bankrupt or insolvent. The IRS views this as a substantial risk of forfeiture and allows the reserved funds to remain tax-deferred because the employee does not have constructive receipt or an economic benefit to the funds.

\* IRS Revenue Procedure 92-64





## HOW IT WORKS

### Step 1

#### Deferring Income

The employee defers a percentage of their pretax salary and/or bonus for a period of years. In return, at the retirement or death of the employee, the employer provides supplemental retirement income for the employee and their family.<sup>1</sup>

Since the deferred compensation benefits are an unsecured promise by the employer and are subject to the claims of the employer's creditors, the employee is not taxed until the income is distributed.

### Step 2

#### Purchasing Life Insurance

The employer purchases a permanent life insurance policy on the life of the executive, suitable to his or her risk tolerance, time horizon, and financial goals.

The employer is the owner of the policy and names itself as the beneficiary. The employee is the insured.

The policy may offer a death benefit free of income tax, grow tax-deferred, and may accumulate a tax-deferred cash value for the employer.<sup>2</sup> Premium payments are not deductible to the employer.

### Step 3

#### Receiving Income

When the employee retires or at another previously specified occurrence, he or she begins receiving the deferred salary from the employer, at which time the amount paid is deductible by the employer and taxable to the employee.

The employer can use the accumulated net cash value, through withdrawals or policy loans,<sup>3</sup> to fund the benefit payments.

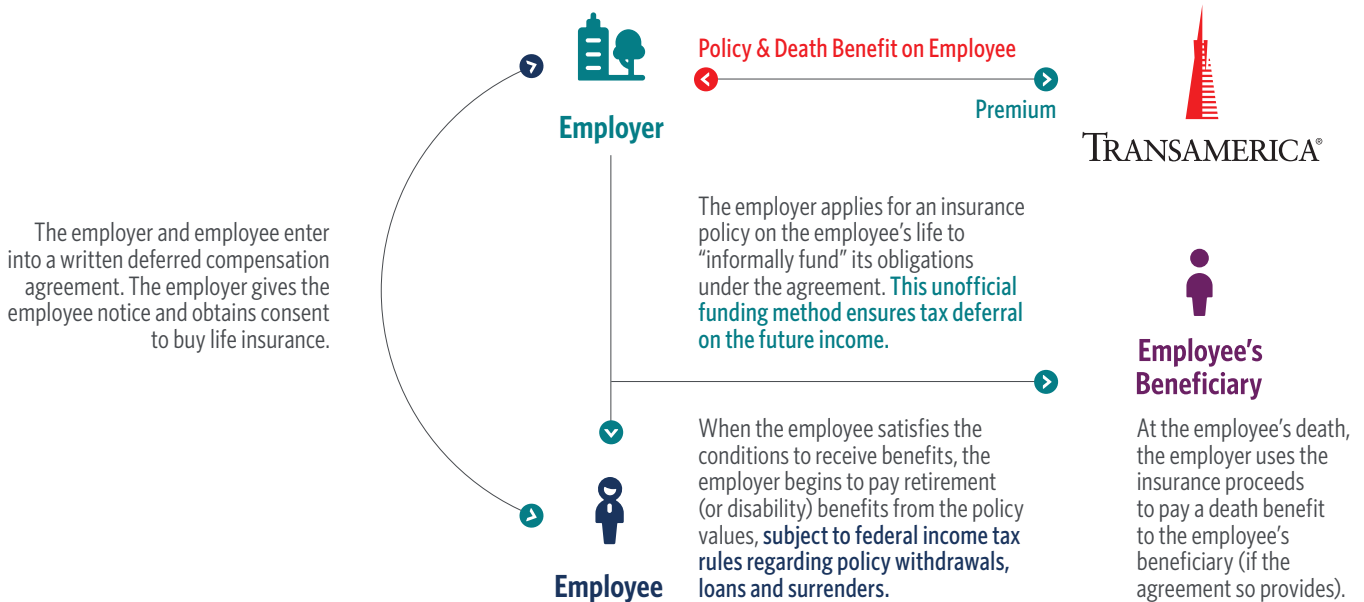
### Step 4

#### Beneficiaries

In the event of the employee's death, the plan may provide that his or her beneficiaries receive either a taxable annual income or a taxable lump-sum death benefit, depending on plan design, funded by the policy proceeds received by the employer.

## HOW A DEFERRED COMPENSATION ARRANGEMENT WORKS

(FUNDED WITH LIFE INSURANCE)



<sup>1</sup> These plans are subject to the requirements of IRCS 409A and ERISA "Top Hat" limitations of 29 U.S.C. §§ 1021-1031 and 1131-1145

<sup>2</sup> Notice and consent requirements and other provisions of IRCS 101(j) must be met. Employer must also follow annual reporting requirements of IRCS 6039I.

<sup>3</sup> Loans, withdrawals, and death benefit accelerations will reduce the policy value and death benefit and may increase the chance of the policy lapsing. Provided the policy is not and does not become a modified endowment contract (MEC), 1) withdrawals are tax-free to the extent that they do not exceed the policy basis (generally, premiums paid less withdrawals) and 2) policy loans are tax-free as long as the policy remains in force. If the policy is surrendered or lapses, the amount of the policy loan will be considered a distribution from the policy and will be taxable to the extent that such loan plus other distributions at that time exceed the policy basis.

## Benefits of Nonqualified Deferred Compensation

### Potential Benefits for the Employee

- Reduces taxable income in deferral years
- Has customizable income deferral opportunities not subject to qualified plan limits
- Accumulates tax-deferred retirement benefits until distribution
- Can provide a preretirement survivor benefit

### Potential Benefits to the Employer

- Has less legal requirements than a qualified plan
- Controls the plan, owns the life insurance policy, and can include the cash value of the life insurance policy as an asset on the company's balance sheet
- Provides selected key employees with additional deferral opportunities different from those available to other employees
- Gains an attractive tool for recruiting, retaining, and rewarding talented executives by providing additional retirement income
- Receives an income tax deduction when benefits are paid out to the executive
- Enjoys greater flexibility in plan design
- Life insurance policy can provide for cost recovery with its benefit being free of income tax. However, the death benefit may be subject to the corporate Alternative Minimum Tax.





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