

Non-Qualified Deferred Compensation

Saving for retirement is often a priority for a company's key employees. Yet caps on allowable contributions to individual retirement accounts and employer-sponsored qualified retirement plans limit the amount that employees can save on a pre-tax basis.

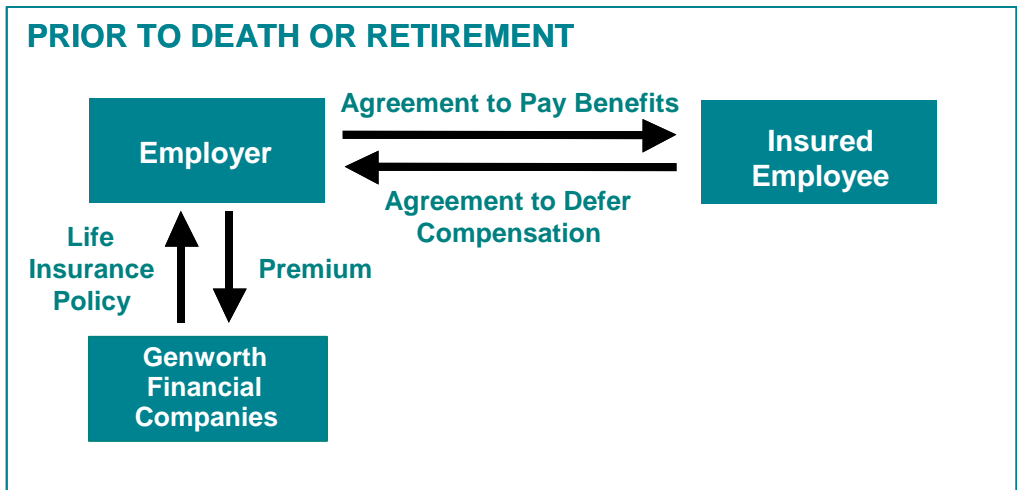
A non-qualified deferred compensation plan can allow a key employee to defer earnings while postponing income taxation on the receipt of those earnings until they are paid to the employee at some future date, usually retirement. The employer may also contribute. The amount and timing of benefits are established by the deferred compensation agreement between the participating employee and the employer at the inception of the plan. The benefits are based on an account balance equal to the employee's deferrals plus earnings (or minus losses) based on a fixed crediting rate or the performance of selected hypothetical investments. The balance may be paid in a lump sum or over a period of years, according to the terms of the plan.

The plan may be informally funded using the death benefits from a life insurance policy owned by, and payable to, the employer. If a cash value life insurance policy is purchased, the employer may opt to use accumulated values to assist in the payment of retirement benefits to the employee. Cash values within a life insurance policy may be accessed by the employer via policy loans or withdrawals (subject to policy limits or restrictions) for any business need.¹ Death benefits collected by the employer may be used to meet obligations of the employer to the participant's family or to provide the employer with cash to recover the costs of establishing and maintaining the plan.



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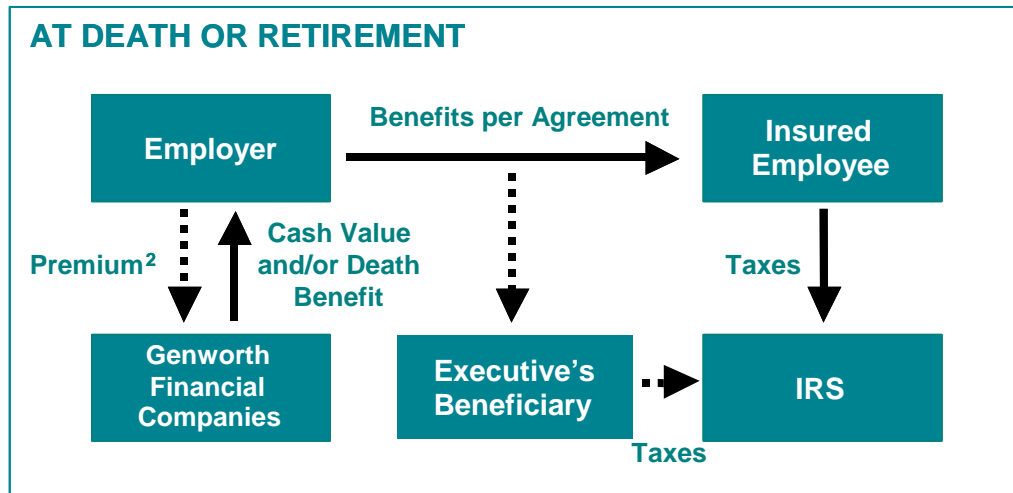
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ADVANTAGES:

- Non-qualified deferred compensation plans can aid the employer in recruiting and retaining quality key employees who may want to contribute more to retirement accounts than qualified plan limitations allow.
- For participating key employees, the benefits of the plan can be designed to help replace income, possibly in retirement.
- The employer can select participants among its key employees and, with certain restrictions, customize the plan features to meet its objectives.
- Minimal IRS reporting is required.

PLAN CONSIDERATIONS:

- Participation in a non-qualified deferred compensation plan must generally be limited to a select group of employees to avoid the application of ERISA, the Employee Retirement Income Security Act of 1974.
- Unfunded plans are generally not subject to additional requirements under ERISA.
- Non-qualified deferred compensation is not available to S corporation shareholders, LLC owners, partners, and sole proprietors.
- Special rules apply to plans sponsored by governments or tax-exempt employers.
- Non-qualified deferred compensation plans are typically “unfunded” agreements. This means that account values remain subject to the claims of the employer’s general creditors and the employee has only the employer’s unsecured promise to pay future benefits, not any right to access the money.
- In an unfunded plan, an employer may “informally” fund its obligation if the assets used are accessible by its creditors.
- The employee’s rights to an informally funded account are subject to a substantial risk of forfeiture. A substantial risk of forfeiture exists if the employee’s right to receive the money is contingent upon future performance of services or the

occurrence of a particular event, and if the possibility the condition will not be satisfied is substantial.

- Generally, under Internal Revenue Code Section 409A, an election to defer compensation must be made prior to the year the compensation is earned, and is irrevocable with respect to the timing and method of benefit payment.
- IRC Section 409A limits the events that can trigger payment to the employee to separation from service, death, disability, severe and unforeseeable financial hardship, a change in control of the business, or a fixed time or pursuant to a fixed schedule.
- Payment of deferred compensation may generally not be accelerated. The employee may not request an early distribution in exchange for forfeiture of a portion of the benefits.

TAX CONSIDERATIONS:

- In most cases, the amount deferred into the plan is not currently income taxable to the employee because the employee lacks constructive receipt. The employee's right to the income is subject to substantial limitation or restriction.
- Failure to comply with IRC Section 409A may result in the inclusion in the employee's income of the amounts deferred for that and previous years. The employee would pay ordinary income tax plus a 20% federal penalty tax on those amounts.
- If life insurance is used to informally fund the plan, the premiums paid by the employer are not income tax deductible.²
- Any growth in the cash value in a life insurance policy is income tax deferred until removed from the policy. Cash value within a life insurance policy may be accessed by the employer on a tax-favored basis provided the policy is not a modified endowment contract.
- Death benefits from an employer-owned life insurance policy are generally income tax free. In some situations, those death benefits may be partially or wholly taxable. These include a transfer of the policy for consideration unless an exception applies, arrangements that lack an insurable interest under state law, and an "employer-owned" policy issued after August 17, 2006 unless notice and consent requirements are complied with and the proceeds fall under a safe harbor (IRC §101(j)).
- In a C corporation, life insurance cash value and death benefit proceeds may be subject to corporate Alternative Minimum Tax (AMT).
- Benefits paid to the employee or his/her family are usually taxable as ordinary income in the first year in which the employee has the ability to access or receive the money.
- Although a retiring employee may no longer be subject to a substantial risk of forfeiture, payments—and the income tax burden—may be made spread out over a specific period. Assuming the agreement was entered into before the

compensation was earned, the employee will not be in constructive receipt if future payments are not secured.³

- Benefits paid to the employee or to the employee's designated beneficiary are income tax deductible to the employer in the year in which they are included in the taxable income of the employee or beneficiary.
- If benefits are payable beyond the employee's lifetime, the present value of future benefits may be included in the employee's gross estate.

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The tax information in this material was written to support the promotion or marketing of the transaction(s) or matter(s) addressed in this material.

¹ Policy loans, partial surrenders and withdrawals will reduce the death benefit and surrender value. If a policy is surrendered, any outstanding loan balances will be used to determine whether there is a taxable gain in the contract/policy. In certain highly funded cases, life insurance policies may be considered Modified Endowment Contracts (MECs). In such cases, distributions will be taxable income to the extent that there is gain in the contract. In addition, a 10% IRS penalty tax may be due on any taxable income received prior to age 59½.

² Continued premium payments may be required after key employee's retirement to maintain the policy.

³ Rev. Rul. 60-31, 1960-1 CB 174, as modified by Rev. Rul. 70-435, 1970-2 CB 100

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