A retirement planning guide for business owners and executives

Guardian®

Non-Qualified Deferred Compensation Plans

Flexible and customizable plans to help recruit, retain, and reward selected executives

Rewarding selected executives . . .
including yourself

Retaining selected executives . . .
golden handcuffs

Supplementing retirement . . .
for executives and yourself

In today's highly competitive environment, businesses are always seeking ways to reward their key employees for their contributions to the success of the business, and perhaps more importantly, to keep them motivated and to keep them with the company.

Unfortunately, the usual employee benefits may not be enough. Most of the tax laws and various rules and regulations governing employee benefits are aimed at protecting the rank-and-file employees. Particularly in the area of saving for retirement, executives, as well as business owners, often find themselves at retirement with insufficient savings to continue the lifestyle that they are accustomed to. Alternative arrangements need to be made to retain the most talented executives and to prevent competitors from hiring away these individuals with more attractive benefits.

A possible solution

A Non-Qualified Deferred Compensation Plan is a well-established strategy that provides a business with a way to provide generous retirement and death benefits to select key executives of the company, while still tying them to the business. These plans are popular because of the flexibility and customization allowed. A plan for one executive need not be the same for another. What's more, the business, and not the government, controls who is selected to receive these benefits. The employees can be selected by criteria such as who meets certain stated goals and/or stays with the business for a stated period of time.

A Non-Qualified Deferred Compensation Plan is a written agreement between a business and an executive. The business makes a contractual, unsecured[1] promise to make future payments to a key executive if the key executive meets certain stated requirements. These payments and requirements may be based on a number of factors.

A Non-Qualified Deferred Compensation Plan can provide valuable benefits to the executive at retirement or to the executive's family or other beneficiaries if the executive dies before retirement. The business receives a tax deduction when benefit payments are made and the executive receives the benefits as taxable income.

A Non-Qualified Deferred Compensation Plan, "informally" funded[2] with permanent life insurance, may allow a business to achieve full cost recovery for this plan. Upon the executive's death, the life insurance death proceeds paid to the business can allow the business to recover any money paid out in premiums and benefits.

A Non-Qualified Deferred Compensation Plan is not subject to the onerous legal and regulatory requirements as qualified retirement plans are:

- No benefit limits
- No minimum funding requirements
- No participation requirements
- No vesting requirements
- No non-discrimination rules[3]
- Minimum disclosure and reporting requirements[4]

Benefits to the business and executive

Benefits to the business

- Helps the business recruit, retain, reward, and retire key employees.
- Allows the business to select the key executives they want to offer this benefit to.
- Increases loyalty.
- Avoids most "ERISA" compliance rules required of qualified retirement plans and there is no IRS pre-approval necessary.
- Gives the business control over plan benefits.
- Provides "golden handcuffs" to lock in key executives. Benefits need not be paid unless the executive meets the terms of the agreement.
- Provides an income tax deduction to the business when benefits are paid.
- Can offer the business complete cost recovery.
- Rounds out a business's benefits package by providing benefits over and above those provided by any existing qualified retirement plan.
- Cash value of a life insurance policy used to informally fund this plan generally accumulates on a tax-deferred basis. The cash values can be used for any company purpose, including paying the promised benefits.[6, 7]
- Death proceeds from the life insurance policy are received income-tax free.[8]
- With proper planning, businesses can reward, motivate, and retain their key executives in a cost-efficient manner.

Benefits to the executive

- Enhances existing retirement savings.
- Supplements existing qualified plan benefits that may be limited by qualified retirement plan limits.
- Provides additional pre-retirement death benefit protection for the executive's heirs.
- Defers taxable income until benefits are paid.
- Knows s/he is valued by the company.

Why life insurance?

The business can purchase business-owned life insurance on the life of the executive[5] to "informally" fund the future payments (with the cash value) and to recover all of the plan costs at the executive's death (with the death benefit). A Non-Qualified Deferred Compensation Plan informally funded with the proper amount of life insurance provides flexibility, while helping the business to pay promised benefits and to recover the cost of establishing the plan. This helps a business recruit, retain, reward, and retire key executives in a cost-efficient manner.

The life insurance, including the cash value and death benefit, can also be used for other business purposes, since the insurance is owned by the business and is counted as a general asset of the business.

Plan variations

Non-Qualified Deferred Compensation Plans are very flexible and can be customized for a given situation. As a result, there are several common variations of a Non-Qualified Deferred Compensation Plan.

Salary continuation plan

A supplemental retirement and/or death benefit plan for selected key executives. The business commits to the future compensation in addition to current compensation. Current compensation is not reduced by participation in the arrangement. There is tremendous flexibility in the use of benefit formulas. Both defined benefit and defined contribution formulas are permitted. These plans are also commonly known as Supplemental Executive Retirement Plans ("SERPs") or Supplemental Income Plans ("SIPs").

Excess benefit

A supplemental benefit plan layered on top of an existing qualified retirement plan. It is generally set up to give selected executives the benefits that may have been lost due to the limits put on qualified plans.

Compensation deferral

A plan that allows selected participants the ability to defer a portion of their income for the upcoming year. The deferrals may accumulate at a pre-determined rate of interest, and are promised to be paid to the executive at a stated time in the future.

Performance pay plan

A plan that provides incentive benefits for selected key executives. The benefit formula is based on performance standards, with amounts based on measurable increases in job performance and/or business profits.

Death benefit-only plan

A plan giving certain key executives additional death benefits. This can be done on a pre- and/or post-retirement basis.

401(k) mirror plan

A non-deductible compensation deferral plan, which supplements the business's 401(k) plan, for a select group of management or highly compensated employees. It allows deferrals for the upcoming year in excess of 401(k) maximums. Deferrals accumulate at interest and are promised to be paid to the executive at an agreed-upon date in the future.

How does a Deferred Compensation Plan work?

Step 1: Execute agreement

The executive and business execute a written legal agreement setting forth the rights and obligations of the parties associated with this arrangement. The company provides written notice to the executive that the company will purchase a permanent life insurance policy on the executive's life. The executive gives written consent.

Step 2: Purchase life insurance

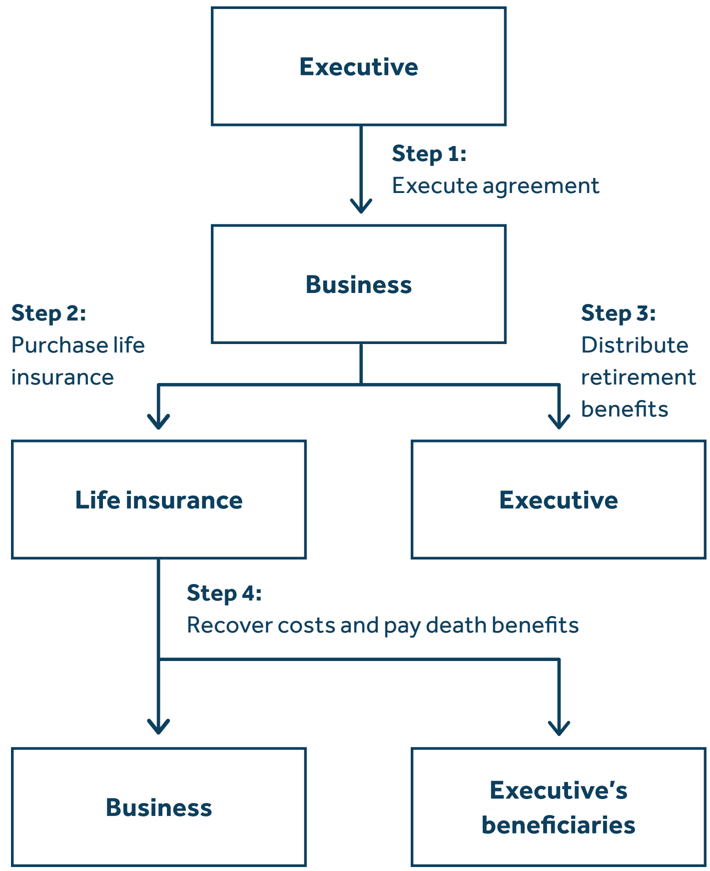
The company purchases permanent cash value life insurance that may be used to help pay the promised benefits to the executive. The policy owner is the business, and the insured is the executive. As a business asset, the life insurance is subject to the claims of business creditors, and the executive has no beneficial ownership rights in the policy.

Step 3: Distribute retirement benefits

Upon reaching the agreed-upon time period, typically at retirement age, the business will pay the promised benefits to the executive. The company can use cash values from the insurance policy to pay the benefits. The company receives a tax deduction for the payments, and the executive pays taxes on the benefit payments received.

Step 4: Recover costs and pay death benefits

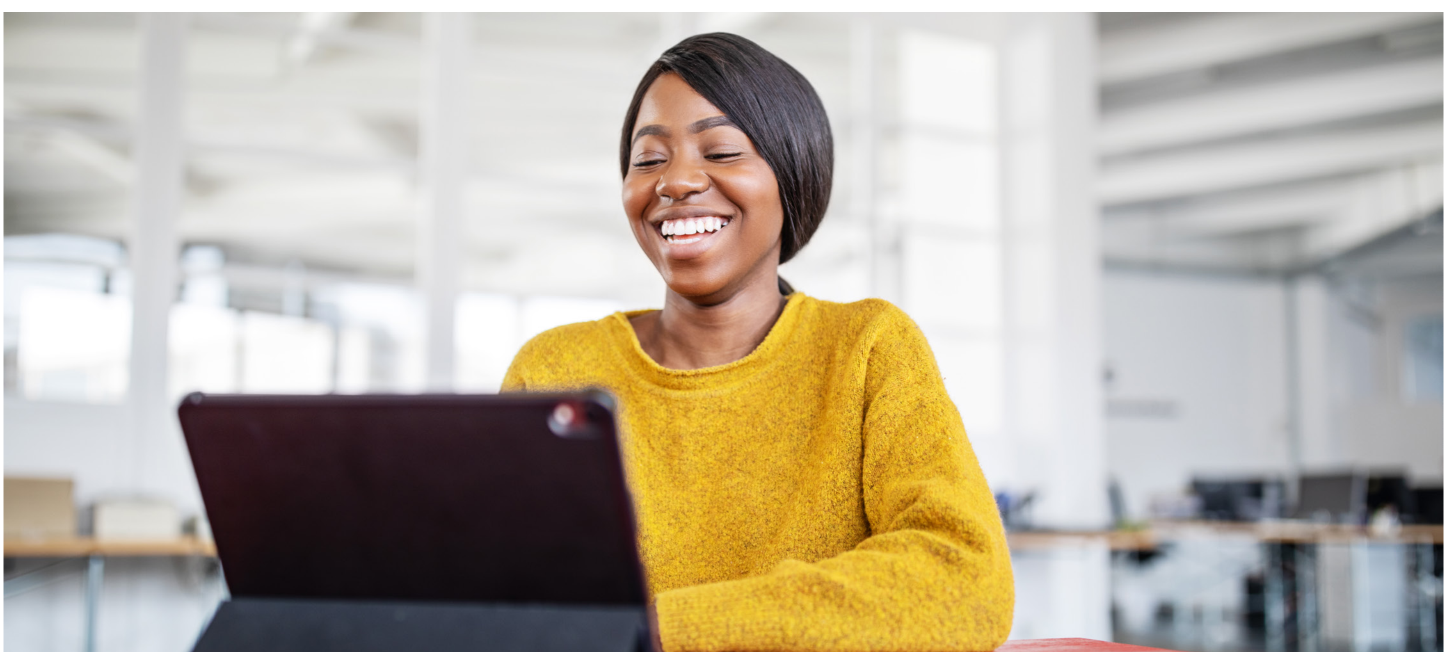
Upon the executive's death, the corporation receives the life insurance death benefit. With proper plan design, the death benefit can pay any remaining benefits due to the named beneficiary and also allow the corporation to recover all of its plan costs. In the event the executive dies prior to reaching the agreed-upon time period, the life insurance proceeds can be used to pay out any agreed-upon death benefits to the executive's family or beneficiaries.



Deferred Compensation Plan checklist

If you answer “Yes” to one or more of these questions, consider exploring how a Non-Qualified Deferred Compensation Plan might fit into your business strategy. Your Guardian financial professional can help you create a specially designed strategy to fit your unique business needs.

- ☐ Are you a business owner?
- ☐ Would you like to provide benefits to your key employees at a minimal cost to the business?
- ☐ Do you want to provide performance incentives to help recruit, retain, reward, and retire top-level executives?
- ☐ Do you want to decide who participates in a plan?
- ☐ Do you want to supplement existing qualified plans by enhancing your executives’ total benefits package?
- ☐ Are your key executives “maxed out” on contribution or benefit limits in your company’s qualified retirement plan?
- ☐ Do you want minimal government reporting?
- ☐ Are you interested in minimal administration expenses?
- ☐ As a business owner, do you need some of these benefits for yourself?



1 To obtain the deferred tax benefits (no tax to the employee until benefits are received), the deferred compensation arrangement must comply with IRC § 409A and be considered "unfunded."

2 As a technical requirement, plan benefits must be "unfunded." An arrangement is considered unfunded if any assets intended to pay promised benefits remain general assets of the business, subject to claims of the business's creditors. However, an employer can purchase financial products, such as permanent life insurance, to help it pay the benefits. In essence, the term "unfunded" is misleading if in fact the company has products it owns that it can use to pay benefits. Only permanent life insurance provides cost recovery to the business from the death benefit, as well as a fund, from the tax-deferred growth of the cash value, to pay the benefit during the executive's lifetime.

3 So long as the program is limited to a select group of management or highly compensated employees.

4 The employer must file notice of the plan's existence with the Department of Labor, Employee Benefit Security Administration, within 120 days of the plan's effective date.

5 The Pension Protection Act of 2006 enacted rules relating to life insurance policies owned by businesses on the lives of "employees" (defined very broadly in the law), that are issued after August 17, 2006. For life insurance death benefits to be income tax free to the business, the "employer-owned life insurance" rules of IRC § 101(j) and 6039I must be met. There are four general requirements: (1) notice must be given to the insured, and her or his consent obtained; (2) either the insured must fit into certain categories, or the proceeds must be used for certain purposes; (3) there must be record-keeping; and (4) reporting to the IRS concerning these policies. Life insurance purchased on a key executive to informally fund a non-qualified deferred compensation plan would fall within the requirements. IRS reporting is done on IRS Form 8925.

6 Some whole life policies do not have cash values in the first two years of the policy and don't pay a dividend until the policy's third year. Talk to your financial representative and refer to your individual whole life policy illustration for more information.

7 Policy benefits are reduced by any outstanding loan or loan interest and/or withdrawals. Dividends, if any, are affected by policy loans and loan interest. Withdrawals above the cost basis may result in taxable ordinary income. If the policy lapses, or is surrendered, any outstanding loans considered gain in the policy may be subject to ordinary income taxes. If the policy is a Modified Endowment Contract (MEC), loans are treated like withdrawals, but as gain first, subject to ordinary income taxes. If the policy owner is under age 59½, any taxable withdrawal may also be subject to a 10% federal tax penalty.

8 For corporate-owned life insurance, if the corporation is in an alternative minimum tax situation, cash value growth and part of the death benefit can be subject to the alternative minimum tax (AMT).

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