

Executive Benefits: Nonqualified Deferred Compensation: A Benefit Strategy



Defining the Issue

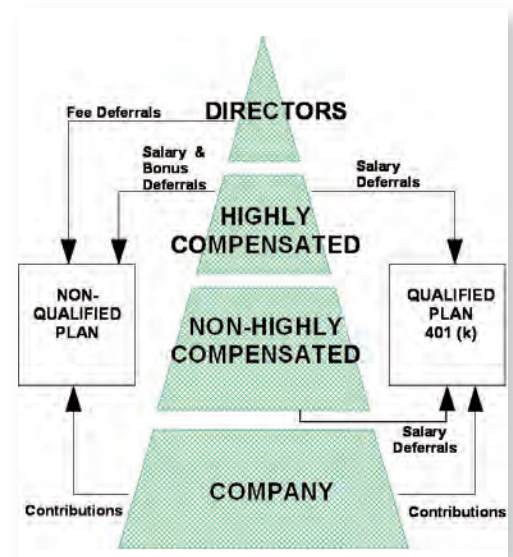
Tax law changes have made "qualified" retirement plans (such as 401(k), profit-sharing, and pension) expensive, restrictive and burdensome, leaving executives without adequate retirement planning opportunities.

Executives are faced with the following issues:

- Limitations on qualified plan benefits and contributions
- Exclusion of incentive compensation from pension formulas
- Lower income replacement ratios and reduced standard of living at retirement
- Security of benefits in the event of a "change of control" or "change of heart"

The Solution

Deferred Compensation arrangements are deemed "nonqualified" plans because they are not subject to the extensive regulatory rules that are imposed on qualified plans (e.g. nondiscrimination tests, vesting, funding, fiduciary responsibility, reporting and disclosure). The employer, not the IRS or Department of Labor, sets the terms and conditions of the arrangement and may even create different plans for different individuals. The only requirement is that the group be considered "top hat" - a select group of employees, usually senior management and highly compensated employees - the very group which is limited by the income and benefit caps placed on qualified plans.



How it is Accomplished

A Deferred Compensation plan provides tailored retirement income benefits to highly compensated individuals. Despite the recent media and legislative attention placed on executive compensation, Deferred Compensation remains a time-tested and cost-effective tool for attracting, retaining, and rewarding key executives. A well-structured plan can also help improve the firm's corporate earnings and build shareholder value.

- Executive Deferred Compensation works much like 401(k) plans from the participants' perspective, however, executives may elect to defer up 100% of their pre-tax salary and bonus compensation (2009 401(k) limit is \$16,500)
- Like 401(k) plans, a company may make contributions to the plan - in the form of "matching" contributions or as a "profit-sharing" option that fills the role of an incentive-based plan
- Deferred Compensation plans may include a vesting schedule on corporate contributions that creates a "golden handcuff" vehicle, which encourages key executives to stay with the organization
- Multiple investment options can be offered in a Deferred Compensation arrangement and may "mirror" those in a 401(k) plan
- A Deferred Compensation plan can produce substantially greater retirement income for the executive than equivalent investments in a traditional taxable plan because plan participants receive earnings on the entire pre-tax deferral amount
- In addition to generating significant retirement income, funds deferred may also be made to "in-service" accounts which are shorter term in nature and are earmarked for college tuition savings, a second home, etc

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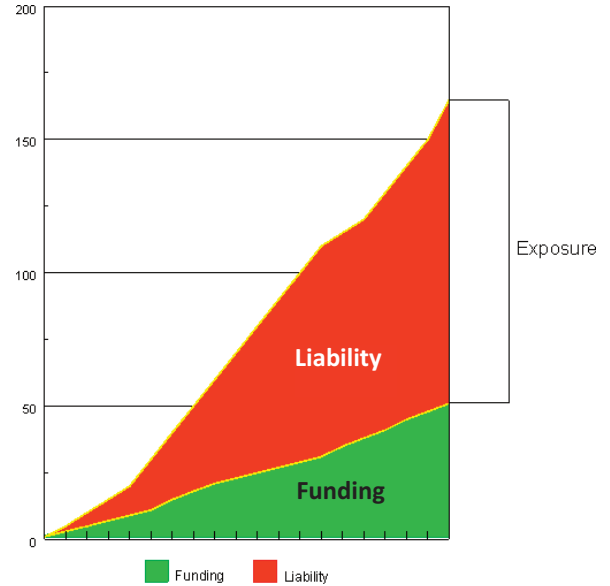
Asset/Liability Management (Funding)

Although there is no requirement to finance these plans, many companies choose to do so. Informal financing of Deferred Compensation arrangements can help:

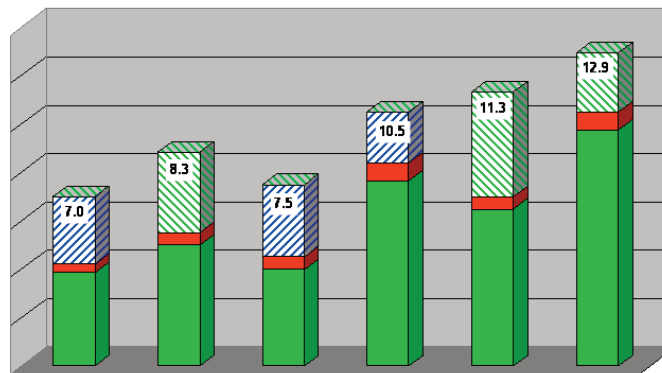
- Fund for the future cost of participant benefit payments
- Hedge the expense of participants' investment decisions if applicable
- Recover the costs associated with establishing and maintaining the plan
- Generate favorable earnings with tax-free investment vehicles

There are essentially three options to finance this obligation:

- 1) Benefits are **paid out of the company's cash-flow** (unfinanced or pay-as-you-go)
- 2) **Taxable investments:** Assets are invested in mutual fund(s) or other managed portfolio(s)
- 3) **Tax-advantaged investments:** Assets are invested inside Corporate-Owned Life Insurance (COLI)



Passive Assets					
1	2	3	4	5	6
Treasuries	Municipal Bonds	Investment Grade Corporate Bonds	Common Stocks	Indexed COLI / TOLI (Corporate or Trust - Owned Life Insurance)	Variable COLI / TOLI (Corporate or Trust - Owned Life Insurance)



Credit Risk	None	Low	Low	Moderate	Low	Moderate
Interest Risk	Moderate	Moderate	Moderate	Low	Low	Low
Liquidity	Very Liquid	Uncertain	Fairly Liquid	Fairly Liquid	Fairly Liquid	Fairly Liquid
Prepayment Risk	None	Low	Low	None	Matures @ Face	Matures @ Face
Market Risk	None	Moderate	Low	High	Low	Moderate to High

