Ark FINANCIAL GROUP

Deferred Compensation

Concept

A non-qualified deferred compensation plan is an agreement between an employer and an executive to defer the payment and receipt of compensation to the future for services performed today. The employer makes an unsecured and unfunded promise to pay the amounts specified under the agreement to the executive at some future date. Non-qualified deferred compensation can be utilized in both the employer/executive and the employer/independent contractor context.

Situations

Qualified plans, social security, and personal savings may provide ample retirement income for many employees; however, they generally will not be adequate for most executives. The shortfall occurs because income taxes reduce what executives can save, tax laws limit either contributions to or benefits available from qualified plans, and social security benefits represent only a small percentage of the executive's total need.

An employer may want to consider offering a non-qualified deferred compensation plan in addition to a qualified plan to select key executives. The two plans can effectively supplement each other. Unlike qualified plans, non-qualified deferred compensation plans allow employers to supplement executive retirement benefits without having to extend the same benefits to all employees.

Requirements and Logistics

There are basically three types of non-qualified deferred compensation plans: (1) Supplemental Executive Retirement Plan, (2) Deferred Income Plan and (3) Nonqualified 401(k) Look-a-Like Plan. The basic difference between them is who contributes the majority of the money.

Supplemental Executive Retirement Plan

Supplemental Executive Retirement Plans (SERPs; also called non-qualified pension plans) are normally employer pay-all plans. There are two types of SERPS. A Defined Benefit SERP is one in which the plan benefits are based on a specific formula such as a percentage of final pay. A Defined Contribution SERP is

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an account balance plan. Contributions are made each year and are credited with interest. The plan benefit is based on the accumulated account value at the designated distribution date.

Both types of SERP plans can provide a pre-retirement and a post-retirement survivor benefit.

Deferred Income Plan

When an executive wants to defer income taxes on earned income that is not currently needed, a deferred income plan (DIP) might be appropriate. A DIP is a form of non-qualified deferred compensation plan in which the executive can defer current income without the contribution limitations of 401(k) plans or IRAs. The employer may at its discretion offer to make matching contributions as specified in the agreement.

The executive may choose to defer portions of current compensation, future salary increases or bonuses. The deferred amounts accrue at an interest rate that is set under methodologies specified in the deferral agreement. The deferred amounts and interest are paid to the executive over a specified period of time, starting at a specified date or upon the occurrence of events set forth in the agreement, such as retirement or in the event of a disability.

The executive is always fully vested in the deferrals and typically entitled to them upon separation from service. In the event of the executive's death, the executive's survivor may be entitled to pre-retirement survivor benefits.

Nonqualified 401(k) Look-a-Like Plan

Given an executive's desire to save for retirement and an employer's desire to encourage executives to remain with the employer, one might consider a non-qualified 401(k) look-a-like (LAL) plan (also called supplemental 401(k)). With an LAL plan for select executives, the same "save and employer match" strategy used in qualified 401(k) plans can be attained without being limited by qualified plan contribution limitations.

Pursuant to the agreement between the employer and the executive, the executive defers a portion of current income as is done under a DIP. The executive is at all times fully vested in his/her deferrals. The employer will agree to make a matching contribution equal to a percentage of the employee deferral as specified in the agreement. A vesting schedule for the employer contributions may be imposed as a key executive retention strategy or incentive.

Section 409A Plan Compliance

Internal Revenue Code Section 409A, which regulates the timing of when compensation/benefits can be deferred and distributed, was enacted in October 2004 and became generally effective on January 1, 2005. Section 409A applies to compensation that workers earn in one year but that is not paid until a future year. Most non-qualified deferred compensation plans are subject to Section 409A. It does not apply to qualified plans such as a Section 401(k) plans and Section 403(b) plans, and does not apply to non-qualified Section 457(b) plans. If deferred compensation arrangements comply with the requirements of Section 409A, the executive's deferred compensation is not taxed until actual receipt of compensation payments.

If the arrangement does not meet the requirements of Section 409A or is not properly administered in accordance with Section 409A, the compensation is subject to retroactive constructive receipt (back to the time of the deferral). In addition to normal income tax, a 20% penalty tax will be imposed as well as interest at a rate 1% higher than the normal underpayment rate. Section 409A imposes a series of requirements on non-qualified deferred compensation plans and arrangements intended to prevent manipulation regarding the amount and timing of deferred compensation payments. To comply with Section

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409A, the material terms of a deferred compensation plan must be in writing. Some of the basic rules include the following:

- ♦ An executive's election to defer compensation generally must be made before the start of the calendar year in which the compensation is earned.
- ♦ The time and form of deferred compensation payments must be elected by the executive, or be contained in plan provisions, before the compensation is earned. Neither the employer nor employee may retain discretion regarding when the payment(s) must be made. Further, the timing of the payments generally may not be accelerated by either or both parties.
- ♦ Deferred compensation may be paid only if:
  - Payment is made at a specified time or pursuant to a fixed schedule:
  - The executive has a separation from service;
  - The executive dies or has a total disability;
  - There is a "change in control" of the employer; or
  - The executive has an unforeseen financial hardship.

Examples of "document" failures for which a plan amendment may be required to correct the failures are:

- ♦ Impermissible definitions of separation from service, disability, or change in control.
- ♦ Impermissible payment event or payment schedule.
- ♦ Impermissible payment periods following a permissible payment event.
- ♦ Impermissible initial or subsequent deferral election procedures.
- ♦ A failure to include the six-month delay of payment for specified employees of publicly-traded companies.

Funding Issues

Avoiding current income taxation of deferred income generally is a principal objective; therefore, a deferred compensation agreement must be unfunded for Internal Revenue Code and ERISA purposes. To achieve this result, the deferred income must be subject to a substantial risk of forfeiture. An agreement is generally considered unfunded if the employer's obligation is an unsecured promise to pay. This generally requires that the assets backing the agreement be subject to the claims of general creditors of the employer, and the executive is a general creditor of the employer with respect to claims under the agreement. The agreement can be informally funded with assets that remain on the employer's balance sheet.

There are basically two ways to achieve this objective. One method is for the assets backing the deferral agreement to consist of the general assets of the employer. These assets are subject to claims of the employer's creditors and are not formally connected to the agreement. The other method is commonly known as a rabbi trust. In a rabbi trust, the employer transfers assets to a trust for the benefit of the executive. While a rabbi trust does not protect the assets from the claims of the employer's creditors, it does provide the executive the added security that the funds have been set aside by the employer and will not be used for any other purpose. From the employer's perspective, a rabbi trust has up-front and on-going costs associated with it.

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Informal Funding

Savings accounts, bonds, stocks, mutual funds, and annuities are some of the investment vehicles that can be used to informally fund a deferred compensation agreement. However, these vehicles may have one or more of the following limitations: subject to market fluctuation; subject to current income taxation; insufficient cost recovery; insufficient survivor benefit; and/or lack of guarantees.

Permanent life insurance on the life of the executive, on the other hand, may be an optimal solution for informally funding a deferred compensation agreement. The death benefit may provide both cost recovery to the employer as well as the funds needed to provide the promised survivor benefits. The cash value of the life insurance policy accumulates on an income tax-deferred basis. Depending on the product, the cash values may be credited based on a guaranteed crediting rate. The employer, as the owner of the life insurance policy, may use the policy's cash to fund the promised benefits to the executive. If the employer purchases life insurance on the lives of the participants, the employer must comply with the notice and consent and exception requirements under Internal Revenue Code Section 101(j) to preserve the income tax-free nature of the life insurance policies' death benefits.

Tax Ramifications

Employer

A non-qualified deferred compensation plan must be structured so that the benefits when taken together with all other compensation paid to the executive are considered reasonable compensation under applicable Federal tax law. In order for the employer to deduct the compensation paid to the executive, the total compensation must be reasonable considering the services provided. Any amount of compensation paid that is determined to be unreasonable under applicable rules and regulations will not be deductible by the employer. The employer gets an income tax deduction when the executive takes the benefit into taxable income. Cash value growth in a life insurance policy is income tax-deferred.

If the compensation is paid in accordance with an agreement that provides the payment is contingent upon future service or the profitability of the company, the statutory requirements will be met, provided that the agreement was made at arm's length and the terms were reasonable at the time the agreement was entered into. The compensation of sole or controlling shareholders in closely held corporations is generally subject to close IRS scrutiny.

Employee

In order for deferrals pursuant to a non-qualified deferred compensation agreement to avoid current taxation, the executive must not constructively receive the deferred compensation. This is accomplished by entering into the agreement before the compensation is earned or the services are performed. Additionally, the executive owes no current income tax on amounts contributed by the employer pursuant to a non-qualified deferred compensation agreement, provided the benefits promised by the employer are subject to a substantial risk of forfeiture. The most common forfeiture provision for employer contributions denies the benefit if the executive terminates employment with the employer before vesting in the benefits.

Pursuant to the economic benefit doctrine, an executive will have taxable income to the extent that he/she enjoys an economic benefit as a result of employment. This holds true even if the executive does not receive any cash or property. An economic benefit would result if an executive had the right to name the beneficiary for any part of the death benefit proceeds from a life insurance policy. To prevent this result, the deferred compensation agreement and the life insurance policy used to informally fund the agreement

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should be separated at all times. The employer should own, apply for, and be the sole beneficiary of any policy used.

If properly structured, an executive will not include any deferred compensation in taxable income until actually received. Once received, the entire amount received in any one year will be included in taxable income for that year. Similarly, any amount received by the executive's beneficiaries after death will be treated as income in respect of a decedent and taxable to the beneficiary in the year received. The beneficiary will be entitled to an income tax deduction for any estate tax paid as a result of the benefits being included in the decedent's estate. When a change in control triggers the payment of a benefit, excess compensation may not only fail to be deductible, but also may cause a 20% non-deductible excise tax to the executive on the excess (as defined in the Code), which is called a golden parachute payment

FICA and FUTA Implications

The Social Security Act Amendments of 1983 established a definition of wages for the Federal Income Contributions Act (FICA) and Federal Unemployment Tax Act (FUTA). Pursuant to that definition, non-qualified deferred compensation benefits are part of the executive's FICA and FUTA wage bases at the later of the tax year in which the services are performed or the year in which there is no substantial risk of forfeiture of the rights to that amount.

In a DIP, the executive should be vested in his/her deferrals at all times. Therefore, the deferred amount will be included as Social Security income in the year earned. In SERPs, the executive might not become vested until retirement. If so, upon vesting the present value of all benefits to be received will be included in Social Security income.

ERISA Requirements

The Employee Retirement Income Security Act (ERISA) was enacted in 1974 and is designed to protect the interest of employees in both pension and welfare benefit plans sponsored by their employers. The term employee pension benefit plan (pension plan) is defined in part to mean any plan, fund or program which is established or maintained by an employer which "results in a deferral of income by employees for periods extending to the termination of covered employment or beyond…." Thus, ERISA clearly covers non-qualified deferred compensation agreements that provide for distribution of the deferred amount at termination of employment.

Generally, that means that a non-qualified deferred compensation agreement must comply with certain ERISA requirements, including: (1) reporting and disclosure; (2) participation and vesting; (3) funding; (4) fiduciary responsibility; and (5) plan termination insurance. However, if a non-qualified deferred compensation plan is unfunded and established only for a select group of management or highly compensated employees, it will be excluded from coverage under most or all of these rules.

For example, an unfunded excess benefit plan (one that provides benefits to any executive who has maxed out under his/her qualified plan Code Section 415 benefits), is generally exempt from all ERISA requirements. Excess benefit plans are not limited to a select group of management or highly compensated employees. Also a "top hat" plan, which is an unfunded deferred compensation plan maintained primarily for a select group of management or highly compensated employees, may provide a safe harbor from most of the ERISA requirements governing qualified plans. For a "top hat" plan, all that is required for ERISA purposes is compliance with limited reporting and disclosure requirements (i.e., notice to the Secretary of Labor within 120 days of adopting the plan that the plan exists and that, if requested by the DOL, necessary documents will be submitted).

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