
# KEY EMPLOYEE PLANNING:

## RECRUIT, RETAIN, REWARD, RETIRE

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# TODAY'S PRESENTER

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# WHAT YOU WILL LEARN TODAY

- The role of 409A in employee retention plans
- Non-409A covered key employee plans
  - Where insurance fits in
  - Case studies
- 409A compliant key employee plans
  - Where life insurance fits
  - Case studies

# The role of 409A in employee retention plans

- IRC 409A regulations govern how **non-qualified deferred compensation** plans must be designed and administered
- Applies to both elective (employee-funded) and non-elective (employer-funded) NQDC plans
- Non-compliance with 409A can result in unexpected tax liability for what was intended to be tax-deferred income

# 409A Plan design requirements include

- Participants must be “top-hat” employees
- Elective deferrals must be made in advance
- Distribution events limited to separation of service, death, disability, specified time, change in control, and unforeseeable emergency
- Timing of benefit payments must be elected in advance


# NON-409A COVERED KEY EMPLOYEE PLANS

# SECTION 162 BONUS PLAN

| Employer | Employee |
|---|---|
| • Pays premium<br>• Includes the premium in the employee's taxable income<br>• Deducts the premium as a business expense | • Purchases and owns the policy<br>• Pays the tax on the premium<br>• Names beneficiaries<br>• Access to living benefits |

**Employee's Heirs**

Family or other named beneficiaries receive policy proceeds at insured's death

# FUNDING OPTIONS

- Life Insurance policy
  - Permanent: Death-benefit oriented
  - Permanent: Cash-value oriented
  - Long-Term Care/Chronic Illness riders
- Disability Income policy
- Linked-benefit policy
- Deferred annuity

# LUMP SUM DEFERRED BONUS PLAN

| Employer | Employee |
|---|---|
| • Pays premium for employer-owned life insurance<br>• Employer promises a specific bonus to be paid at a specific period in the future*<br>• Company has option to endorse a portion of the death benefit to key employee<br>• Employer retains ownership of policy until bonus is paid | • Pays income tax on economic benefit of endorsed death benefit as measured by Table 2001 rates/ carrier rates<br>• Designated beneficiaries receive tax-free death benefit if death occurs prior to bonus payment<br>• Bonus is taxable in year received |

*If the bonus is not paid within 2½ months of the executive meeting the service requirement, the plan may become subject to Internal Revenue Code (IRC) Section 409A.

# FUNDING OPTIONS

- Life Insurance policy
    - Permanent: Cash-value oriented
- Unfunded / mutual funds
- Combination of both

# LOAN REGIME SPLIT DOLLAR PLAN

## Employer

- Makes interest-free loan to employee to fund premiums
- Cumulative premiums booked as receivable note
- Repaid from policy death benefit upon death
- Upon termination of Split Dollar Agreement
  - Loan is paid back by employee
  - Loan amount is forgiven

## Employee

- Owns life insurance policy funded by employer loans
- Collaterally assigns policy cash value and death benefit to employer to secure repayment obligation
- Recognizes imputed interest as taxable income annually
- Names beneficiary for death benefit in excess of repayment obligation

# FUNDING OPTIONS

- Life Insurance policy
  - Permanent: Cash value oriented
  - Permanent: Death benefit oriented
  - Long-term care / chronic illness riders
  - Trust-owned policy (gifting considerations)
  - Single-life or survivorship

# CASE STUDIES

- Nonprofit health care facility
- Dentist office
- University Coach / Credit Union CEO

# 409A COMPLIANT KEY EMPLOYEE PLANS

# SUPPLEMENTAL EXECUTIVE RETIREMENT PLAN (SERP)

| Employer | Employee |
| --- | --- |
| • Makes **unsecured promise to pay** future benefit<br>• May include a vesting schedule<br>• Bears investment risk<br>• Often with employment/non-compete agreement | • Forfeits any unvested benefits upon employment termination<br>• Pays income taxes only as benefits are actually received |

# SALARY / BONUS DEFERRAL PLAN

| Employer | Employee |
| --- | --- |
| • Makes **unsecured promise to pay** currently deferred compensation<br>• Offers one or more options for crediting employee's account<br>• May offer employer match of deferred amounts<br>• Provides regular reporting to plan participants of account values | • Elects deferral amounts, up to 100% of compensation, on annual basis<br>• Elects allocation(s) to crediting methods<br>• Recognizes taxable income as benefits are received in retirement |

# SYNTHETIC EQUITY PLANS

## Phantom Equity / Stock Appreciation Rights

| Employer | Employee |
|---|---|
| • Makes **unsecured promise to pay** future benefit based on value or growth of company's stock<br>• Determines how PSU/SAR grants are tied to company/employee performance<br>• Determines how PSUs/SARs are valued based on valuation formula<br>• Determines vesting schedule<br>• Determines distribution triggers | • Has no actual rights to company stock<br>• Recognizes taxable income as benefits are received |

# FUNDING OPTIONS

- Unfinanced
  - Simple, but potentially risky
  - Company is contractually liable for benefit regardless of earnings
- Sinking Fund – Taxable Investments
  - Flexible (investment options), but potentially volatile
  - Highest cash flow to support tax on earnings
- Sinking Fund – Corporate Owned Life Insurance
  - Tax deferred earnings; tax-free distributions (subject to limitations)
  - Tax-free death benefit proceeds

# CASE STUDY

5 person DC SERP plan/Natural Gas Company

# QUESTIONS?

Remember … **It's About a Plan**

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