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Benefits of a Deferred Compensation Plan for Business Owners and Highly Compensated Executives that Wealth Advisors Need to be Aware of

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Employers and employees alike are interested in supplementing their retirement income. Doing so on a tax advantaged basis is always a plus. While life insurance is usually thought of as an estate planning tool primarily used to provide tax-free death benefits to an insured's beneficiaries, it can also be used to provide a significant ''Living Benefit'' to the insured during the insured's lifetime whether the insured is the owner, a key employee of a business, or a highly compensated executive.

In this article we will be discussing a non-qualified deferred compensation plan and the use of life insurance to provide a Living Benefit, as well as the additional tax benefits it can uniquely provide as a supplemental retirement benefit. Specifically, the Living Benefit Policy (the ''LBP'') is one capable of providing lifetime benefits to the owners or key employees (the ''Targets'') of companies by building up a significant amount of tax deferred cash value within the LBP and containing the minimum amount of death benefit coverage necessary to retain the unmatched favorable tax attributes afforded to life insurance under the I.R.C. One of those tax attributes is the ability of the LBP owner to take loans against the LBP or to draw down the cash values up to its basis in the policy without income recognition. This feature can enable the Targets to maximize the future tax-free supplemental retirement distributions the Targets can derive from an LBP.

The LBP can be used to fund a non-qualified deferred compensation plan for key employees (the ''DCP''), a Supplemental Owner Retirement Program for the business owners (the ''SORP''), or Supplemental Executive Retirement Program for key employees (the ''SERP''). On the other hand, qualified retirement plans are heavily regulated by the I.R.C. and by ERISA[1] and must meet a plethora of eligibility, vesting, funding, and distribution requirements as well as complying with the restrictive fiduciary responsibility and prohibited transaction rules. In essence, the DCP allows the business owner to discriminate in favor of is executives and to craft plan provisions that are tailor made to attract, retain, and compensate a group of management and highly compensated employees who are primarily responsible for the company's profitability and success. The information below outlines a very broad overview of the uses of DCPs in the context of closely held businesses, and

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[1] Employee Retirement Income Security Act of 1974, Pub. L. No. 93-406.

how the combination of a DCP, SORP, or SERP with an LBP can be a win-win tax leveraged deferred compensation program for both business owners and their Target/highly compensated executives.

If your small business owner client wishes to reward executives and key employees for their loyal service after a five, 10, or 20-year period of service and is unable to provide those benefits under its qualified plans because of the prohibitive cost of complying with the nondiscrimination rules under the I.R.C., a DCP, which permits discrimination in favor of highly compensated and management employees, can be an ideal solution. The DCP can also serve the purpose of attracting and/or retaining key employees. Because the qualified plan vesting rules are inapplicable to DCPs, the DCP sponsor is able to craft a vesting provision that will cause the Target to forfeit significant benefits if the key employee is contemplating quitting to work for a competitor. The use of the DCP as a "golden handcuff" combined with the use of a non-compete provision in the DCP makes the DCP a very attractive tool for the retention of a company's key employees. With the removal of the constraints of qualified plans, the business owner is able to tailor the provisions (e.g., completion of a minimum number of years of service or successful completion of performance goals, most suitable to the particular business).

A DCP, is a contractual agreement between the employer and one or more Targets under which the employer promises to pay benefits to the Target in the event of death, disability, or retirement; provided that the executive is vested in his rights to the benefits at the time the benefits becomes payable in accordance with the terms of the DCP. The Target is not taxed on the vested benefits until they are paid, and the employer must defer the deduction of any amounts set aside to fund the benefits until such time as it makes distributions to the Targets. The DCP must be "unfunded" in order to be exempt from ERISA's requirements;[2] but that does not mean that the employer is not able to set aside funds or provide a sinking fund for the purpose of accumulating assets for the payment of DCP benefits. As long as the Target has no preferential security interest in the funds set aside by the employer, the DCP is considered unfunded. Many companies establishing DCPs for their key executive group establish "Rabbi Trusts" to set aside funds which the company can use to pay the benefits when due. Under the terms of the Rabbi Trust the trust assets may not be used by the company for any purpose other than to pay benefits under the DCP unless the company becomes insolvent or is unable to pay its bills when due.[3]

The terms of the typical DCP must be set forth in a written agreement between the employer and the Targets, and should specify the amount of benefits to be provided by the employer, the specific timing of benefit payments, and the distribution options for the payment of benefits (e.g., lump sum or installments over a fixed period of years).

The obligations of the employer to pay benefits under the DCP are mere unsecured promises by the employer. Benefits under a DCP aren't protected against a financial failure of the company. Even if the benefits are quasi-funded with an LBP owned by the employer and contained in a Rabbi Trust, if the employer declares bankruptcy, the Targets must stand in line with other unsecured creditors and behind secured creditors.

The DCP can be contributory through a salary or bonus deferral arrangement, or can be non-contributory or a combination of both. It can take the form of a defined contribution profit sharing plan or a traditional defined benefit plan. The Targets can defer a portion of their current income to supplement their retirement income in amounts that far exceed the amounts of contribution permissible under the §401(k)[4] rules. . . .currently $19,500 with a catch up of $6,500 for those who have attained age 50. If the employer chooses, the Target's deferral amount can be matched and each Target participating in the DCP can be provided with differing matching amounts based upon each Target's attaining his or her unique performance goals or completion of a number of years of service. The DCP typically permits the Targets to construct an investment portfolio similar to their portfolios under the employer's qualified 401(k) plan in order to insure the growth of the tax deferred amounts.

Although the DCP is not subject to the rigorous qualification requirements under the I.R.C., or the fiduciary requirements under ERISA, §409A imposes specific rules that must be met by most DCPs in order to avoid current recognition of income by the Targets. These rules relate to the timing of contributions and distributions from DCPs and the prohibition against the acceleration of benefit payments. Non-compliance with §409A can result in current income tax recognition and tax penalties to the Targets. Although the §409A regulations provide exceptions to and exemptions from a number of its rules, it is imperative that the implementation of a DCP for a closely held busi-

[2] ERISA §301(a)(3).

[3] See GCM 39230 (Jan. 20, 1984), and Rev. Proc. 92-64, which contains the model terms of a Rabbi Trust.

[4] All section references herein are to the Internal Revenue Code of 1986, as amended (the "Code"), or the Treasury regulations promulgated thereunder, unless otherwise indicated.

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ness whether an LLC or an S or C corporation be reviewed by a competent attorney who is experienced with the §409A compliance rules.

LBPs can be used to provide quasi-funding to DCPs, to SORPs for business owners, and to SERPs for key employees. One of the most significant benefits of a SORP or SERP funded with an LBP, specifically designed to minimize pure life insurance protection and maximize the tax deferred accumulation of cash value, is that it allows the insured owner or Target to eventually receive the cash value tax deferred accumulations within the LBP, 100% tax-free, through a series of loans and surrenders that never have to be repaid, as long as the policy **survives the insured**. Keep in mind that many of the existing underlying non-guaranteed life insurance policies funding DCPs, SORPs, or SERPs of many of your clients must be managed on an ongoing basis to make certain that the death benefit does survive the insured, in order to maintain the various tax advantages. Many of these non-guaranteed policies are currently expiring prematurely as a result of years of reduced and sustained interest rates, coupled with neglect on the part of the owners of these policies. . .. . .owners that weren't aware that the premiums should have been increased over the years to make certain that their policy did not expire prematurely.

The Newport Group, an organization that offers group benefits, recently surveyed members of Fortune 500 companies and found that 92% of them offer DCPs to their employees.[5] The top three reasons for doing so were to provide a competitive compensation program (83%), allow executives to accumulate assets to supplement retirement needs (72%), and retain valued executives (63%). Although there are no surveys about implementing DCPs in the closely held business marketplace, their use there can be equally effective.

Let's look at a situation where an owner desires supplemental retirement income through the implementation of a SORP. For example, a 45-year-old owner could choose to defer $25,000 of pre-tax income into a deferred compensation plan funded with an LBP that will continue to grow its cash value on a tax-deferred basis until the employee reaches age 65. At that point, after 20 years the employee will have paid in $500,000. Then on the 25th year, at age 70, that owner could begin to draw out an annual income of approximately $139,000 income tax free for the next 15 years until age 85, all the while having been covered for approximately $1 million of life insurance coverage that could have been used by his beneficiaries to complete the plan had the business owner died during the accumulation period.

In summary, many in the public corporate world have already taken advantage of the significant benefits of a strategically designed DCP. More and more these popular corporate benefits are increasingly finding their way into the ranks of many smaller closely held businesses due to the relative ease of administration of DCPs, SORPs, and SERPs compared to qualified plans and the ability of the business owners to discriminate in favor of executives and key employees. Furthermore, combining the tax leveraging benefits of these plans together with the unique tax attributes of Lifetime Benefit Policies can sometimes be more tax effective than the benefits provided under a qualified plan.

[5] https://www.newportgroup.com/knowledge-center/december-2019-(1)/an-advance-look-at-our-compensation,-retirement-an/.

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