A NEW PARADIGM FOR EXECUTIVE BENEFITS:

SELF-OWNED BENEFITS FUNDED WITH LIFE INSURANCE

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Today's employers have a problem: How will they be able to recruit and retain key executives as the economy rebounds? Today's key executives have a problem: How can they adequately prepare for retirement when there are limits on how much they can contribute to qualified retirement plans? These two big problems lead to one big opportunity for today's life insurance professional: Executive Benefits funded with Life Insurance.

Traditionally, employers have offered retirement benefits to key executives through nonqualified deferred compensation ("NQDC") arrangements funded with corporate-owned life insurance ("COLI"). But new legislation and a changing economy have created some challenges for these arrangements. Section 409A of the Internal Revenue Code has added complexity, restrictions, and the potential for big penalties to deferral plans, salary continuation plans, and supplemental executive retirement plans. At the same time, an uncertain and volatile economy has executives wondering about the security of promised nonqualified retirement benefits. And finally, large national budget deficits have many executives considering the possibility that income tax rates may increase substantially in future years.

What if there were a way to provide key executives with the same net benefit amount while eliminating many of the risks and concerns associated with NQDC arrangements funded with COLI?

The answer may lie in a new paradigm: self-owned benefits funded with life insurance.

Comparison with Nonqualified Deferred Compensation Plans

Nonqualified retirement benefits are typically offered by employers to supplement what can be offered to executives as qualified retirement benefits. Typically, employers offer nonqualified retirement benefits to recruit, retain, and reward the key talent needed to make their businesses successful. To accomplish these goals, employers need to be able to offer nonqualified benefits on a selective basis to key executives and the benefits need to be able to overcome the contribution limits placed on qualified retirement plans.

NQDC plans are nonqualified arrangements where an employer promises to pay an executive a future benefit. The benefit may be structured as a single payment or as a series of payments which typically commence at the executive's retirement. NQDC plans may be funded with employer contributions, executive contributions, or a combination of both. Contributions to NQDC arrangements are pre-tax for the executive (with no current tax deduction for the employer) and the growth in these plans is tax-deferred. Employers typically fund their obligations under NQDC plans by purchasing corporate-owned life insurance.

Prior to 2004 there was very little guidance on how NQDC plans should be set up. Congress enacted IRC § 409A as part of the American Jobs Creation Act in 2004. Section 409A has taken away some of the flexibility these arrangements once offered. For example, executives participating in NQDC plans must now determine ahead of time how they want to take distributions during retirement (i.e., via a lump sum or over a period of years). Section 409A also requires that any assets used in these arrangements must be exposed to the claims of the employer's creditors – the executive cannot have a secured interest in any assets held to fund the promised NQDC benefits.

In sum, NQDC arrangements offer a nonqualified alternative or supplement to the typical 401(k) Plan that is not subject to contribution limits and which allows employers to choose who will participate in the plan. Executives are able to save for retirement using pre-tax dollars and defer taxation until the benefits are paid out. But the assets set aside for these promised benefits are unsecured, subject to the claims of creditors, and the

employer cannot take a current deduction for contributions made to the NQDC arrangement.

Tax-Deferral vs. Tax-Advantaged

NQDC arrangements have long been the favored nonqualified retirement benefit for recruiting and retaining key executives because these arrangements offer tax deferral – the ability to defer recognition of income until benefits are paid out. The popularity of these arrangements is a direct result of the commonly held belief that tax deferral is the most important feature to offer in a nonqualified retirement benefit. Yet the rising popularity of the Roth IRA (and the recent introduction of the Roth 401(k) plan) suggests a change in thinking -- that what is truly important for a retirement plan may not be that it is tax-deferred, but that it be "tax-advantaged."

So what is "tax-advantaged"? A retirement benefit is tax-advantaged when it avoids income taxes at two of the three potential stages of taxation.

When money is set aside to help fund retirement needs, there are three stages at which it is potentially subject to income taxes: (i) upon contribution to a plan, (ii) while the money is growing inside the plan, and (iii) upon distribution out of the plan to the participant. NQDC arrangements are tax-advantaged because money escapes taxation at stages (i) and (ii): money is not taxed when it is contributed to the plan nor is it taxed while growing inside the plan. Money contributed to a NQDC Plan is only taxed when it is distributed to the participant.

But using tax-free contributions is not the only way for a retirement plan to be considered tax-advantaged. The Roth IRA offers another model for tax-advantaged retirement benefits: expose money to income taxes at stage (i) when the money is contributed to the plan, but then allow for tax-free growth and tax-free distributions from the plan. This type of arrangement uses tax-free distributions instead of pre-tax contributions.

So which form of tax-advantaged benefits is better? Of course the answer depends on expectations about the participant's current and future tax brackets.

If we assume that tax rates are the same both at the time of contributions and distributions, a participant will fare just as well in the after-tax design of a Roth IRA as using pre-tax contributions in a 401(k) Plan.

Example: Participant has $10,000 to contribute to a retirement plan. Assets in the plan grow at 6% annually. Participant will take a lump-sum distribution of all plan assets in 10 years. Participant's current tax bracket is 35% and his tax bracket in 10 years will also be 35%. When tax rates are equal, the after-tax distributions from both plan types are also equal.

Plan	Contribution	Taxes	Growth	Taxes	Distribution
401(k)	$ 10,000	-	$ 7,908	($ 6,267)	**$ 11,641**
Roth IRA	$ 10,000	($ 3,500)	$ 5,141	-	**$ 11,641**

But if we assume that future tax rates are going to be higher, then a post-tax design (such as a Roth IRA) would likely perform better.

Example: Participant has $10,000 to contribute to a retirement plan. Assets in the plan grow at 6% annually. Participant will take a lump-sum distribution of all plan assets in 10 years. Participant's current tax bracket is 35% and his tax bracket in 10 years will be 45%.

Plan	Contribution	Taxes	Growth	Taxes	Distribution
401(k)	$ 10,000	-	$ 7,908	($ 8,059)	**$ 9,849**
Roth IRA	$ 10,000	($ 3,500)	$ 5,141	-	**$ 11,641**

Increased taxes in the future result in reduced after-tax distributions for plans which rely on pre-tax contributions as opposed to plans relying on tax-free distributions.

The New Paradigm: Self-Owned Benefits

NQDC arrangements have been a very popular tool for helping key executives save for retirement. However for some, as times have become more uncertain, NQDC arrangements have become less desirable. Many executives today are looking for ways to avoid the restrictions of § 409A. In addition, with the growing expectation that tax rates will increase in the future, many executives would prefer to pay income taxes at today's rates and take tax-free distributions during retirement. Finally, with the economy being less certain than ever, some executives are uncomfortable with a retirement plan that is unsecured and subject to the claims of the employer's creditors.

And so a new paradigm for nonqualified retirement benefits is emerging: self-owned benefits funded with life insurance. Such benefits use after-tax contributions to fund the purchase of cash value life insurance owned by the executive. This new paradigm offers employers an upfront tax deduction for plan contributions and, if funded using a properly structured cash value life insurance policy, allows executives to enjoy tax deferred accumulation and potentially tax-free distributions.[1]

A self-owned benefits plan is an arrangement where an executive purchases a cash value life insurance policy to provide death benefit protection and to help accumulate funds for retirement. The plan can be funded through employer contributions (such as a § 162 bonus plan), through after-tax contributions from the executive, or a combination of both.

However funded, the executive would pay income tax on all of the money used to pay premiums. An employer could, if desired, pay an additional bonus to cover the taxes owed (a "double bonus"). Alternatively, if the life insurance policy allows it, the executive may be able to borrow funds from the policy itself to pay taxes. Finally, if the employer wants to create an incentive for the executive to stay with the business, the benefit could be structured as a restricted executive bonus arrangement ("REBA") where the parties enter into a supplemental agreement which provides incentives for the executive to remain with the employer for a specified period of time.

The self-owned benefits plan, when funded with life insurance, offers the following potential benefits:

- ***Security Against Employer's Creditors*** – A life insurance policy owned by the executive and purchased with after-tax funds is not exposed to the claims of the employer's creditors.
- ***Tax Deductible*** – Provided the executive's total compensation is reasonable, the employer may take a current tax deduction for contributions to the arrangement.
- ***Tax-Deferred Growth*** – No income tax is payable while money is accumulating inside the life insurance policy.
- ***Tax-Free Income*** – Provided the life insurance policy is not structured as a modified endowment contract ("MEC"), the employee will be able to receive tax-free income through a combination of policy withdrawals and loans.
- ***Flexibility*** – Because self-owned benefits are not subject to IRC § 409A, there are no limitations (other than restrictions created by a REBA) on when the executive can take distributions from the life insurance policy.
- Selective Benefit – The self-owned benefits plan can be offered on a selective basis. Unlike qualified retirement plans, there is no requirement that the plan be available on a nondiscriminatory basis.
- ***Reduced Administration Expenses*** – NQDC plans often require a fair amount of annual administration. Frequently, a TPA needs to be hired to administer the plan and make sure it is being handled properly. Annual administration costs can potentially be reduced or in some cases eliminated completely with self-owned life insurance policies.

Conclusion

NQDC arrangements have long been the preferred tool for employers who want to use retirement benefits to help recruit, retain, and reward key executives. But with the passage of IRC § 409A, an economy that is embroiled in uncertainty, and the prospect of rising tax rates, many executives are looking for retirement benefits that are more flexible than NQDC arrangements and not subject to the claims of the company's creditors. The new paradigm for Executive Benefits is self-owned benefits funded with life insurance. Rather than focusing solely on tax deferral, many of today's executives are seeking tax-advantaged retirement benefits coupled with flexibility and security. Self-owned benefits funded with life insurance offer those employees the tax advantages and security they seek.

[1] Income-tax-free distributions are achieved by withdrawing to the cost basis (premiums paid) then using policy loans. Withdrawals will reduce the policy's cash value and may reduce the policy's death benefit. The reduction of the policy death benefit in the first 15 years may have adverse tax consequences. Policy loans will reduce the policy's cash value and death benefit. This assumes the policy qualifies as life insurance and does not lapse.

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