EXECUTIVE DEFERRED COMPENSATION PLANS

Executive Deferred Compensation Plans give business owners and highly-paid employees a tax-deferred way to save for retirement beyond the limits imposed on qualified retirement plans. In our experience, executive plans have become widely used for two primary reasons:

- Strict limits on qualified plan contributions prevent "highly-compensated employees" from accumulating enough to maintain their standard of living in retirement. In fact, qualified plans and social security combined may provide as little as 30% of pre-retirement income. Companies can help these individuals close the gap by offering an Executive Deferred Compensation Plan.

- Executive plans are not subject to the discrimination rules that apply to qualified plans. Benefits may vary by participant, allowing companies to tailor plan provisions to meet their specific objectives. For example, a company hoping to attract or retain selected executives could design a plan for those individuals alone.

In a 2003 survey of publicly-held Fortune 1000 companies, 93% of respondents maintained Executive Deferred Compensation Plans. Many of these plans were 100% employee-funded through voluntary deferrals of salary or bonus, while some included company contributions for selected participants.

Advantages for Key Employees

From an employee's perspective, an Executive Deferred Compensation Plan looks and acts much like a qualified 401(k) plan with greater accumulation potential.

- Similar to a 401(k), any money the employee contributes is a pre-tax deduction from compensation and all investment earnings accumulate tax-deferred. Employees can design their own investment strategy from a wide range of options.

- Unlike a 401(k), there are no contribution limits, which means employees can defer as much as desired. Moreover, there is no requirement to begin withdrawals at age 70½ and no 10% tax penalty on withdrawals before age 59½.

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Advantages for Employers

Aside from the obvious advantage gained by addressing key employees' retirement needs, executive plans can solve a variety of recruiting and retention problems as well. For example, a carefully-drafted plan can:

- Permit newly hired executives to participate, even though not eligible for the company's qualified retirement plan.
- Include company contributions for selected employees, with the flexibility to impose any vesting schedule desired (an option to create "golden handcuffs").
- Provide benefits for an owner or executive's early retirement.

Additionally, money accumulated to finance the plan remains an asset on the company's balance sheet.

Considerations

Although executive plans offer key employees many of the same tax advantages as qualified 401(k) plans, they differ in several respects:

- There are no loan provisions, and employees cannot roll over distributions into an IRA or qualified plan.
- Plan assets are owned by the company and are subject to corporate creditors in the event of bankruptcy.
- Deferrals reduce wages for qualified plan contributions, although this would not be a disadvantage if the company coordinates the executive plan with the qualified plan.

From a corporate perspective, there are also certain differences:

- Qualified plans allow companies to deduct employee deferrals "up front" when the contributions are made. With an executive plan, corporations cannot take the

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deduction until the employee reports taxable income from the plan. In most cases, the delayed deduction for an executive plan will be larger because it will include earnings on contributions, which may be significant. This scenario amounts to a "tax-timing charge" that can be measured through present value analysis.

- Accounting rules require companies to accrue future benefits as a liability on their financial statements. However, assets set aside to finance an executive plan can offset this liability. There may be a charge to earnings on these assets.

Plan Design

Executive Deferred Compensation Plans allow great flexibility. Following are some key plan provisions we address during the design process.

Eligibility: The company has wide latitude in determining who can participate, but must limit the plan to a “select group of management or highly-compensated employees.” Although the law gives no specific definition for this group, guidelines include: (1) less than 10% of the workforce; (2) $90,000+ compensation; (3) employees who, by virtue of their position or compensation level, have the ability to influence the plan’s design and operation.

Contribution Limits: Participants can defer up to 100% of compensation on a pre-tax basis if they wish. However, the company can set limits on the level of deferrals or on the types of compensation eligible for deferral (base salary, bonuses, LTIP income, etc.)

Contribution Types: Participants make an election once a year to defer compensation, and the company can choose to make matching or profit sharing contributions at any time on a selective basis. Company contributions may be subject to any vesting schedule desired.

Investment Options: Most companies offer a broad range of investment options and allow participants to choose among multiple fund families, similar to a 401(k) plan.

Benefit Payout: Standard benefit payment events include retirement, termination of employment, unforeseen financial hardship, disability or death. The company has the option to include certain other benefit payment events. Benefits can be distributed as a lump sum or in annual installments over a specific term.

Plan Financing: Executive plans are technically an unfunded obligation to pay participants future benefits. However, most companies set money aside to finance these benefits. The three most common methods of financing are:

- Self-funding – The company puts no money aside and simply pays future benefits from cash flow when needed.

- Taxable Investments – The company invests in various vehicles in the same proportion as participants invest their deferred compensation accounts.

- Non-Taxable Investments – The company invests in non-taxable accounts in the same proportion as participants invest their deferred compensation accounts.

The best financing method depends on the company's financial characteristics and the degree of risk that is acceptable to both the company and plan participants.

Plan Security: Since contributed amounts must remain a property of the company until payment, executive plans sometimes include measures to help ensure future benefits will be paid. Among these measures are Rabbi Trusts and provisions that trigger benefits payments upon certain financial events or a change of control.

Plan Administration

BDS Consulting Group, Inc. offers complete plan design and administration for Executive Deferred Compensation Plans. Our services are designed to assist companies at all stages:

- Initial assessment
- Plan design
- Plan documents and DOL filing
- Plan enrollment
- Ongoing administration, including daily valuation of accounts, customized quarterly statements, and participant website

To begin discussing the best plan solution for your company, please complete our Executive Benefits Questionnaire.