



# NYLEX News

*Premier Executive Benefits Plan Services*

April, 2006

## To our clients and friends

**This issue of NYLEX News discusses frequently implemented executive benefit programs; approaches used to enhance the security of executive benefits, including trust and nontrust approaches; effective approaches in designing a comprehensive executive retirement program; and an update on section 409A and further guidance we can expect. Please send comments about this newsletter, as well as suggestions for future issues, to our Stamford, CT office.**

### SUPPLEMENTAL EXECUTIVE BENEFITS

Companies continually seek to enhance benefits in order to attract top executives in today's competitive job market. Nonqualified benefit programs are consistently viewed as effective vehicles in helping businesses meet their goals of increasing value to their owners while rewarding productive members of the management team.

A 2005 industry survey of executive benefits trends found that 91% of responding companies had implemented nonqualified deferred compensation (NQDC) plans and 69% reported having supplemental executive retirement plans (SERPs).

A comprehensive and well-structured executive compensation and benefits strategy has never been more important to a business' success. The following is a summary of some of the more popular supplemental programs:

#### ■ Supplemental Executive Retirement Plans (SERPs)

SERPs are intended to supplement retirement income that executives will receive from other sources, such as qualified plans, social security and personal savings. SERPs are usually designed as defined benefit plans, with retirement payments calculated according to a predetermined formula. Annual retirement payments often are based on the employee's compensation and years of service with the company.

Retirement payments in defined contribution plans are based on the accumulated value of contributions to the plan while the employee is actively at work. Contributions often are tied to annual compensation and company performance. An executive's retirement benefit is based on the balance in that individual's account when he or she retires.

NYLEX Benefits' SERP-PLUS™ Model is uniquely designed to structure these programs and help companies assess their benefits and cost.

#### ■ Deferred Compensation Plans

Deferred compensation plans allow executives to save for retirement and defer paying taxes on these amounts until the cash is actually received. Generally elective, the executive decides on the amount of compensation to defer and often can choose how these deferred amounts will grow.

Some deferred compensation plans are funded with employer contributions, with deferred bonuses or other compensation added to the employee's account for distribution at a later date.

Although deferred compensation plans generally provide for distribution at retirement or other separation from service, some plans permit "in service" distributions, with executives electing to receive distributions at pre-selected dates. When structured correctly, these distributions can be timed to coincide with events such as children beginning college or the desire to purchase a second or vacation home.

NYLEX Benefits' 501K™ Program can help a company determine the advantages of implementing a deferred compensation arrangement.

### ■ Survivor Benefit Plans

These plans provide for the payment of a survivor benefit to the executive's beneficiary in the event of the executive's death while employed by the company. These payments, which often continue for three to five years, generally are based on the executive's compensation at the time of his or her death.

### ■ Long-Term Care Insurance

Long-term care insurance (LTCI) provides benefits when the covered individual needs substantial (standby or hands-on) assistance with daily living activities, such as eating, bathing or getting dressed. With the cost of such assistance continuing to grow and individuals living longer and therefore more likely to need such help, this benefit can ease the concern of executives who face the possibility of incurring such expense for themselves or their family.

Company provided LTCI is becoming more prevalent for executives and their spouses. These programs often continue LTCI coverage into retirement. Company programs can give executives the option of paying for coverage for additional family members.

### **Financing Nonqualified Benefit Programs**

Companies often seek to provide informal financing for nonqualified benefit programs, such as SERPs and deferred compensation arrangements. Many of these companies choose company-owned life insurance (COLI) as the financing vehicle, because the growth in the COLI is tax deferred and the cash proceeds, when received by the company either as borrowings from the policies or as death benefits upon the death of the insured, are income tax free. In addition, companies can recognize in their financial statements the increase in cash surrender value each year.

### **SECURING NONQUALIFIED BENEFITS**

Nonqualified benefit plans involve unfunded promises with the executive-participant having the status of an unsecured creditor of the company. The employee's benefit depends on the financial solvency and, to some extent, the trustworthiness of the sponsoring employer.

Unlike a qualified plan where assets to fund the executive's benefits are protected by a special trust designed to insulate him or her from the employer's creditors, a nonqualified plan must be "unfunded". This unfunded status is required in order to avoid current taxation of the employee, even though benefits may not be payable until some future date.

It should come as no surprise that executives have sought to enhance the security of their retirement benefits. Several approaches have been developed to help ease the concerns of participants in nonqualified benefit plans, including:

#### ■ Rabbi Trusts

The rabbi trust takes its name from the beneficiary in the initial IRS ruling approving this type of arrangement. A rabbi trust is a grantor trust established to hold the assets intended to pay the nonqualified benefits.

In order to avoid current taxation of the plan participant, assets in a rabbi trust must remain subject to the claims of the employer's general creditors in the event of the employer's insolvency or bankruptcy.

However, by making the trust irrevocable, it offers the participant the protection, short of the company's bankruptcy or insolvency, that the assets will only be used for the payment of the intended benefits.

For most purposes, the rabbi trust's activities are considered as those of the sponsoring company's and the trust's activities are included in the employer's

income tax return.

The IRS has developed a model rabbi trust document, which companies generally follow in order to make sure they are complying with the safe harbor requirements established by the Service.

#### ■ Secular Trusts

Secular trusts are similar to rabbi trusts, but offer the additional benefit of insulating plan participants from the creditors of the employer company. Specifically, benefits are protected not only from an employer's change of heart or change in control, but also from a change in the employer's financial condition.

This additional level of protection comes at the cost of current taxation of the employee-participant, even though actual receipt of benefits is deferred until a later date. For this reason, secular trusts generally are used only in special situations, such as where a company's financial condition makes employees unwilling to bear the risk that the employer will default on its benefit promise.

#### ■ Non-trust Arrangements

Non-trust security arrangements generally do not set aside specific assets to pay promised benefits. Instead, they rely on a third party to make the payments should the employer be unable to do so.

Employer-provided security arrangements have been frowned upon by the IRS, which has contended that such arrangements result in current taxation to the employee. Employee-arranged security devices sometimes are available, although the cost may be high relative to the protection they offer.

Furthermore, third-party guarantees rely on the financial solvency of the guarantor. In the appropriate circumstance, third party arrangements may be worth considering.

## REI-SOURCE MANAGEMENT SYSTEM™

A key objective of executive retirement planning is to provide a level of postretirement income sufficient to maintain the executive's standard of living. NYLEX Benefits' Rei-source Management System™ helps executives achieve this goal.

Annual studies by Georgia State University have shown that, because of qualified plan and Social Security caps, retired executives typically will replace a smaller percentage of their pre-retirement income than will lower-paid employees. To address this issue, the Rei-source Management System™ estimates the percentage of current income a company's executives will receive at retirement. Many companies have found this analysis valuable in designing a nonqualified executive benefits program that will supplement qualified plan benefits and provide executives sufficient income for their postretirement years.

The use of the Rei-source Management System™ gives a company confidence that its nonqualified plans are designed to:

- Restore benefit levels lost due to pension gaps;
- Deliver additional benefits not subject to qualified plan restrictions;
- Allow the company to remain competitive in the market for executives;
- Provide benefits that are appropriate and not excessive;
- Give executives the opportunity to receive retirement benefits commensurate with their pre-retirement income.

## SECTION 409A UPDATE

### Further Guidance Expected

Section 409A of the Internal Revenue Code, enacted as part of the American Jobs Creation Act of 2004, changed substantially the tax treatment of arrangements that postpone payment of compensation to another year, including SERPs and arrangements with non-employees such as directors and trustees.

On December 20, 2004, Treasury and the IRS released Notice 2005-1, interim guidance under IRS Code Section 409A. In September 2005, Treasury and the IRS issued proposed regulations which would replace the interim guidance.

The proposed regulations generated many comments from industry and tax practitioners. Revised regulations are expected to be issued during the summer of 2006, although that timing could be extended.

The proposed regulations would require existing deferral plans to be amended by December 2006 to comply with the new law, although there have been several calls for that date to be extended.

The proposed regulations did not include rules for calculating amounts to be included in income and determining how reporting and withholding will work under Section 409A. Treasury and the IRS have announced that these rules are forthcoming.

## About NYLEX Benefits

NYL Executive Benefits LLC (NYLEX Benefits) provides supplemental executive benefit programs to a wide range of commercial clients. We focus on developing cost effective executive benefit solutions that are designed to attract, reward and retain key employees. Our services are designed to assist clients at all stages in the adoption and operation of executive benefit programs, and include:

- Initial assessment
- Plan design
- Funding
- Plan implementation
- Ongoing administration

NYLEX Benefits' professional staff includes the following professional disciplines, all dedicated to supporting our clients' programs, processes, systems and services:

- Accountants
- Actuaries
- Attorneys
- Benefit specialists
- Insurance specialists

We take great care to assure that client programs are practical and cost effective and that they are designed to achieve our clients' strategic and operational goals.

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