MassMutual

Nonqualified Deferred Compensation Arrangements

The art of recruiting, retaining and rewarding

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The decision to purchase life insurance should be based on long-term financial goals and the need for a death benefit. Life insurance is not an appropriate vehicle for short-term savings or short-term investment strategies. While the policy allows for loans, you should know that there may be little to no cash value available for loans in the policy's early years.

A Primer on Nonqualified Deferred Compensation (NQDC) Arrangements

Nonqualified deferred compensation (NQDC) arrangements can help you attract, retain and reward your most valuable and "mission-critical" employees. They are designed by the company to help their key employees grow and flourish with the company. They can allow for flexibility and customization. The "art" of designing company compensation arrangements is in understanding the laws of taxation, the power of tax deferral and the power of tax-deferred investing.

If your business is thriving in today's competitive business marketplace, it's likely because of a few mission-critical players in your organization. You know the types: the go-getters, the winners, the difference-makers, the keepers, the next generation of owners, the best of the best employees, the ones that are hard to get and even harder to keep. Current compensation and benefits keep them happy, productive and motivated. But what keeps them there for the long run? The company needs to offer them a powerful incentive such as a benefits package based on performance, stability and even ownership. Massachusetts Mutual Life Insurance Company (MassMutual) can help you meet that need.

Selecting the proper design

Unlike a tax-qualified arrangement which is non-discriminatory, a nonqualified arrangement can be discriminatory. A company should select only those key employees they want to protect and reward, designing payment schedules that emphasize those aspects of compensation they wish to incent. For example, the top salesperson's arrangement can be designed to reward reaching sales goals; a chief financial officer's arrangement could be based on financial savings or increases in shareholder value achieved. Your financial services professional has the knowledge and experience to help you design and "informally fund" a nonqualified arrangement and also assist in the search for a suitable administrator, if needed.

Benefitting the top performers

NQDC arrangements enable you to take care of your mission-critical top performers. Like qualified arrangements, these are in writing and can either be structured as defined contribution (a specified amount set aside) or defined benefit arrangements (promise of a percentage of salary).

However, unlike qualified arrangements, NQDC agreements are not subject to the full Employees Retirement Income Security Act of 1974 (ERISA) participation, vesting and funding requirements. Only the reporting and disclosure, and administration and enforcement requirements need to be met. Employer contributions are also not deductible to the company until they are received as income by the participants.

An NQDC arrangement is a promise to pay a benefit upon a specified payout event identified in the agreement. The promised benefit cannot be accelerated without creating adverse tax consequences for your employee. Suppose your NQDC arrangement promises to pay a select employee a benefit when they reach age 65. This employee cannot receive the promised benefit prior to age 65 without facing an additional 20% income tax penalty for violating Internal Revenue Code (IRC) § 409A.

Rules Around NQDC

Informal funding of an NQDC arrangement

The NQDC arrangement must be unfunded. This means that the employee only has the employer's unsecured promise to pay benefits in the future. The employee is a general unsecured creditor with respect to the promised benefit. An NQDC arrangement can be informally funded, where a company, solely for its benefit, accumulates or purchases an asset to meet the future payment requirements. The company must be the owner of any asset or fund, and the employee is an unsecured creditor, with no interest in such asset or fund.

In contrast, a formally funded arrangement is defined as one where an employer "formally" titles corporate assets into the name of the employee (which makes these assets immune from the reach of corporate creditors). This arrangement is subject to full ERISA compliance and also subject to immediate taxation if the benefit is vested.

Whole life insurance with a cash value feature on the employee's life can play an important role in "informally funding" employee benefits. The employer must be the owner and the beneficiary of the policy. The life insurance premiums are not deductible by the company; however, these costs may be offset by policy cash values, which are reported as an asset on the books of the company. At retirement, the employer may use policy cash values[1] or policy loans to make the agreed upon benefit payments. Without the insurance, the employer would have had to use current earnings to fulfill the payout. Any remaining policy values (especially death benefit coverage) can then be used by an employer to recover costs.

[1] Distributions under the policy (including cash dividends and partial/full surrenders) are not subject to taxation up to the amount paid into the policy (cost basis). If the policy is a Modified Endowment Contract, policy loans and/or distributions are taxable to the extent of gain and are subject to a 10% tax penalty. Access to cash values through borrowing or partial surrenders will reduce the policy's cash value and death benefit, increase the chance the policy will lapse, and may result in a tax liability if the policy terminates before the death of the insured.

Taxes can be deferred, but rules are rules

Many employer plans are Supplemental Executive Retirement Plans (SERP) and use only employer funds to pay or informally fund the benefit. Alternatively, the NQDC arrangement can be a true deferral plan. Employers can use NQDC arrangements to assist highly compensated employees with mitigating the impact of their high tax brackets. It is important that these arrangements be carefully managed so as not to run afoul of IRC § 409A. Compliance with IRC § 409A is essential to avoid the imposition of significant tax penalties and requires the following:

1. Elections to defer compensation must be made before the beginning of the calendar year in which the services giving rise to the compensation are performed (though newly eligible participants may make an election to defer compensation not yet earned in the current calendar year);
2. At the time of the deferral election, participants specify when the retirement benefit is to be disbursed, as well as the form of this payment (e.g., lump sum or payment over a specified time period);
3. Payout of benefits is limited to one or more of the six payment triggers permitted under IRC § 409A; and
4. A 20% federal income tax penalty plus the current federal underpayment rate will be assessed against any amount of an NQDC arrangement that the employee can accelerate into their income.

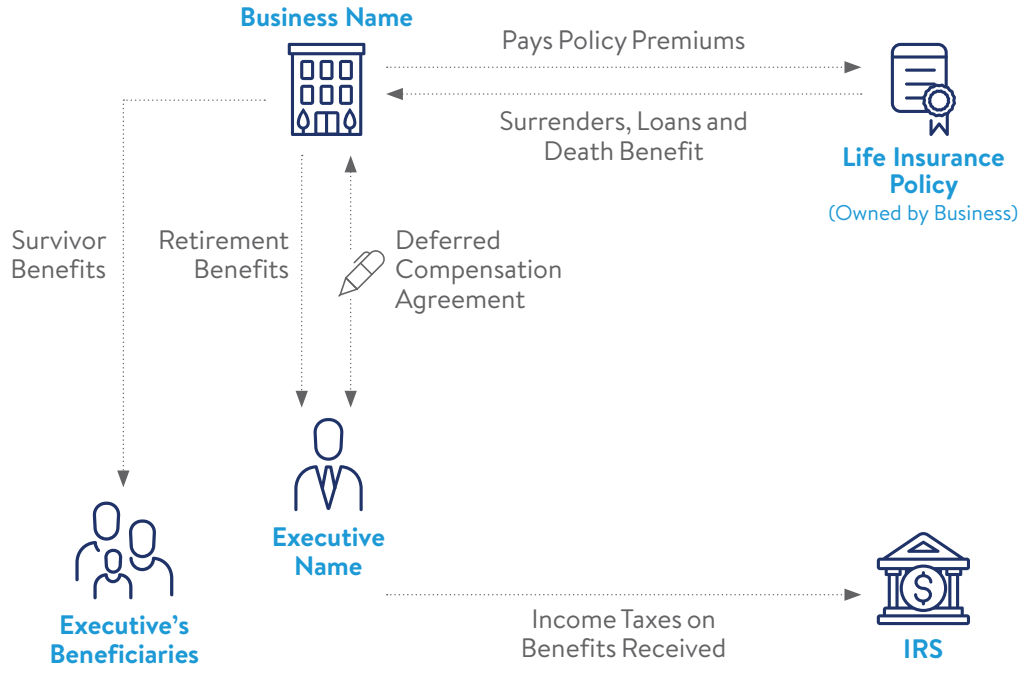
Subject to very limited exceptions, the date elected for distribution of the deferred compensation cannot subsequently be changed. Generally, the date chosen for payment cannot be accelerated. It can only be deferred to a later date if the subsequent deferral election is made at least 12 months before the deferred amount was originally scheduled to be paid and the date for payment is deferred by at least five years. Thus, the employee considering deferring compensation under a nonqualified arrangement must, in addition to planning to maximize the tax advantage of deferring compensation, carefully consider his or her needs for cash in the coming years. This is done by electing payment dates that are reasonably expected to coincide with his or her cash flow needs.

As indicated, IRC § 409A limits the number of exceptions under which a benefit can be paid out. One or more of the following triggers can be included in the agreement:

1 | Separation from service with the employer;
2 | Death;
3 | Disability;
4 | Unforeseeable financial emergency;
5 | Change of control of the employer owing the deferred compensation; or
6 | Upon attaining a specified date or pursuant to a specified schedule.

No other "event" can trigger payment of deferred amounts. Thus, for example, a participant in an NQDC arrangement cannot specify that payment be made when his or her child goes to college. He or she must specify the years in which they think the child will be in college and take the distributions scheduled for those years, regardless of whether a child is in college or not.

SUPPLEMENTAL EXECUTIVE RETIREMENT PLAN (SERP)



NQDC: How it Works

Notice and consent

Since 2006, Congress has required that employers wishing to purchase life insurance on the lives of their employees (and thus benefit from the tax-free death benefit protection of these contracts) must seek employee permission for such coverage. Congress was prompted to initiate these requirements as a result of a number of cases where employee coverage was purchased for the benefit of the employer without employees' consent. In many of these cases, employees were not aware that their heirs would not receive any of the death proceeds, but instead the death benefit was payable to the employer. They were also unaware that the employer would continue to maintain the insurance even after the employee terminated employment.

The notice and consent requirements include:

- The employer must notify the employee to be insured of the maximum amount of coverage that may be obtained on the employee's life at the time the policy is issued.
- The employer must obtain the employee's written consent to the policy being obtained, along with the employee's acknowledgement that the employer will receive the death proceeds and that the insurance may continue after the insured's employment terminates.
- The employer must maintain records of the employer's notice and the employee's consent, and must file certain annual reports with the IRS.

Here's how the arrangement works:

- Your company enters into an NQDC agreement with the individual or a group of employees. Documents must then be drafted by your company attorney. Sample documents are available that your attorney may consider.
- Your company selects and applies for life insurance on the employee with a face amount sufficient to cover all promised death and retirement benefits, as well as optional additional amounts, subject to design. The company is the policy's sole applicant and owner, pays all premiums, and retains all rights of ownership.
- When the key employee retires, your company can use policy cash values, dividends, or loans to make the agreed upon payments to the employee.[2]
- Your company may opt to keep the policy intact after retirement and pay the employee from company revenues. Upon the employee's death, the company receives the death benefits income tax free,[3] recovering the expense of payments made to the family.
- If the employee dies before all payments are made, his or her dependents receive the balance of payments.
- If the employee dies before retirement, lump sum death benefits are paid to the company. The deceased employee's family would then receive benefit payments subject to the terms of the agreement.
- Subject to some limitations, your company takes tax deductions for payments made to the employee or beneficiary. All NQDC payments (taxed as income to the beneficiary) are subject to income tax as and when they are received.
- The agreement is terminated when all payments have been made.

[2] Policy loans will decrease the death benefit otherwise payable. Policy withdrawals are not subject to taxation up to the amount paid into the policy (your cost basis). If the policy is a Modified Endowment Contract, policy loans and/or withdrawals will be taxable to the extent of gain and are subject to a 10% tax penalty. Access to cash values through borrowing, partial surrenders or withdrawals can reduce the policy's cash value and death benefit, increase the chance the policy will lapse and may result in a tax liability.

[3] Depending upon the factual situation presented, there may be potential Alternative Minimum Tax consequences for the business. In addition, the portion of the death benefits that exceeds the premiums and other amounts paid may be taxable, depending on the factual situation.

NQDC: Is it Right for You?

Why an NQDC arrangement benefits an employer

- Retains valued employees until their retirement or specified date.
- Attracts top executives.
- Values in a corporate owned life insurance are assets of the company and can be used to offset the impact of benefit liabilities.
- Coverage may be transferable to either the executive or a replacement executive.

Why an NQDC arrangement fosters loyal employees

- Shifts income from peak productive years to later years where income taxation may be lower.
- Unlike a traditional increase in compensation, pretax dollars are used to fund the arrangement.
- Salary may continue to dependents in the case of a premature death.
- Can supplement pensions and profit sharing arrangements by creating an additional source of retirement income.

When is an NQDC arrangement right for you?

- When you want to provide a deferred compensation benefit to an executive or group of executives but the cost of a qualified arrangement would be prohibitive due to a large number of non-executive employees who would have to be covered.
- When you want to provide additional deferred compensation benefits to an executive who is already receiving the maximum benefits or contributions under the company's qualified retirement arrangement.
- When you want to provide certain key employees with tax-deferred compensation under terms or conditions different from those applicable to other employees.
- When an executive or key employee wants you to create a before-tax, automatic and relatively painless program that uses tax savings to "leverage" the future benefits.
- When you need to solve the "3R" (recruit, retain or retire) problem.
- When your closely held company needs to attract and retain non-owner employees, but the equity-based compensation packages (company stock and stock options) that these employees would expect to receive if they were employed by a publicly held company are not possible.

STRATEGIES FOR
COMPETITIVE BUSINESS

Nonqualified deferred compensation (NQDC) arrangements can help you attract, retain and reward your most valuable and mission-critical employees.

Since 1851, our business decisions have been guided by our customers' needs. Today, we offer a wide range of financial products and services to help people secure their future and protect the ones they love.

Learn more at **www.massmutual.com**

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