

Non-Qualified Plans for Family Businesses

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Presentation Handouts

Today's presentation materials may be downloaded at:

<http://www.wolfandco.com/webinars/2011>

Objectives

- What is a non-qualified plan?
- How could a non-qualified plan benefit your business?
- Does your plan have to be funded?
- What funding alternatives exist?

What is a Non-Qualified Deferred Compensation Plan?

What is **Non-Qualified Deferred Compensation**?

- A legally binding right during one taxable year to compensation payable at a future date
 - Deferred salary
 - Deferred bonus
- Supplemental Retirement Plans
- Severance payments
- Phantom stock plans

What is **Non-Qualified Deferred Compensation**?

- Pension & profit sharing plans, 401(k) plans are **QUALIFIED** plans

Why Establish a Non-Qualified Plan?

Why Establish a Non-Qualified Plan?

- Incentivize retention of key employees
- Provide benefits to only a select group (“top hat plans”)
- Avoid ERISA regulations
- Help to offset the “reverse discrimination” faced by highly compensated executives under qualified plans
- Provide consideration for non-competition agreements

Phantom Stock

Economic Benefits:

- The right to receive a payment based on the value of the company at designated liquidity events
- The right to receive annual “phantom stock dividends” when declared by the Company’s Board of Directors

Phantom Stock

Plan Features:

- Share in future appreciation
- Vesting
- Designated liquidity events
- Non-compete and non-solicitation covenants
- No rights of a shareholder
- No fiduciary duties

Phantom Stock

Income taxes

- The receipt of phantom stock is not currently taxable, nor does the recipient have to purchase the phantom stock with personal funds.

Phantom Stock

However...

- The receipt of future proceeds is taxed as *ordinary income* rather than capital gain

But...

- Tax deductible by the Company

Section 409A

- Imposes difficult and expensive regulations governing the deferral of compensation
- Substantial tax penalties for non-compliance
- 6 permissible payment events for which Section 409A does not apply

6 Permissible 409A Payment Events

1. Termination of Employment
2. Death
3. Disability (a medical disability expected to last more than one year or result in death)
4. Specific date specified at the time of deferral (not an event)
5. Unforeseen emergency (such as a severe financial hardship resulting from an illness or accident)
6. Change in control

Funding SERPs and Deferral Plans

Funding Alternatives

- Deferred Compensation plans, by law, are “unfunded”
- An unfunded plan is merely a promise by the employer to pay the participant compensation at some future point
- Assets may be “informally” maintained in connection with the plan; however,
 - Assets must remain assets of the employer, not the employee; and
 - Assets must remain subject to the claims of the employer’s general creditors

Funding Alternatives

- Three options available to finance or fund a DCP:
 - Pay as you go
 - Taxable separate investment accounts or mutual funds
 - Corporate-owned life insurance (COLI) or Trust-owned life insurance (TOLI)

Funding Alternatives

How the funding options differ:

Funding Option	Charge to Earnings	Effect on Cash Flow	Tax Impact	Unfunded Liabilities	Trust & Custodial Fees
Unfunded Pay As You Go	Highest	Lowest at beginning; highest at end	No impact other than timing	Highest	None
Taxable Investments	Modest	Moderate at beginning; low at end	Adverse as all gains taxed as incurred	None	Highest
COLI/TOLI	Lowest	Moderate at beginning, lowest at end	No adverse tax impact	None	Modest to lowest

Funding Alternatives

Pay as you go

- Benefits are paid out of corporate cash flow as they come due
- Advantages
 - Employer does not have to set aside funds
 - Employer can invest the deferrals back into the company

Funding Alternatives

Pay as you go

- Disadvantages
 - Does not provide any cost recovery
 - Assumes employer's financial position in future will allow payments to be made from cash flow
 - Mounting financial obligation for future management
 - P&L expense will be higher since no gain on assets to offset benefit expense
 - Lower benefit security to the executives
 - Less desirable and less motivating to executives

Funding Alternatives

Taxable Investments

- Contributions are invested in equities/mutual funds to pre-fund the executive benefits so assets are available in the future as the benefit payments come due
- Advantages
 - Provides large selection of investment options
 - Provides added security and assurance to the executives

Funding Alternatives

Taxable Investments

- Each participant defers an amount of compensation and allocates it among the available “hypothetical investment options”
 - The amount the company must repay then rises or falls in conjunction with the earnings or losses in the respective “valuation funds”
 - Each deferral is adjusted for the earnings/losses of the respective “valuation funds”
 - This determines the amount of the liability that is ultimately repaid to the participant
- The “investment” is considered a paper transaction (to avoid constructive receipt)

Funding Alternatives

Taxable Investments

- Disadvantages
 - Employer has to bear the cost of taxes on investment earnings
 - Does not provide for cost recovery
 - If securities are classified as “available for sale,” unrealized gains on equity investment do not flow through to the P&L statement until realized (FAS 115)

Funding Alternatives

COLI

- COLI is used to pre-fund the executive's benefit so assets are available in the future as the benefit payments come due
- May be funded on an aggregate basis to help improve funding efficiency
- As benefits come due, employer may take aggregate withdrawals up to cost basis and/or tax-free loans for the after-tax amount of the benefits due
- Residual death benefit remains in force for cost recovery upon the death of an executive

Funding Alternatives

COLI

- Advantages
 - Provides added security and assurance to the executives
 - Tax-deferred appreciation of investment options inside the policies benefits the employer
 - Flow through of unrealized gains to the P&L statement (FASB Technical Bulletin 85-4)
 - Death benefit proceeds may help provide cost recovery, reducing funding costs and resulting in NPV gain to P&L statement

Funding Alternatives

COLI

- Disadvantages
 - Investment choices are limited to those funds offered within the COLI product, although these products generally offer 50-80 fund choices along with fixed accounts
 - Cost of insurance wrapper

Funding Alternatives

COLI Product Due Diligence

- If COLI funding is pursued, there are a number of high quality, highly competitive COLI products that may be considered.
- The company and the consultant must be prepared to conduct an RFP and due diligence search to procure the most competitive product from among the leading COLI providers due to the periodic updates to these products.

Thank You/Questions

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Wednesday, April 6, 2011

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Presented by:

Family business Vice-President,

Kristin Sundin Brandt of Sundin Associates