IS THERE A FREE LUNCH IN EXECUTIVE COMPENSATION?

Proposals for low or no cost funding of nonqualified executive benefit plans continue to proliferate.

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If there existed a list of truisms which almost all financial executives could agree, the list would include:

> "Pension plans are expensive."
> "Cash value life insurance is a poor investment."

Yet financial executives are encountering a proliferation of plans which would provide substantial retirement income and deferred compensation wealth accumulation benefits for top management, with "little or no cost to shareholders". How is this possible – by funding the plans with Corporate Owned Life Insurance (COLI)? The result is a win-win, valuable benefits that attract, retain and reward key employees at no cost to the company.

Here are a few examples of executive benefit plan designs:

1. The plan was designed as a voluntary nonqualified deferred compensation plan, which allowed the executives to defer compensation over and above the company's 401(k) plan limits (i.e. $14,000 salary deferral limit under IRC Section 402(g) in 2005). The executives were given 14 investment fund choices, similar to the 401(k). The plan was designed as having no cost to the company, even after an allowance for the time value of money.

2. Another plan was structured as a "performance" plan. The company made annual contributions between 2% and 8% of the executive's annual cash compensation, based on the company's return on equity (ROE). This plan, like the deferred compensation plan allowed the executive to invest the company contributions into a family of mutual fund type investments. The plan was designed to cost nothing, other than the time value of money.

APPEAL LIES IN TAX DEFERRED WEALTH ACCUMULATION BENEFITS

The principal appeal of these plans, and others like them, lies in the tax deferred wealth accumulation. Executives are rightly concerned about the government limitations of qualified pension plans and their inability to defer dollars for later retirement. The limits governing how much a person may contribute to a 401(k) plan make it only marginally valuable to highly compensated executives who could never accumulate adequate retirement savings as a percentage of their annual compensation solely through their

401(k). To address this inequity created by the government limitations, and to provide a valuable executive compensation benefit, companies began to offer savings plans considered "nonqualified", which refers to their exemption from ERISA's* requirements for qualified plans. Since these programs do not have to meet ERISA or other technical requirements applicable to broad based retirement plans, they can be focused narrowly on an employer-defined top management group.

When these benefits are delivered at an extremely low cost, the appeal is overwhelming. But the skeptical financial executive will ask how it is possible that a plan can provide significant benefits for executives, that the insurance company will presumably earn a profit on the policies used to fund the plan, that the firm's marketing the programs will realize a profit, and yet there is very little cost. Everyone seems to win, and nobody pays.

Further, he knows that the broad-based pension and other employee benefits are expensive, and he is also mindful of the reputation of cash value life insurance as a poor investment. How is it all possible?

Determining the answers requires an intriguing inquiry into the costs of funded employee benefit programs, and the economics of buying COLI policies bought primarily as an investment rather than for traditional insurance protection motives.

DEFERRAL ELECTION AND INFORMAL FUNDING

In a typical deferral plan, employees are given the option to defer a portion of their annual cash incentive pay, their base salary, or both. Elections must be made sufficiently in advance of the time that the payment is otherwise due to avoid current taxation. The amounts deferred and interest earned are recorded as a liability by the company on its' balance sheet. In order to offset this liability, companies often choose to "informally" fund these plans.

Formal funding, as is required with qualified plans such as the 401(k), occurs when the company sets the money or investment vehicles outside of its general assets. The company, in other words, can't touch the monies earmarked for payout under the plan. Should the company become insolvent, creditors cannot make claims against monies in formally funded programs.

Nonqualified plans are informally funded when a company sponsoring such a plan decides to take some or all of the money received from the executive's deferrals and invests it to help ensure that when the time comes to pay out funds, those funds will be there. The company may invest in virtually anything to accomplish this goal, but the most common choices are mutual funds and COLI.

COLI products are quite prevalent among the Fortune 1000 because of the tax advantages they provide to the corporation. The cash value of the policy is invested in mutual fund type investments, similar to your 401(k) plan. The company can allocate the cash value among these accounts and mirror employee elections under the deferral plan.

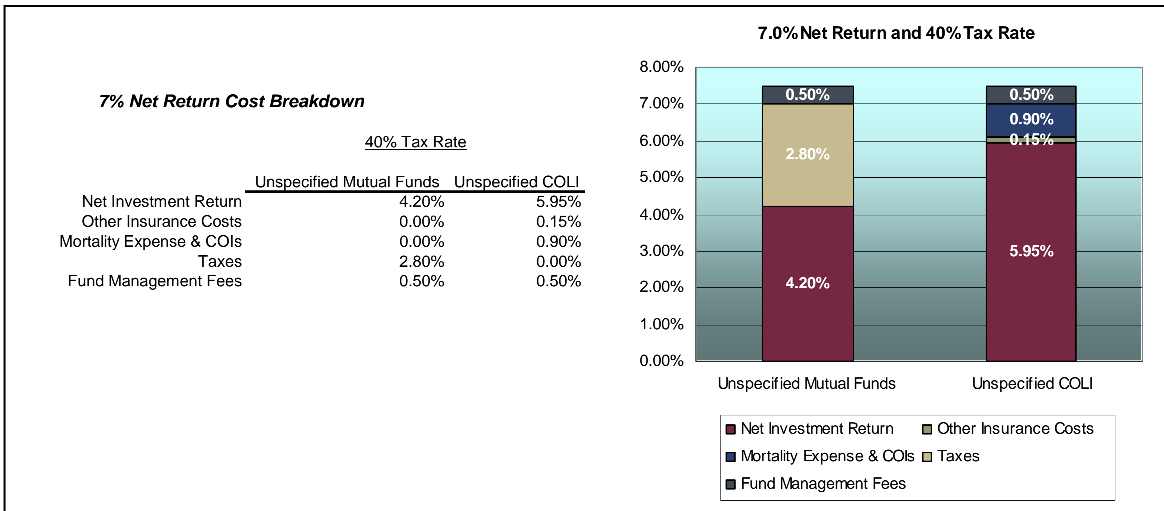
Furthermore, the allocation can be changed and rebalanced without triggering any tax on realized gains. Any investment gains, dividends or interest earned within a COLI contract that is held to maturity are tax free to the company. On the other hand, if the company funded with mutual funds, essentially all gains are ultimately taxable.

SIMPLE MATH OF INFORMALLY FUNDING

The decision to informally fund these plans is generally driven by the company's tax paying status. Companies that do not pay taxes due to loss carry-forwards or net operating losses almost always utilize mutual funds to informally fund their nonqualified deferred compensation plans. The gains from mutual fund investments are taxable, but since the company isn't a taxpayer, those gains do nothing to increase the company's liability.

However, if the company is a tax paying entity, then COLI is probably the way to go. Gains and other income that result from investments inside of an insurance contract owned by the corporation and held to maturity accrue tax-free to the company. There are costs associated with purchasing a COLI contract and a portion of those costs provide a death benefit. The executive participating in the plan becomes the insured; the beneficiary is the company (or a trust) which also owns the policy.

Figure 1



7% Net Return Cost Breakdown

40% Tax Rate

	Unspecified Mutual Funds	Unspecified COLI
Net Investment Return	4.20%	5.95%
Other Insurance Costs	0.00%	0.15%
Mortality Expense & COIs	0.00%	0.90%
Taxes	2.80%	0.00%
Fund Management Fees	0.50%	0.50%

The math is simple. The company needs to weigh the cost of the COLI against the cost of paying taxes on the mutual fund gains, that simple. Figure 1 compares the difference in long-term net after tax returns for a mutual fund with the return for COLI invested in the same fund. In this example, the return (net of management fees) is 7.0 percent. With mutual funds, the investment earnings are taxed as realized. Some of the taxation can be deferred by using passive index funds or by qualifying the funds as a hedging transaction; however, gains eventually are realized when the funds are liquidated to pay benefits. In the example, the annualized after-tax rate of return with mutual funds is 4.2 percent, compared with COLI expected return through death of 5.95 percent. COLI has a clear

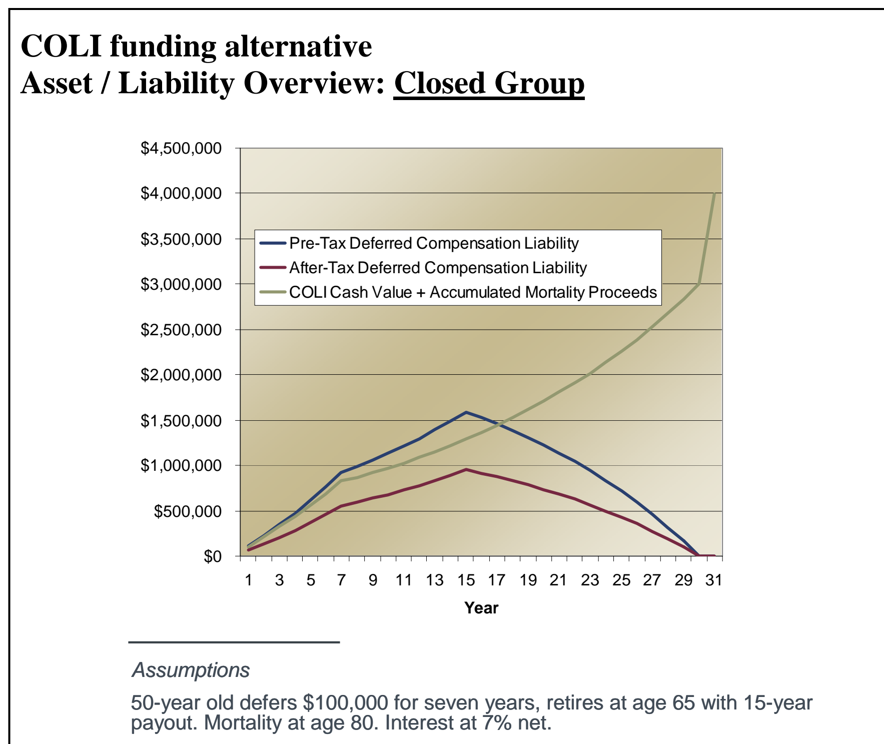
advantage due to the favorable tax treatment, even despite any slippage due to expense charges for insurance. COLI also has favorable accounting under Technical Bulletin 85-4, verses mutual funds which fall under FAS #115.

STRESS TEST YOUR COLI CONTRACTS

As we discussed above, COLI is advantageous when a company is in a tax paying position. Any COLI analysis should do a little stress testing. There are a number of factors that can influence the returns from COLI contracts;

1. Company tax rate;
2. Investment returns from the mutual funds in COLI;
3. The company's cost of capital;
4. The loads in the COLI contract.

Figure 2



A company also should consider the trade-off between tax efficiency and liquidity. When the company pays benefits out of current cash, while holding the COLI until the insured's death, it could find itself with excess funding. Figure 2 illustrates the funding mismatch when COLI is held on a closed group and the company pays benefits out of current cash. To avoid this mismatch, COLI is best used as a funding vehicle for a plan with continued growth. Also, the company has the ability to withdraw cash from the policy tax deferred, to facilitate these benefit payments. A full analysis is recommended looking at all upside and downside exposure.

PERCEPTION OF COLI BEING A BAD INVESTMENT

Unfortunately, COLI comes in many shapes and sizes. Various forms of COLI have had some negative press. Leveraged COLI, for example, in which companies were permitted to borrow against their policies to make the premium payments and deduct the interest of the loans, is no longer permitted. Broad-based COLI, or what the press refers to janitor insurance, in which employees are insured, not just those in the plan, is a thing of the past. Today's generation of COLI is a highly sophisticated, competitively priced contract that allows the company to choose mutual fund investment managers to better match their liabilities.

On May 12, 2005 U.S. Representative Thomas M. Reynolds, R-NY announced the introduction of H.R. 2251, the "COLI Best Practice Act of 2005," in the U.S. House of Representatives. The bill is intended to reform the use of business-owned life insurance.

The legislation will preserve COLI as a valuable tool for employers seeking to fund employee benefits. Most firms consulting on COLI have been following these best practices.

CONCLUSION

"Things are seldom what they seem", as Gilbert A. Sullivan once put it. Analyzing these products requires reorientation of some of our conventional thinking regarding the determination of retirement income costs, and role of life insurance We need to think of life insurance more from its' asset value than we do from purely a tax free death benefit. And we need to analyze a life insurance policy for its investment potential, rather than its traditional role as a hedge against the adverse consequences of premature death. By taking this approach the financial executive should be able to deal with these proposals in straightforward, cost/benefit analysis terms. There shouldn't be black boxes.

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The preceding overview of the most common funding devices – mutual funds and Corporate Owned Life Insurance (COLI) – is provided at the request of the company. RCG emphasizes that there are significant differences between mutual funds and COLI. Moreover, no two mutual funds are the same, and no two COLI products are the same. Both mutual funds and variable COLI are offered by prospectus only. Please refer to the prospectus, as well as specific policy forms, for a complete discussion of all applicable fees, charges, expenses and risks.

The hypothetical illustrations show how the performance of underlying accounts could potentially affect a policy's cash values and death benefits. It may not be used to predict or project investment results.