

# Securing Executive Benefits from Takeover or Bankruptcy

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Even in a tight economy, both large and small organizations face the challenge of how to attract, retain, and reward key employees. More than any other asset, employees, especially executive staff, can make a big difference in a company's profitability and overall future.

For decades companies relied on the 401(k) and other traditional defined contribution and defined benefit plans to secure and satisfy top talent. But now, because of government restrictions on qualified plan offerings, along with accounting, funding, and creditor security issues, these plans are not enough. Nonqualified deferred compensation plans are stepping up to fill the void (Chart 1). In fact, 90% of Fortune 1000 companies have put these plans in effect. \*

Qualified Plans	Nonqualified Plans
<input type="checkbox"/> Must include all eligible participants in plan design	<input type="checkbox"/> Can be selective
<input type="checkbox"/> Must meet ERISA reporting requirements	<input type="checkbox"/> No onerous reporting requirements
<input type="checkbox"/> Employer gets immediate tax deduction for contributions	<input type="checkbox"/> No tax deduction until benefits are paid
<input type="checkbox"/> Contributions protected from creditors of the employee	<input type="checkbox"/> Assets subject to claims of corporate creditors

\*Clark Consulting; *Executive Benefits - A Survey of Current Trends 2005 Results*  
(Chart 1)

Nonqualified deferred compensation plans are contracts in which an employer defers a certain amount of compensation received by the employee. The plan is called "nonqualified" since it does not qualify for income tax deductions. Monies accumulate within the plan over time without being considered income subject to taxation until the benefit is paid.

Nonqualified deferred compensation plans offer flexibility for the company to determine the level of employee covered and to tailor the options to the needs of a select group. They are informally funded, meaning that the employer makes a

contractual promise to pay the executive employee at some date in the future. Many companies set aside assets, however they are still subject to creditor claims and qualified plans are not.

The downside of many nonqualified deferred compensation plans is that after several years of wealth accumulation, executive participants may face the possibility of losing their retirement savings. In the event of bankruptcy, hostile takeover, or sudden change of management control, executive participants may lose their benefits because they are “unsecured general creditors” of their employers.

Most companies with deferred compensation plans in place provide benefit security through a Rabbi Trust. Within a Rabbi Trust, a company contributes assets to an independent trustee with the aim of providing protection to executives if the company fails to make payments. But Rabbi Trust assets are subject to the claims of creditors, providing no benefit protection if the company becomes bankrupt. Most alternatives to the Rabbi Trust that try to protect the executive in the event of bankruptcy are seen as pushing the corporate governance envelope. One of the only true and safe alternatives today is to use the Secular Trust, but is there a better economical alternative?

### **Secular Trust**

A Secular Trust is an irrevocable trust that holds assets to be used for the exclusive purpose of paying an employee’s nonqualified plan benefits. Unlike the Rabbi Trust, the assets of a Secular Trust are not subject to the claims of the employer’s bankruptcy and insolvency creditors.

Contributions made to the Secular Trust are currently tax deductible to the company and taxable to the participant. Earnings on trust assets are also taxable to the participant unless invested in tax exempt assets (i.e., municipal bonds or life insurance).

### **Insured Security Option Plan - The Best of Both Worlds**

A new option has emerged. It provides the executive with a fully secured asset that they control. Unknown to many companies, it is called the Insured Security Option Plan, or ISOP<sup>®</sup>.

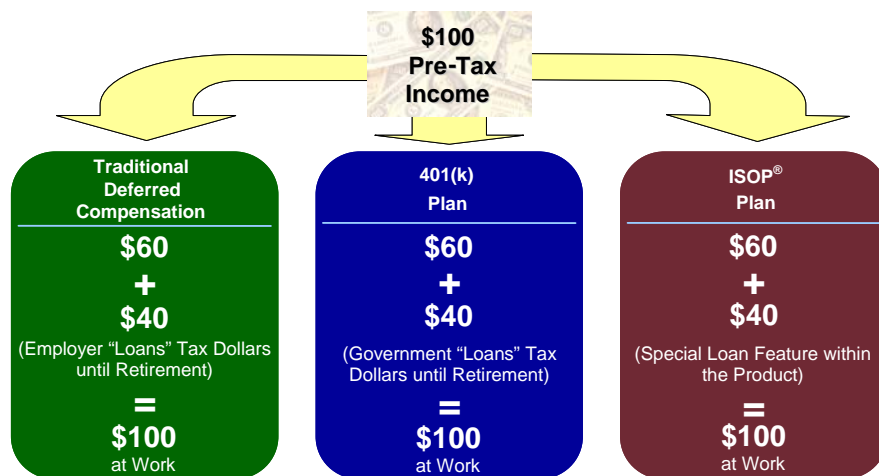
To understand how the ISOP<sup>®</sup> works, understanding the operation of traditional qualified deferred compensation plans (i.e., 401(k)) and nonqualified plans (i.e., NQDC) from a tax and cost prospective is important.

When an executive participates in a typical nonqualified deferred compensation plan, the employer holds the executive deferred dollars in the corporation. For balance sheet purposes the company establishes a deferred tax benefit, however, no current tax deduction is realized. Since these assets are held by the company, the executive is subject to the claims of creditors.

If an executive defers \$100,000, the company (assuming a 40% tax bracket) loses \$40,000 to corporate taxes plus its cost of money. With most plans, the company sets the entire \$100,000 aside in a Rabbi Trust with a current cost of \$40,000. The company will realize its deduction when benefits are paid. In this case, the company is lending the executive the tax deferred savings (Chart 2).

### *Comparison of Retirement Funding Plans*

With all employee retirement plans, someone is always lending the tax funding. The following chart compares two alternatives with the ISOP<sup>®</sup>. In the case of the traditional deferred compensation plans, the company is also losing the use of money on the loan.



**Traditional Deferred Compensation Plan** Employer has loss of current deduction plus

**401(k) Plan** Government is the best deal; however has a limit on amount you can defer.

**ISOP<sup>®</sup> Plan** Special Loan Feature within the Product

*Note: All plans based on 40% tax bracket*

(Chart 2)

Turning to the qualified plan, its major advantage is the current tax deduction to the company and the postponement of taxes to the individual, as well as bankruptcy protection to the participant. In this case, the government is lending the tax to the executive on his deferral (Chart 2). The only major problem with the qualified plan is that government limits on 401(k) deferrals (\$15,000 in 2006) and levels of compensation that can be used for such plans (\$220,000 in 2006) make them unsuitable for deployment to senior executives. Unlike the nonqualified plan, ERISA provides full protection against creditors.

If the benefits of current corporate deduction are combined, creditor-proofed with ERISA, while allowing the executive to accumulate retirement dollars, the best of all worlds is the result. The ISOP<sup>®</sup> accomplishes this feat. The ISOP<sup>®</sup> has added third party lender to the plan in place of the company in traditional deferred compensation or the government in qualified plans (Chart 2).

The ISOP<sup>®</sup> is funded with a special design life insurance product that capitalizes the interest cost and deducts it from death benefits. This feature really makes the ISOP<sup>®</sup> concept unique.

### **ISOP<sup>®</sup> Operating Mechanics**

An ISOP<sup>®</sup> secures the payment of supplemental retirement income or deferred compensation benefits and provides a death benefit to the executive's beneficiary. Typically, the executive is covered by an unfunded deferred compensation plan and/or by a group term/supplemental death benefit. The ISOP<sup>®</sup> program replaces one or both arrangements to deliver the benefits regardless of changes in the solvency or management of the employer.

Thus, the ISOP<sup>®</sup> program is similar to the Secular Trust under which an employee trades tax deferral for benefit security. However, unlike the Secular Trust, the ISOP<sup>®</sup> program does not result in current tax on the investment earnings, and the third-party lender substitutes the taxes with a loan giving the participant full accumulation on the pre-tax deferral amounts. The loan, since it is part of the "employee's plan", complies with the requirements of the Sarbanes-Oxley Act for publicly-traded companies. As mentioned earlier, the loan is simply part of the actual policy structure.

The plan design can be flexible to meet corporate and individual objectives. A basic design has the employer adopt an ISOP<sup>®</sup> program for eligible employees as defined by a plan document. The employer picks and chooses the eligible employees similar to a traditional nonqualified plan.

Next, the plan provides for contributions made by the employer and/or by the employee from current salary and/or bonus. Generally, the employer will be the "plan administrator" and "named fiduciary" (as defined in ERISA) for an ISOP<sup>®</sup> program.

Because the ISOP<sup>®</sup> trust's income is taxed to the participant, the trust invests in a variable life insurance contract that gives the participant a number of investment alternatives. The tax free or deferred accumulation, should distributions occur prior to death, helps to provide a similar after-tax benefit to traditional deferred compensation (Chart 3).

<b>Hypothetical Growth of Investment Amount \$100,000</b>				
<b>Pre-Tax</b>	<b>After Tax</b>	<b>Year</b>	<b>ISOP® Trust Net Trust Value</b>	<b>Net Tax-Free Death Benefits</b>
\$ 107,000	\$ 64,200	1	\$ 65,196	\$1,728,299
\$ 615,329	\$ 369,197	5	\$ 345,341	\$1,541,423
\$ 113,366	\$ 680,620	10	\$ 606,516	\$1,795,218
\$1,591,006	\$ 954,604	15	\$ 849,816	\$2,074,168
\$2,231,469	\$1,338,881	20	\$1,176,627	\$2,411,717

- Net of loan and taxes
  - Assumes 7% and 40% tax bracket
- (Chart 3)

It should be noted that the assumed hypothetical rate of 7% growth is dependent on investment performance which cannot be accurately predicted due to market volatility. Optional policy riders are available at an additional cost.

Variable annuities are long-term, tax-deferred investment vehicles designed for retirement purposes. Guarantees are based on claims paying ability of the issuer. Withdrawals made prior to age 59 ½ are subject to 10% IRS penalty tax and surrender charges may apply.

Nothing herein should be construed as representative of any investment.

At retirement, the participant has many alternatives. If the participant took his account balance over 15 years (similar to deferred compensation plans) he could withdraw equal annual installments of \$118,589 vs. the after-tax amount from traditional deferred compensation of \$137,385. Also, since the ISOP® accumulation was funded with life insurance, the participant would have an additional tax-free death benefit of \$790,931, assuming death at age 82.

The ISOP® is a solid retirement funding alternative, which eliminates risk of loss through bankruptcy or sudden management change. It truly combines the best of the nonqualified and traditional deferred compensation plans in a win-win for the company and the executive.

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