

Free Up Cash in Your Nonqualified Plan Funding

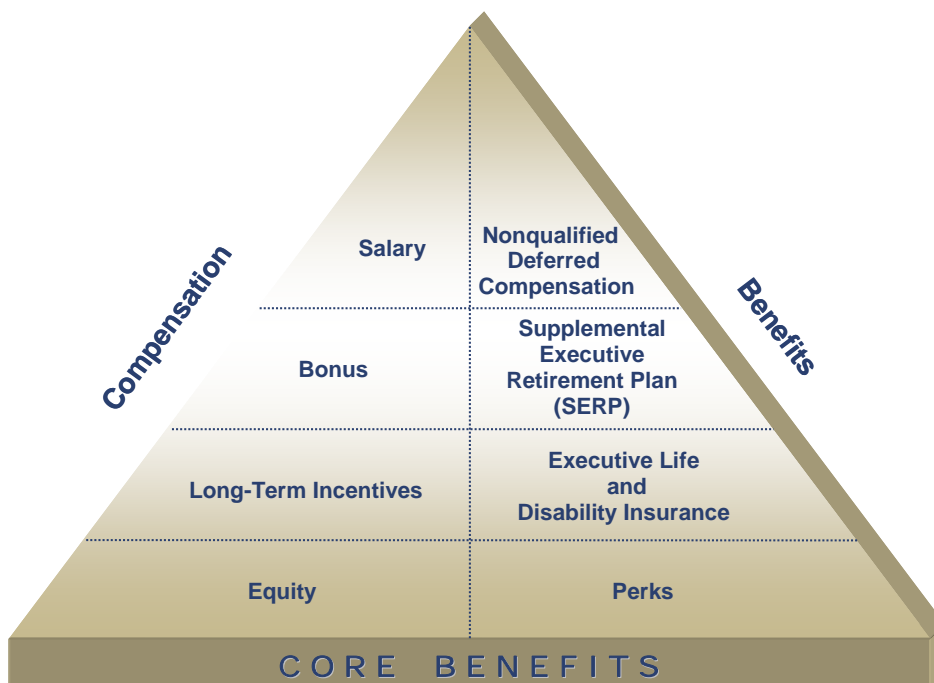
Funding Nonqualified Deferred Compensation
Cash Flow and P & L Neutral

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Many organizations provide their key employees with the opportunity to defer compensation in voluntary nonqualified deferred compensation plans. In fact, when the opportunity is presented, over 80% of eligible participants take advantage of it.

Deferred Compensation Great Deal for Executive

Executives are typically seeking diversification in their compensation-related wealth accumulation assets. They already hold a fair amount of company stock in their 401(k) plans and long-term incentive plans or through direct purchases. Deferred compensation for many employers has been a differentiation for attracting and retaining key people who can make a difference in the growth of their businesses. These types of plans are great tools in the recruiting package to help balance out the compensation and benefit plans (Chart 1).



(Chart 1)

Nonqualified plans usually have high deferral limits for executives (e.g., 90% salary and 100% bonus). Any monies deferred escape current taxation (both federal and state) until the executive has elected to receive them. With proper planning one could defer compensation in a high income tax state and retire in a state with lower or no income taxes, thus taking advantage of the tax arbitrage (source tax provision).

With a best practice design, a wide variety of flexibility on the timing of deferrals and assets the executive can invest in is very important. Participants are using these arrangements to provide for many lifestyle events, such as funding a child's college education or accumulating for their own retirements.

Cost of Deferred Compensation

With most deferred compensation plans, a cost to the company is incurred when the executive defers current income. When the participant in the deferred compensation plan defers his or her bonus, the company does not get a current tax deduction (it also is deferred). As an example, if the executive earned a \$100,000 bonus in a current tax year, it would actually cost a company in a 40% bracket only \$60,000. By offering the executive the opportunity to defer \$100,000, the company does not realize the current tax deduction, in the current tax year, so it is out that money plus time value cost of it.

Since the company will credit the executive's deferred compensation account with the full \$100,000 deferral, the company will incur additional cost when it credits this deferred compensation account with a pre-tax return.

To illustrate the full cost associated with deferred compensation plans, let's refer to Chart 2, a hypothetical illustration. Assume an executive earns \$100,000 a year. The company credits a pre-tax return of 7% to the executive's deferral of \$100,000. Thus, at the end of the year, the company has a deferred compensation liability to the executive of \$107,000. Assuming a 40% tax rate, the tax savings to the company from deducting the payment of \$107,000 of deferred compensation is \$42,800 ($\$107,000 \times 40$ percent). Therefore, the company needs \$64,200 ($\$107,000$ minus \$42,800) in after-tax funds in order to fulfill its obligation.

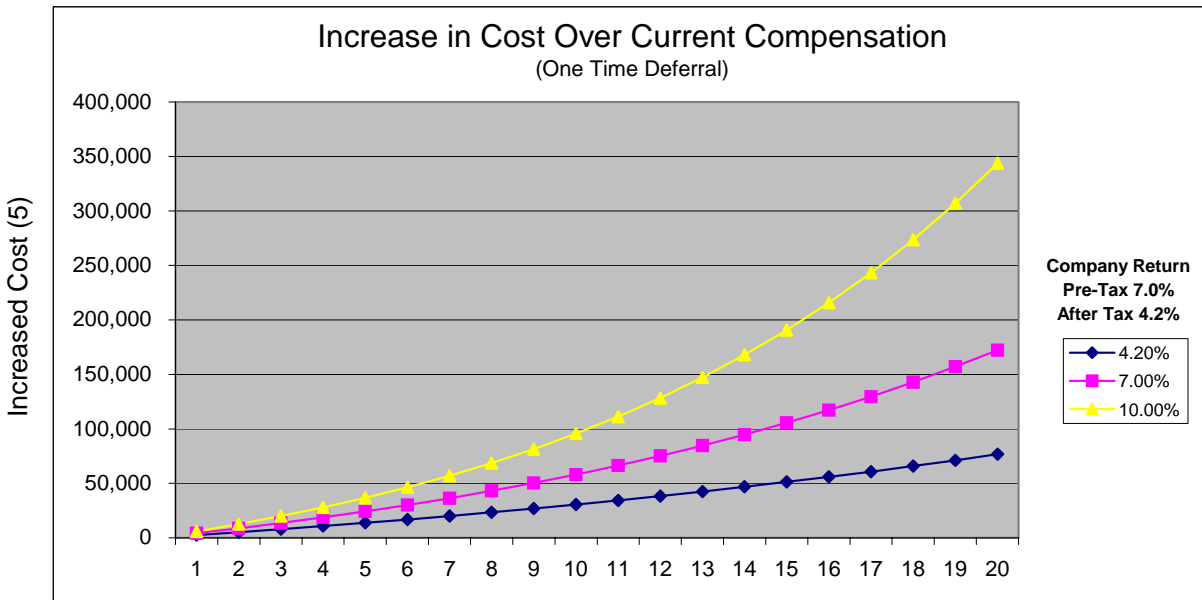
\$100,000 One-Time Deferral

	<u>AFTER ONE YEAR</u>		<u>AFTER 10 YEARS</u>		<u>AFTER 20 YEARS</u>	
Investable Assets	Company Earns 4.2%	Company Credits 7%	Company Credits 7%	Company Credits 7%	Company Credits 7%	Company Credits 7%
1.) Amount deferred	\$100,000	\$100,000	\$100,000	\$100,000	\$100,000	\$100,000
2.) Tax bracket 40%	(40,000)	(40,000)	(40,000)	(40,000)	(40,000)	(40,000)
3.) Net investment (1 plus 2)	60,000	60,000	60,000	60,000	60,000	60,000
4.) After-tax return (at 4.2%)	2,520	2,520	30,537	30,537	76,617	76,617
5.) Accumulated value (3 plus 4)	62,520	62,520	90,537	90,537	136,617	136,617
Deferral Liability						
6.) Amount deferred	(100,000)	(100,000)	(100,000)	(100,000)	(100,000)	(100,000)
7.) Interest credited to deferral	(4,200)	(7,000)	(96,715)	(96,715)	(286,968)	(286,968)
8.) Benefit payment (6 plus 7)	(104,200)	(107,000)	(196,715)	(196,715)	(386,968)	(386,968)
9.) Tax savings on benefit payment (40%)	41,680	42,800	78,686	78,686	154,787	154,787
10.) Net after-tax benefit payment (8 minus 9)	(62,520)	(64,200)	(118,029)	(118,029)	(232,181)	(232,181)
Cost of the Plan						
11.) After-tax impact to company	-0-	(1,680)	(27,492)	(27,492)	(95,564)	(95,564)
12.) Present value cost at 4.2%	-0-	(1,612)	(18,219)	(18,219)	(41,970)	(41,970)
13.) After-tax compensation (1 x 40%)	(60,000)	(60,000)	(60,000)	(60,000)	(60,000)	(60,000)
14.) Increased cost (11/5)	N/A	2.68%	30.37%	30.37%	69.96%	69.96%

(Chart 2)

When the executive defers \$100,000 of current pay, the company defers the tax savings of \$40,000 it would have realized from making a payment of current compensation, in the current year. As a result, it only had \$60,000 to invest without dipping into other financial resources. If 7% (\$4,200) is earned on the \$60,000 investment, the company will be taxed on its investment earnings and only realize \$2,520 after taxes. Thus, the company will have accumulated only \$62,520 to fulfill its after-tax deferred compensation obligation of \$64,200. The difference of \$1,680 represents the after-tax cost of the plan to the company. It's only 2.68% more than the after-tax cost of paying current compensation; however, the difference increases to 30.37% if the one time deferral of \$100,000 extends for 10 years and to 69.96% if it extends for 20 years (Chart 3).

The more money is deferred, the higher the rate of return and long periods of time will add to this cost.



(Chart 3)

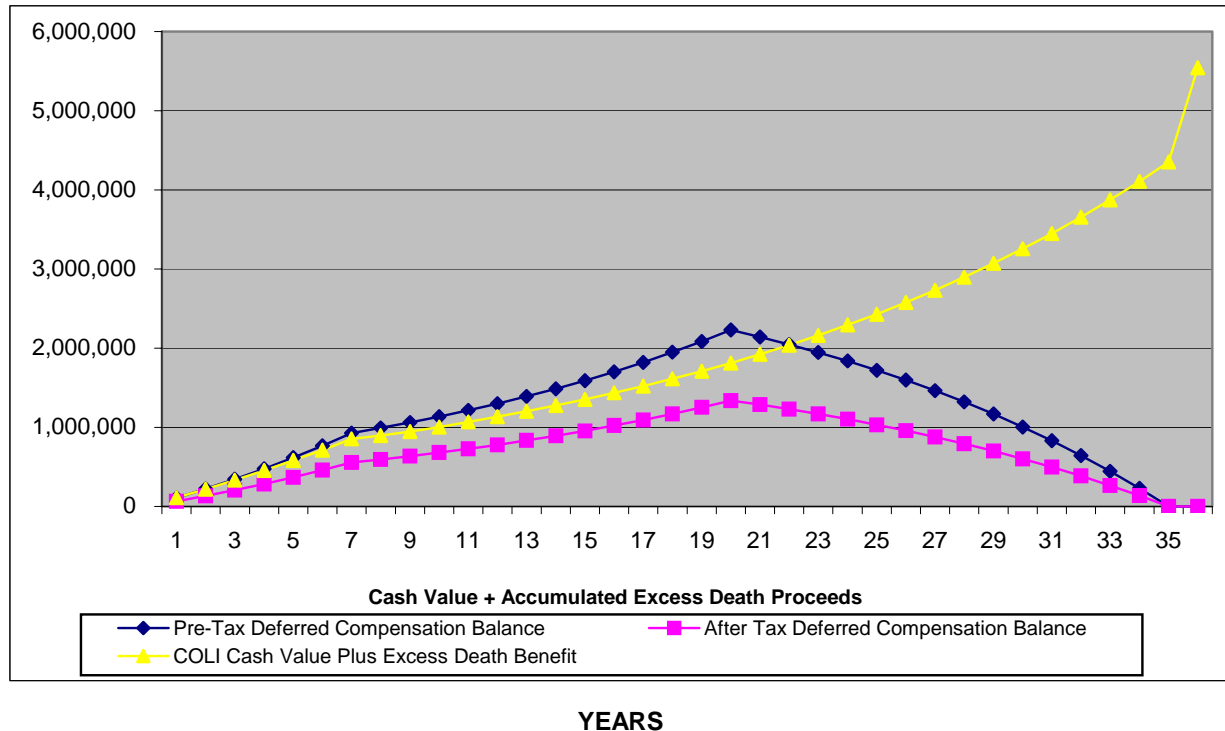
Corporate Owned Life Insurance (COLI) To Mitigate Cost

A high percentage of companies purchase COLI instead of mutual funds to informally fund deferred compensation liabilities to avoid the cost discussed above. When this strategy is used, an employer purchases life insurance on its executives and is the owner and beneficiary of the policies (through a trust owned by the company). The cash value accumulates on a tax deferred basis. When an insured dies, the company receives tax-free death proceeds, thereby converting a tax-deferred investment into a tax-free return. It is important to note however, that if the policy is surrendered prematurely the gain is taxable.

The majority of COLI policies used to informally fund these arrangements are variable life insurance policies in which the cash value accumulates based on the performance of underlying subaccounts. The company can allocate the cash value among these accounts to mirror executive elections under the deferral plan. Furthermore, the allocation can be changed and rebalanced without triggering realized gains like mutual funds.

When using COLI, a company typically takes an executive's pre-tax deferral (e.g., \$100,000), and applies it to the purchase of an insurance contract. Even though a company may recapture the entire cost of a plan, including its cost of money, it may have to wait 30 or 40 years to do so (Chart 4).

Cost Recovery COLI



(Chart 4)

A Better Alternative than Traditional COLI

RCG, in concert with a major reinsurer, has developed a COLI product that only requires the company to fund its pre-tax deferral commitments (i.e., the aforementioned executive's deferral of \$100,000) with the after-tax deferral amount (i.e., \$60,000), therefore the company is not tying up its capital for 30 or 40 years based on low assumed cost of capital returns.

The new product has an internal mechanism that loans the company the taxable portion (i.e., \$40,000), and capitalizes it against the ultimate life insurance death benefits which were designed to do that anyway. The insurance company will wait 30 to 40 years to get its money back. Chart 5 illustrates how the policy compares against a comparable policy paying full premiums.

Unlock Working Capital from Current Policies

If a nonqualified plan is currently funded with COLI, the ability to transfer the net amount of the obligation into the new insurance contracts exists. This option is dependent on an individual's unique situation as constituted by a variety of factors.

On a go forward basis, the company needs only to contribute the after-tax deferral amounts.

As illustrated in Chart 5, the company retains the \$40,000 as working capital, and uses only the after-tax participant's deferral amounts to fund the plan (i.e., \$60,000). If a

company is currently sitting on \$20 million of assets to fund its \$20 million liability, this could be a great way to unlock 40% of the \$20 million and be put back to work.

Conclusion

Voluntary nonqualified deferred compensation liabilities continue to increase as these plans continue in popularity. The new funding strategy discussed in this article will help the company fund these liabilities both cash flow and P&L Neutral.

Executive Age 45

\$100,000 Deferrals for 7 Years @ 7% Interest

Benefits to be paid @ Age 65 over 15 Years

Benefit Cash Flow

Using traditional COLI (Premiums Equal Deferrals)	Year	New Concept (Premiums Equal after Tax Deferrals)
\$(40,000)	1	-0-
(40,000)	2	-0-
(40,000)	3	-0-
(40,000)	4	-0-
(40,000)	5	-0-
(40,000)	6	-0-
(40,000)	7	-0-
-0-	8	-0-
-0-	9	-0-
-0-	10	-0-
Cumulative	Year	Cumulative
(280,000)	20	-0-
(1,373,850)	30	(1,373,850)
(2,060,775)	40	(2,060,775)
5,268,842	Life of Plan	2,810,952
301,407	NPV @ 5.00%	121,406
6.81%	Internal Rate of Return	6.82%

- Company in 40% tax bracket
- Executive death age 80

(Chart 5)

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