

# Nonqualified Deferred Compensation for LLCs, Partnerships, S-Corps, Not-for-Profit and Mid-Sized Organizations

Do they make sense? What is the best  
funding strategy? Are there better alternatives?

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# Nonqualified Deferred Compensation

- ❑ There are several key issues to consider when designing nonqualified benefit plans for mid-market companies.
  - ◆ Business structure – C-Corp, LLC, Sub S-Corp, Not-for-Profit, etc.
  - ◆ Tax considerations
  - ◆ Business continuity
  - ◆ Impact on “exit” strategy

# Nonqualified Deferred Compensation

## ❑ Tax Consideration

- ◆ Under deferred compensation arrangements these agreements are:
  - “Unfunded” obligations of the sponsoring company
  - Subject to corporate creditors
  - Not tax-deductible to sponsoring company
  - Growth (if any) attributable to plan is subject to current taxation

# Nonqualified Deferred Compensation

## □ Tax Consideration

- ◆ Five sources of U.S. business tax complexity
  - C-Corp
  - S-Corp
  - Partnership
  - LLC/LLP
  - Proprietorship
- ◆ Plus we have Not-for-profit organizations

# Nonqualified Deferred Compensation

## □ Taxation of the employer

- ◆ “Tax leverage” is the most important attribute of deferred compensation planning.
- ◆ For Fortune 1000 companies, substantial leverage is generated by the combination of *non-taxable insurance proceeds*, *non-taxable accumulation of cash values*, and *fully deductible benefit payments*.
- ◆ This leverage enables the employer to provide substantial benefit to key employees at little or no cost.

# Nonqualified Deferred Compensation

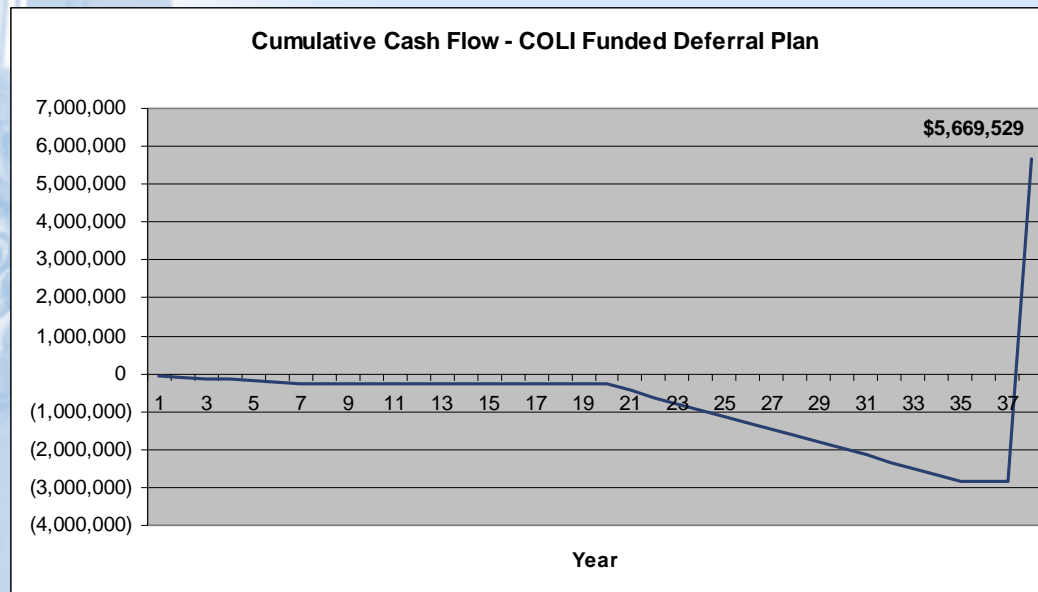
## □ How leverage works

- ◆ When cash value life insurance is utilized by the employer to “informally fund” deferred compensation arrangements, three income tax questions are raised.
  1. Q: Are the premiums paid by the employer tax deductible?  
A: No.
  2. Q: Are the benefit payments, when paid by the employer to the employee, deductible?  
A: Yes.
  3. Q: Are the insurance death proceeds paid to the employer income tax-free?  
A: Yes.

# Nonqualified Deferred Compensation

## □ How leverage works *(continued)*

- ◆ Executive, age 45, defers \$100,000 per year for 7 years and takes benefits at retirement, age 65, for 15 years.



Represents cash  
utilized in  
company



**Note:** Assumed 8% net earnings and Mortality at age 82.

# Nonqualified Deferred Compensation

## □ How leverage works *(continued)*

Cash Flow				P&L		
After-Tax Benefits	After-Tax COLI	Net Plan Cash Flow	Year	After-Tax Benefits	After-Tax COLI	Net Plan P&L
60,000	(100,000)	(40,000)	1	(4,800)	7,000	2,200
60,000	(100,000)	(40,000)	2	(9,984)	14,490	4,506
60,000	(100,000)	(40,000)	3	(15,583)	22,504	6,922
60,000	(100,000)	(40,000)	4	(21,629)	26,640	5,010
60,000	(100,000)	(40,000)	5	(28,160)	31,385	3,225
0	0	0	10	(53,953)	72,168	18,215
0	0	0	20	(116,480)	140,450	23,970
(170,104)	0	(170,104)	35	(0)	390,673	390,673
0	8,501,087	8,501,087	38	(0)	1,675,836	1,675,836
(2,131,557)	7,801,087	5,669,529	Total	(2,131,557)	7,801,087	5,669,529
(190,998)	392,635	201,637	NPV@6%	N/A	N/A	N/A

# Nonqualified Deferred Compensation

## □ How leverage works *(continued)*

### ◆ Observations with COLI Funding Strategy

- Company produced NPV gain \$201,637
- P&L impact was positive \$5,669,529 gain over life of plan
- Company utilized cash (\$2,831,557) for 38 years until death benefits were received (assume age 82)
  - To maximize COLI, benefits are paid from company cash flow and recovered at death.

# Nonqualified Deferred Compensation

- How leverage works *(continued)*
  - ◆ Observations with COLI Funding Strategy *(continued)*
    - Impact of mortality

Age at Death	Cash Utilized	NPV @6%
80	(2,831,557)	209,918
82	(2,831,557)	201,637
85	(2,831,557)	190,700
90	(2,831,557)	177,411

# Nonqualified Deferred Compensation

## □ How leverage works *(continued)*

- ◆ So why do Fortune 500 companies fund their benefits with COLI?
  - Cash flow not as important as EPS (earnings per share)
  - Insuring larger group, mortality more predictable
  - At high corporate tax rates, more cost effective than other strategies like mutual funds

COLI*		Mutual Fund**
201,637	NPV @6%	(204,020)

\*Assumes death at age 82

\*\*Mutual Fund Tax Rate of 28%

# Nonqualified Deferred Compensation

- ❑ How leverage works (*continued*)
  - ◆ To mitigate the utilization of cash, mid-size companies pull cash values out of policies to pay after-tax benefit payments
    - i.e., \$283,506 pre-tax, \$170,104 after-tax, employer withdraws \$170,104 from cash values\*

# Nonqualified Deferred Compensation

## □ How leverage works *(continued)*

- ◆ Pulling cash from policies to facilitate cash flow has impact on economics

Cash Withdrawn From Policies			Benefits Funded Through Company		
Age at Death	Cash Utilized	NPV @6%			NPV @6%
80	(279,997)	36,741			209,918
82	(279,997)	11,099			201,637
85	(279,997)	(22,580)			190,700
90	(279,997)	(68,245)			177,411

\*Cash withdrawal up to basis (premium paid) and then loan from policy.

# Nonqualified Deferred Compensation

- ❑ The use of nonqualified plans in partnerships, LLCs, Sub S-Corps and proprietorships raises special tax questions.
  - ◆ For federal tax purposes partnerships are not a taxable entity separate and distinct from the owners.
  - ◆ In LLCs and Sub S-Corps, the net income is taxed to shareholders individually according to their shareholdings whether or not such income is, in fact, distributed to them.
  - ◆ The tax leverage of deferred compensation plans is partially lost.

# Nonqualified Deferred Compensation

- ❑ General tax consequences of establishing an informally funded deferred compensation plan for Sub S-Corps and LLC's are as follows:
  1. Corporation is denied a business deduction for premiums paid to COLI and amounts deferred by individuals.
  2. Premiums and deferred amounts are part of the "undistributed taxable income" (UTI) of the corporation, and therefore, taxed pro-rata to the shareholders at their individual tax rates.
  3. As long as the death process of the COLI are held by the company, they would not be includible in UTI and would not be taxable to shareholders.

# Nonqualified Deferred Compensation

## ❑ Not-for-Profit Organizations

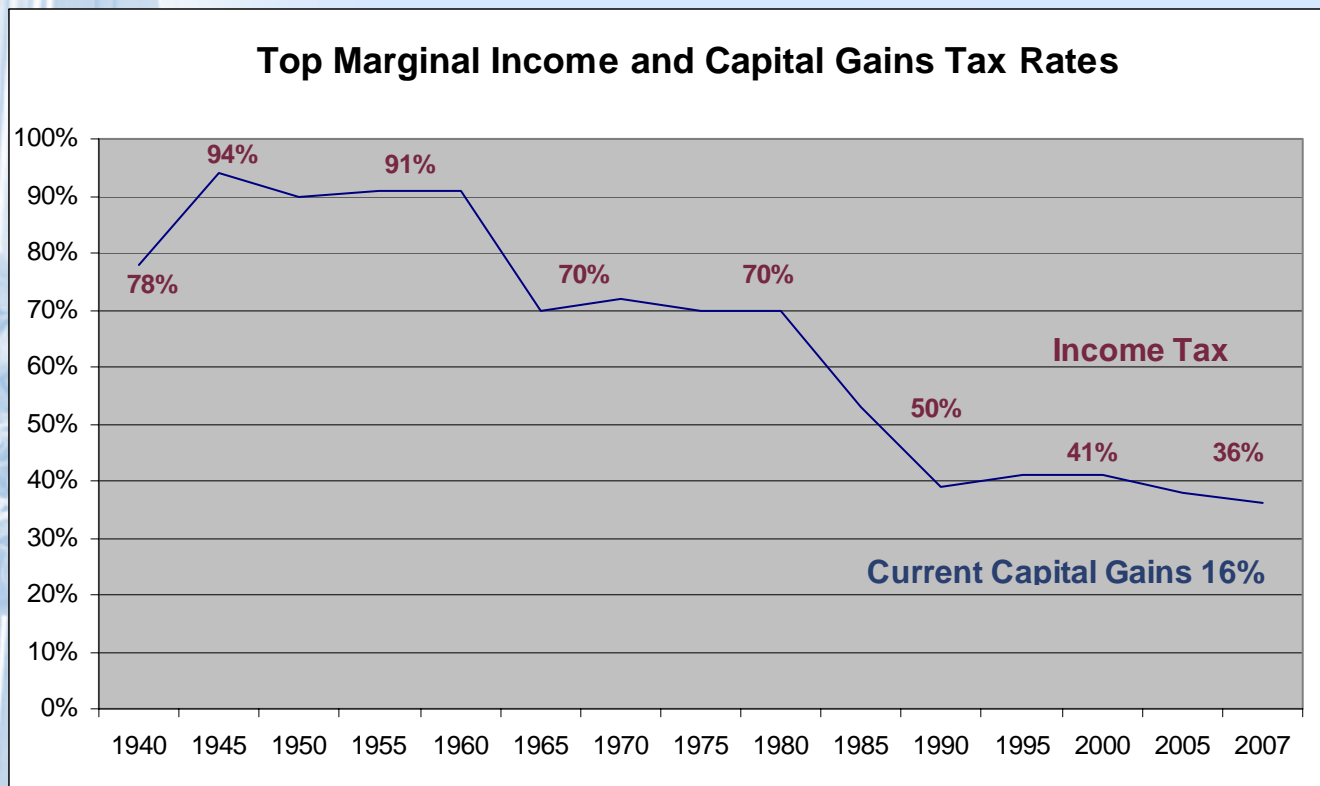
- ◆ Impacted by IRC 457(f)
- ◆ Passage of 409A sets new guidelines that limit flexibility for the participants to plan the same way for profit companies do.
- ◆ “Substantial risk of forfeiture” requirements leaves the participant with limited viable options.
  - Failure to meet 409A requirements face severe penalties (income tax plus 20% excise tax)
  - Liquidate the 457(f) plan account and pay taxes
  - Defer the taxes by remaining “unvested” and leaving total amount deferred at risk.

# Nonqualified Deferred Compensation

## ❑ The Changing Tax Environment

- ◆ One of the original promises of the NQ Plans was to defer taxation until retirement when “tax rates would be lower.”
- ◆ Consequently, executives have assumed an over-concentration of tax-bracket deferral risk (assuming that current tax rates will be lower than post-retirement tax rates.
- ◆ Combined marginal income and capital gains tax rates are at an all time low; if rates increase, it may be inefficient to currently defer into a higher tax bracket.

# Top Marginal Income and Capital Gains Tax Rates



# Nonqualified Deferred Compensation

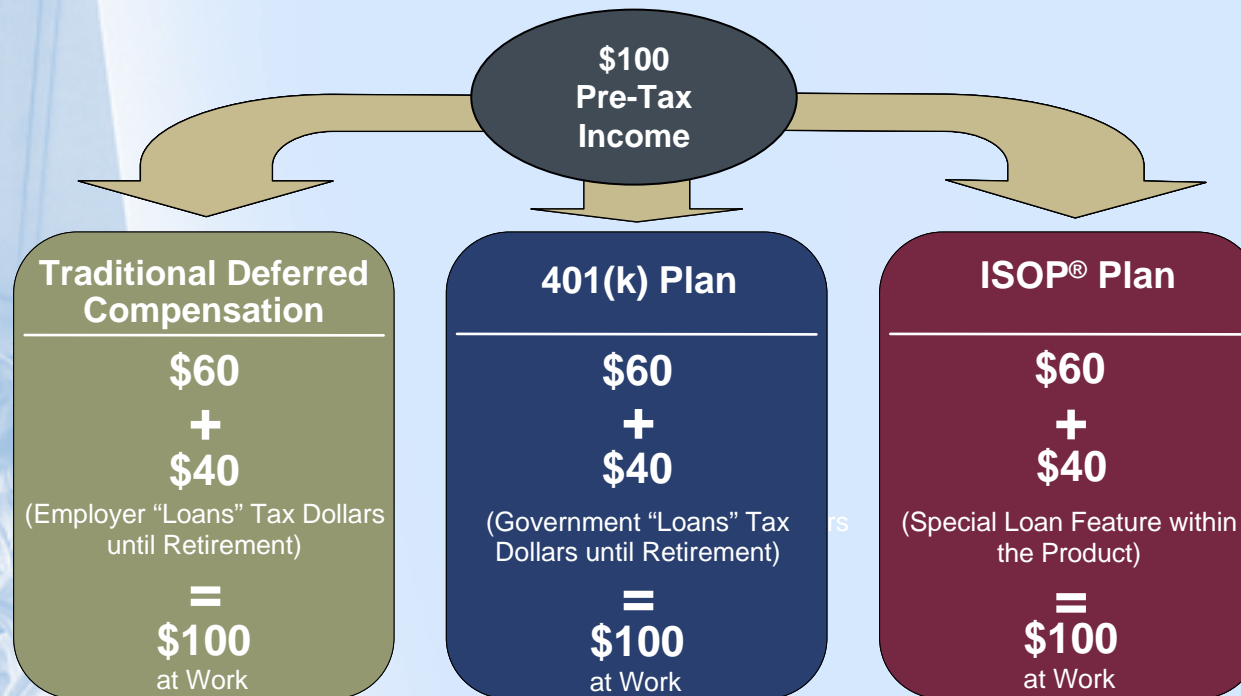
- ❑ Additional concerns with mid-size organizations
  - ◆ Who will be running the firm 10, 15, or 20 years after you retire? Your future benefit depends on it.
  - ◆ The unsecured general creditor status is a significant concern.
  - ◆ Continuity of firm is the only way to get leverage.
  - ◆ New deferred compensation plan legislation (IRC 409A) imposes restrictions to companies and participants.

# Nonqualified Deferred Compensation

- ❑ For mid-size organizations, traditional deferred compensation arrangement may not be attractive.
  1. Irrevocable commitment to servicing the plan until the last participant is paid out as it becomes difficult to terminate the plan.
  2. Company loses a tax deduction on all compensation deferred.
  3. Company has to accrue a liability on its balance sheet for promises to pay.
  4. Onerous accounting and ongoing administration.

# Nonqualified Deferred Compensation

## ❑ Comparison of Retirement Funding Plans



**Traditional Deferred Compensation Plan** - Employer has loss of current deduction plus opportunity cost of money.

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

**ISOP Plan** – Special loan feature within the Product.

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

# Nonqualified Deferred Compensation

## ❑ ISOP<sup>®</sup> as an alternative

- ◆ The Insured Security Option Plan (ISOP<sup>®</sup>) is an **after-tax** funding arrangement organizations are utilizing as an alternative to traditional deferred compensation arrangements.
  - Assets accumulating with the ISOP<sup>®</sup> plan:
    - Are bankruptcy remote – not subject to corporate creditors
    - Have no contribution limits
    - Have no age restrictions
    - Have no early withdrawal penalties
    - Are not subject to 409A or new funding restrictions – its portable

# Nonqualified Deferred Compensation

- ❑ The ISOP<sup>®</sup> (like a qualified Roth Plan), provides a hedge against increasing tax rates by:
  - ◆ Taxing the “principal” contributions now, under low current income tax rates;
  - ◆ Providing tax deferred investment earnings;
  - ◆ Enabling non-taxable benefit distributions;
  - ◆ And, unlike a Roth Plan, providing a mechanism to restore current tax payments, keeping those dollars working in the plan.

# Nonqualified Deferred Compensation

## ❑ ISOP<sup>®</sup> as an alternative *(continued)*

- ◆ What is an ISOP<sup>®</sup>?
  - New option for retirement savings
  - Vehicle that determines how you're taxed on contributions, accumulation, and withdrawals.

	ISOP <sup>®</sup>	Traditional Deferred Compensation
Contributions	<ul style="list-style-type: none"> <li>• Made after-tax</li> <li>• No current tax benefit</li> </ul>	<ul style="list-style-type: none"> <li>• Made pre-tax; no tax paid on contribution amount</li> </ul>
Accumulation	<ul style="list-style-type: none"> <li>• Tax-deferred earnings on full pre-tax deferral</li> </ul>	<ul style="list-style-type: none"> <li>• Tax-deferred earnings on pre-tax deferral</li> </ul>
Withdrawals	<ul style="list-style-type: none"> <li>• Received without income tax*</li> </ul>	<ul style="list-style-type: none"> <li>• Taxed as ordinary income</li> </ul>

\*Loans, interest accruing on loans, and withdrawals reduce available cash value and reduce the death benefit or may cause the policy to lapse. If withdrawals go over basis they may be subject to taxation.

# Nonqualified Deferred Compensation

- ❑ ISOP<sup>®</sup> as an alternative *(continued)*
  - ◆ Assumptions
    - Keep my take-home pay the same
    - \$100,000 annual contribution
    - Retire in 20 years
    - 7 years of contributions
    - Annual growth rate of 8% net

# Nonqualified Deferred Compensation

## ❑ ISOP<sup>®</sup> as an alternative *(continued)*

### ◆ Assumptions *(continued)*

- 40% current tax bracket
- 40% tax bracket at retirement
- Assets in ISOP<sup>®</sup> fully secured – assets in traditional plan subject to claims of the general creditors

	ISOP <sup>®</sup>	Traditional Deferred Compensation
Annual Contribution	\$100,000	\$100,000
Amount Deposited After-Tax	\$60,000	\$100,000
Balance at Retirement	\$1,441,547	\$2,620,800
Balance After-Tax	\$1,441,547	\$1,572,480
Non-Taxable Life Insurance at Retirement	\$2,932,863	\$0

# Nonqualified Deferred Compensation

- ❑ ISOP<sup>®</sup> provides non-taxable life insurance benefit too...
  - ◆ Since the ISOP<sup>®</sup> is funded by a specially designed variable universal life insurance policy offered through Lincoln Financial, the participant will be insured upon enrolling. Assuming the same assumptions for a 45-year old male, his personal life insurance benefits would be as follows:

Year	Life Insurance Benefit
1	\$1,728,116
5	\$1,535,776
10	\$1,962,018
15	\$2,389,785
20	\$2,932,863

# Nonqualified Deferred Compensation

- ❑ ISOP<sup>®</sup> provides non-taxable life insurance benefit too...*(continued)*
  - ◆ Assuming retirement age of 65, if the executive receives 15 years of annual non-taxable income of \$143,295 (total \$2,149,425), his beneficiary will still have a non-taxable life insurance benefit.

Age of Death	Life Insurance Benefit
80	\$1,387,632
85	\$1,400,072
90	\$1,419,520
95	\$1,404,995

# Nonqualified Deferred Compensation

## □ ISOP®

### ◆ Advantages to company

- Plan funding is not subject to restrictions under Section 457(e) or 409A – there is no liability on the balance sheet and all contributions are tax deductible.
- Unlike most employee benefit plans which must meet a host of cumbersome eligibility, participation, benefit, vesting and reporting requirements, the ISOP® is simple and straightforward.
- There are no ongoing accounting, record keeping, or administrative issues with which the sponsor must contend.

# Nonqualified Deferred Compensation

- ❑ 2007 (under the transition rules) is key to solving these concerns

## Planning Opportunities

Issue	Solution
1. Terminated Plan	1. After-tax balanced can be redirected to ISOP® and made whole with “tax restoration feature.”
2. Dealing with existing plans	2. Existing plans can be frozen and new deferrals can be transitioned to ISOP®.
3. Locked into old plan	3. Participants can elect to get out of the old DCP and into ISOP®, or maintain their account balance.



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