June 28, 2011

"What's Happened to Deferred Compensation Plans?"

THE VISIONLINK ADVISORY GROUP

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Today's Presenter:

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We’re happy to provide a copy of today’s slides. Information will be provided at the close of the presentation.

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What is a Deferred Comp Plan?

A Deferred Compensation Plan (DCP) is a retirement plan that is intended to provide long-term security for a select group of key employees above and beyond that provided under the company's qualified retirement plans.

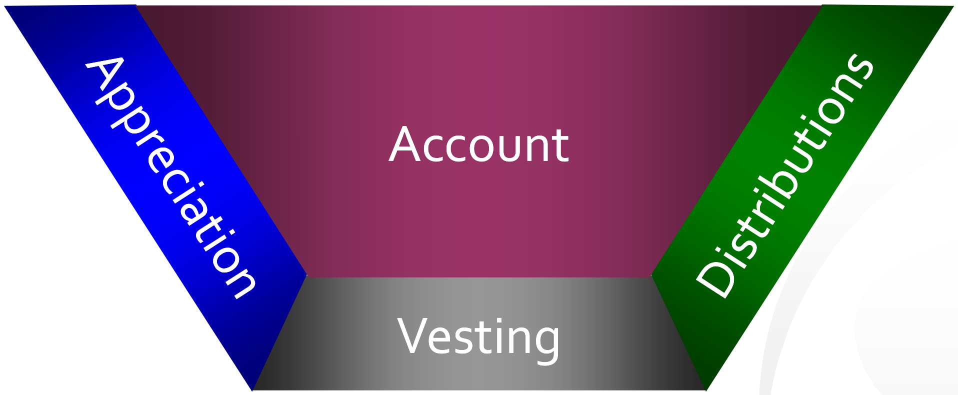
Features

- Nonqualified
- Selective
- Unsecured
- Unfunded
- Flexible

Total Compensation Allocation

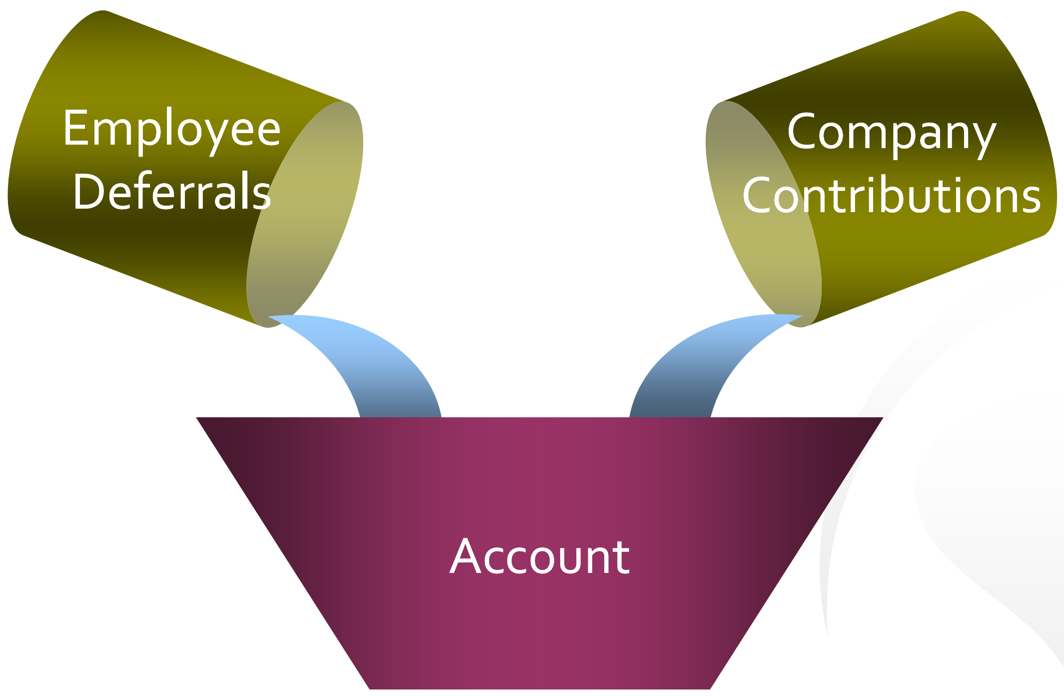
Total Compensation Allocation

The 4 Basic Components of a Deferred Compensation Plan (DCP)

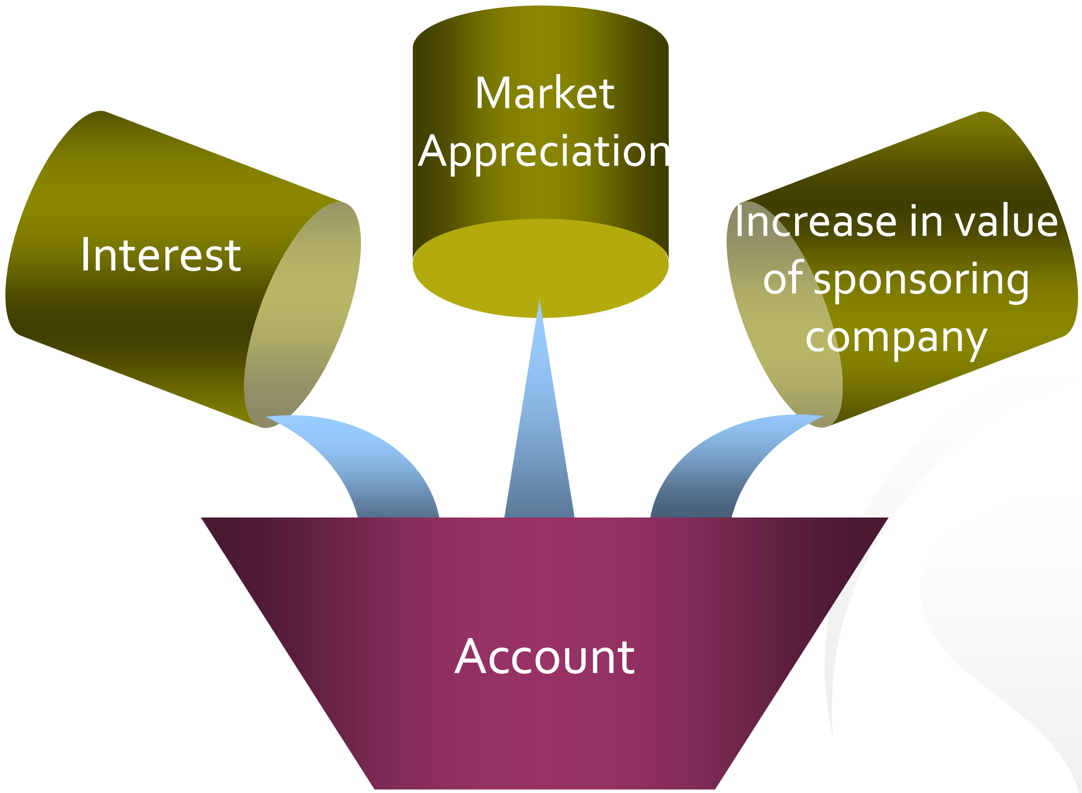


The Account

A liability on the books of the sponsoring company

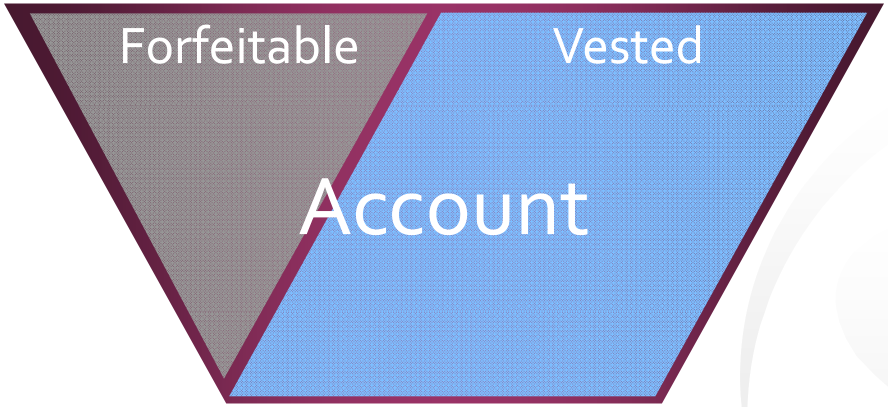


The Appreciation
The gains (or losses) credited to the Account



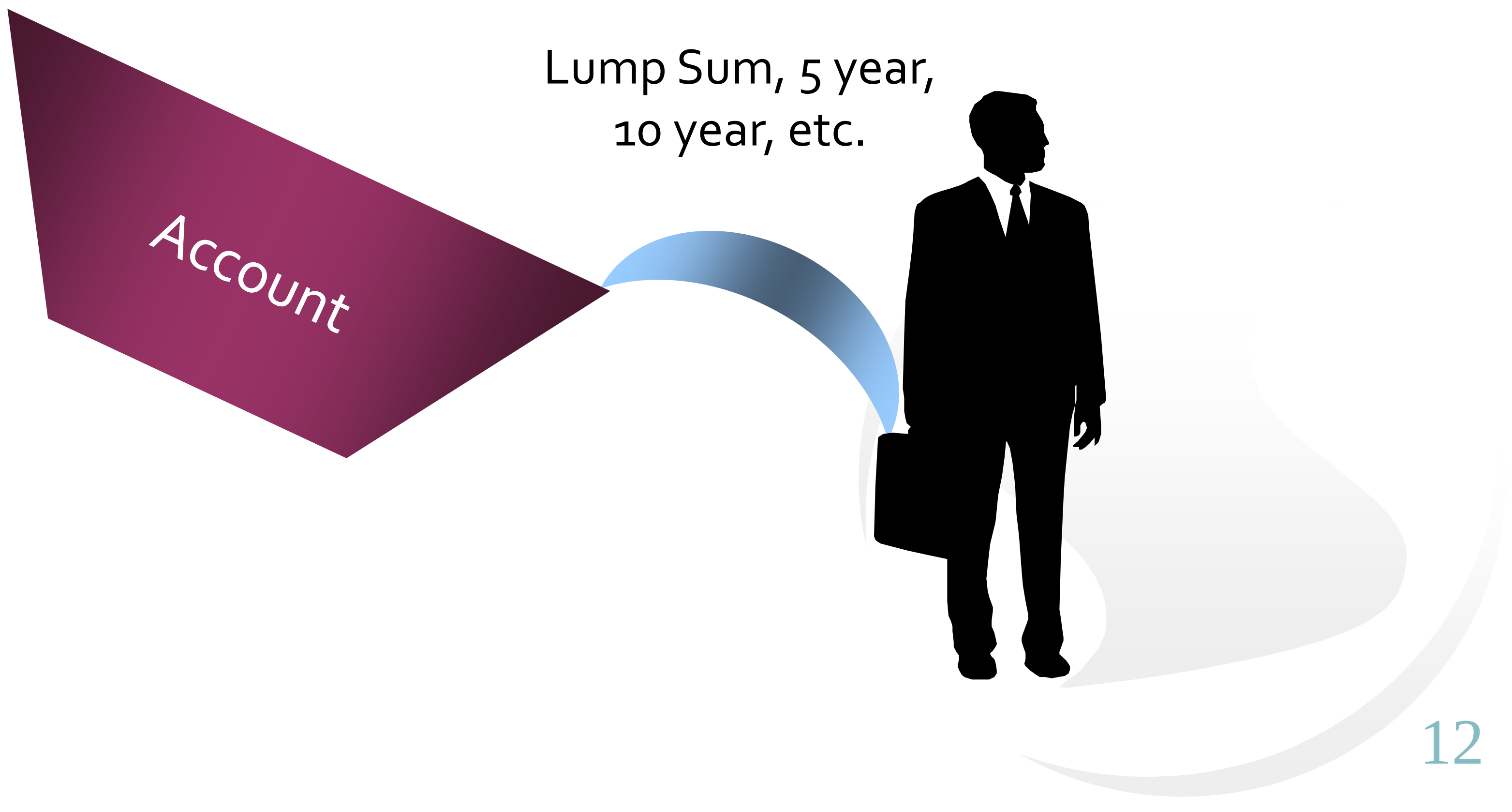
Vesting

The percentage of the Account payable upon termination (or other selected events)



Distributions

The manner in which the Account is distributed



Plan Type:
Executive Deferral Plan

- Executives given option to *voluntarily* remit *pre-tax* deferrals
- May include company contribution (matching, ad hoc, profit sharing, incentive)
- Investment options provided similar to company 401(k) plan
- Participants are fully vested in their own deferrals, partially vested in company's

Executive Deferral Plan

- Deferral election made at beginning of plan year (always calendar year after first year of eligibility)
- May defer different percentages from salary, bonus or any other cash compensation component

Executive Deferral Plan

- Investment choices may be offered
- May change investment choices at any time
- Investments are “hypothetical”
- Participants *must not* control investments (constructive receipt)

Key Advantages

- Selective participation
- Creative contribution options (virtually unlimited)
- Inventive distribution arrangements (with some limitations)
- Attractive appreciation possibilities

Corporate Purposes

1. Offer a helpful and attractive (pre-tax) way for higher-paid employees to save for retirement (attraction and retention)
2. Tie wealth of the employees to the achievement of key corporate goals

In recent years, the use of deferral plans has dropped noticeably. Why?

[redacted]

- New compliance rules (409A)
- Risk issues (economic uncertainty)
- Perception that the plans do not create "alignment"

But the original problems still exist:

- High tax rates (and possibly getting higher)
- Limits on 401(k) deferrals (with no other pre-tax options remaining)

Suppose…

- …could turn 409A into a positive?
- …could deal with the risk issue reasonably?
- …could use these plans to create greater internal alignment and focus?

Challenge #1: 409A

- New IRC Code Section added in 2005
- "The ERISA of Nonqualified Plans"
- Purpose was to establish rules relating to the timing of deferrals and distributions
- Also restricts the "acceleration" of benefits
- Imposed tax penalties (20% excise tax) for non-compliance

409A

- For the first several years…
  - …uncertainty about how the law would be interpreted
  - …confusion about the meaning of specific terms
  - …debate about how to interpret areas not mentioned or not clear
  - …efforts by the IRS to clarify and opportunities to repair problems

Now that the rules have settled

- Numerous gray areas clarified
- Uniform definitions of terms
- Three key questions resolved:
  - How do we avoid constructive receipt?
  - When can we accelerate benefits?
  - Under what conditions can we postpone distributions?

The result

Consultants and attorneys are now able to provide bright-line guidance. DCPs can be established and administered with greater confidence and clarity.

Challenge #2: Risk

- Reality—employees must consider employer insolvency risk
- However, if this is an over-riding risk, they will have to assume other risks in order to prepare for retirement

Deferral Plan Risk

Assume:

- Employee defers $25,000 for 10 years
- Earns 8% total return
- 40% tax bracket

Value in 10 years:

Pre-tax	**$391,137**
After tax	**$234,682**

Bankruptcy risk : $234,682 after taxes

Alternative Risk

Assume:

- Employee takes the $25,000 as income
- Invests $15,000 for 10 years
- Earns 8% total return (taxable)
- 40% tax bracket

Value in 10 years

After tax	**$195,888**

What's the risk?

Comparing Risks

AT Value in Deferral Plan	$234,682
AT Value outside Plan	$195,888
Difference	$38,794
Total Return needed to Equalize	13.3%

What additional investment risk must the employee assume to achieve the same result?

How does this risk compare with the employer insolvency risk?

Challenge #3: Alignment

- How does a deferral plan support corporate financial goals?
  - A typical plan doesn't drive productivity
  - It may support attraction and retention goals, but not alignment goals
- Is there a better way?

Strategic Implications

How might a deferred compensation plan be employed to drive company results?

Plan Objectives

- Help management employees build a long-term retirement account
- Finance the plan based on the achievement of specific production targets
- Message: “The more successful the company is, the bigger your retirement account will be.”

Option #1: Sample Target Matrix

Revenue Growth %					
>25	12%	15%	20%	22%	25%
>20	9%	12%	17%	20%	22%
>18	6%	10%	**15%**	17%	20%
>15	4%	7%	10%	13%	17%
10 to 15	0%	4%	6%	8%	10%
	<8	**8-9.5**	**9.5-10.5**	**10.5-12**	**>12**
	PT Income %				

Assume: Revenue Growth of 22% and PTI of 11%

Contribution Award

Assume: Revenue Growth of 22% and PTI of 11%		
Contribution = 20% of TCC		
Name	TCC	Contribution
John	325,000	65,000
Sam	235,000	47,000
Mary	210,000	42,000
Pete	200,000	40,000
Sue	185,000	37,000
	1,155,000	231,000

Company Contribution

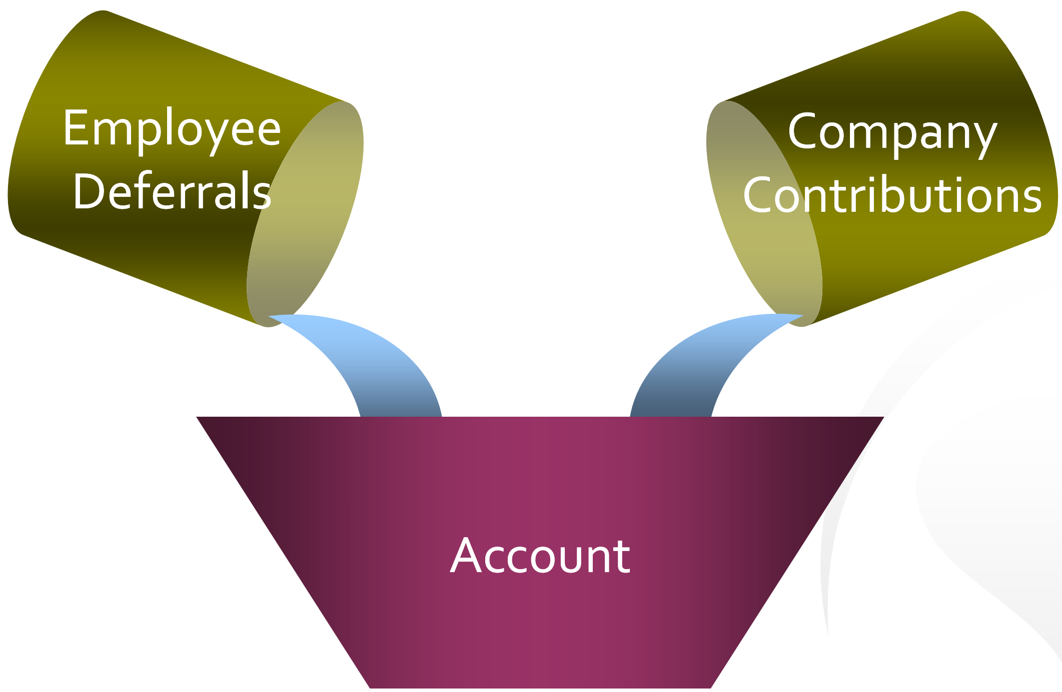
- Identify one or two key drivers of company performance (e.g., revenue and/or income goal)
- Establish factors that calculate contributions to employees' accounts as targets are met
- Factors and targets can be company based, or vary by department or employee

Option #2: Phantom Stock Investment Account

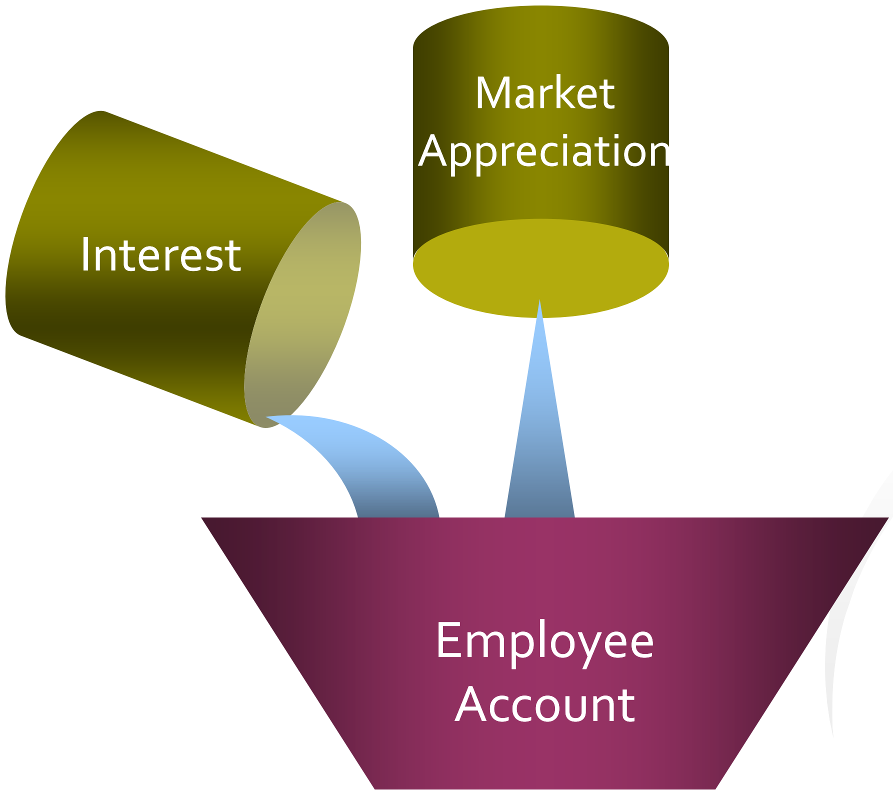
- Establish company "phantom share price"
- Credit earnings to the deferral plan tied to change in the share price
- Employee "account" may remain "self-directed"
- Company "account" would reflect changes in value of the sponsoring company

The Account

Two sources of funds



Employee Account



Company Account

Combine both incentives

- Tie company contribution to performance
- Tie appreciation to phantom stock price

Results/Objectives

- Clarify targets
- Meaningful awards
- Win-result for shareholders (self-financing plan)
- "Ownership" commitment (funds at risk)
- Retention enhancement (vesting schedule)

"Bottom line"

If you're not offering a deferred compensation plan you may be foregoing a competitive advantage needed to attract and retain key talent as well as an effective way to focus your people on your most important goals.

Attracting Premier Talent

- They will find non-traditional pay structures alluring and differentiating
- The pay structure will respect their entrepreneurial mindset and appeal to their interest in wealth accumulation opportunities
- They will accept the responsibilities and accountability associated with true value creation (i.e., they won't "expect" higher pay without creating results)

Last point—shareholder equity creation

- A DCP may be subject to a unique tax-leverage opportunity that results in long-term value for the sponsoring business
- The value results from the effect of the timing differences for the company tax deduction between the date of deferral and the date of payment

Assumptions:

- $10,000 of annual deferrals
- 8% average annual growth
- Level deferrals for 7 years
- Lump sum payment in year 8

[redacted]

Future Value of Employee's Account	$89,228
Deferrals	70,000
Gain	19,228

[redacted]

Let’s follow the tax deduction related to the gain.
At the time the money is paid:

$19,228	
X 40%	
$7,691	tax <u>benefit</u>

[redacted]

Let’s follow the tax impact of the matching investment

$19,228	
X 40%	
$7,691	tax <u>cost</u>

$7,691	—	$7,691	=	$0
Tax benefit		Tax Cost		

Right?

Wrong

[redacted]

What if the gain on the Company's investment was not subject to taxes?

$19,228	Investment gain
($0)	Taxes on gain
($19,228)	Payment to employee
$7,961	Tax benefit
$7,691	Net Impact (permanent benefit to shareholders)

DCP’s use carefully structured insurance arrangements that can help create this opportunity for long-term benefit.

Today's Take-Aways

- DCPs are back
- Consulting professionals can guide you through the 409A zone
- The tax benefits are real for both employees and employers
- Take your plan to the next level by including strong performance incentives

Questions?

Complementary Offer

DCP Feasibility Study

- Project likely deferrals
- Quantify impact on financial statements
- Identify possible shareholder gains

Next Online Seminar:

"Pay Strategy and Business Strategy:
A Co-Dependent Relationship"

To be held on:
Tuesday, July26th, 2011

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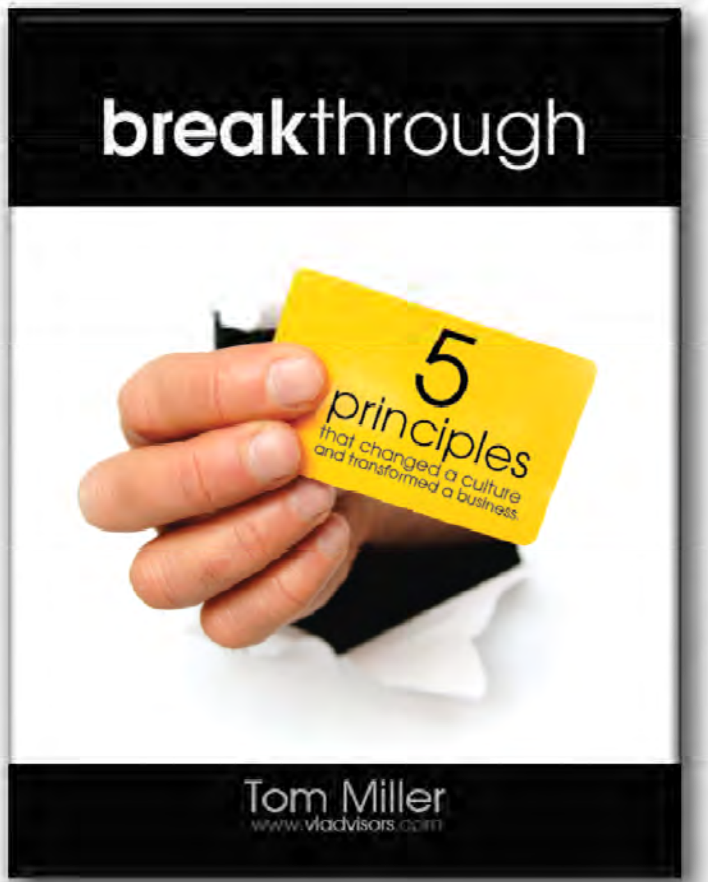

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You may request a copy of our slides, Breakthrough and more information about the DCP Feasibility Study.

Thank you!

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