

May 22, 2012

“Why Deferred Compensation is Making a Comeback”



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Today's Presenter:

Tom Miller

President

(949) 265-5700

tmiller@vladvisors.com



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

For questions during today's presentation:

Use the question panel
to the right of your screen

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

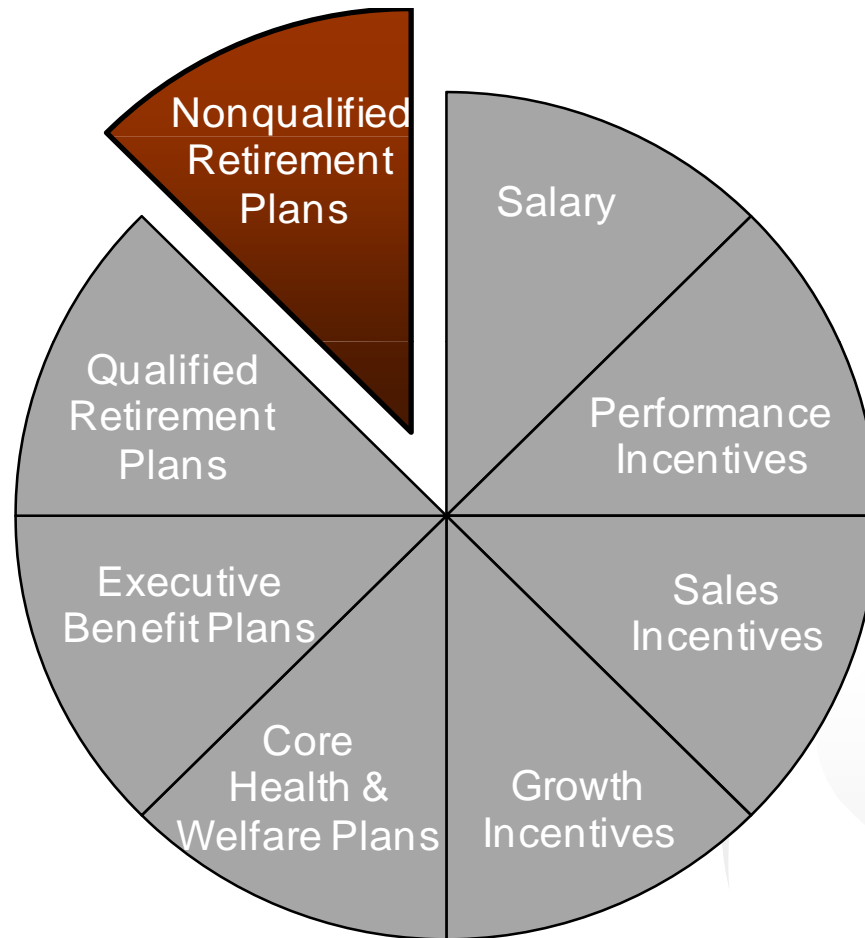
- Nonqualified
- Selective
- Unsecured
- Unfunded
- Flexible



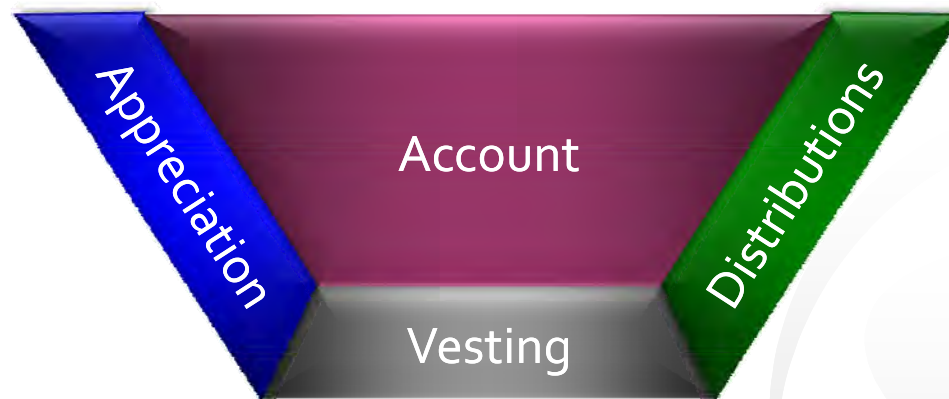
Total Compensation Allocation



Total Compensation Allocation

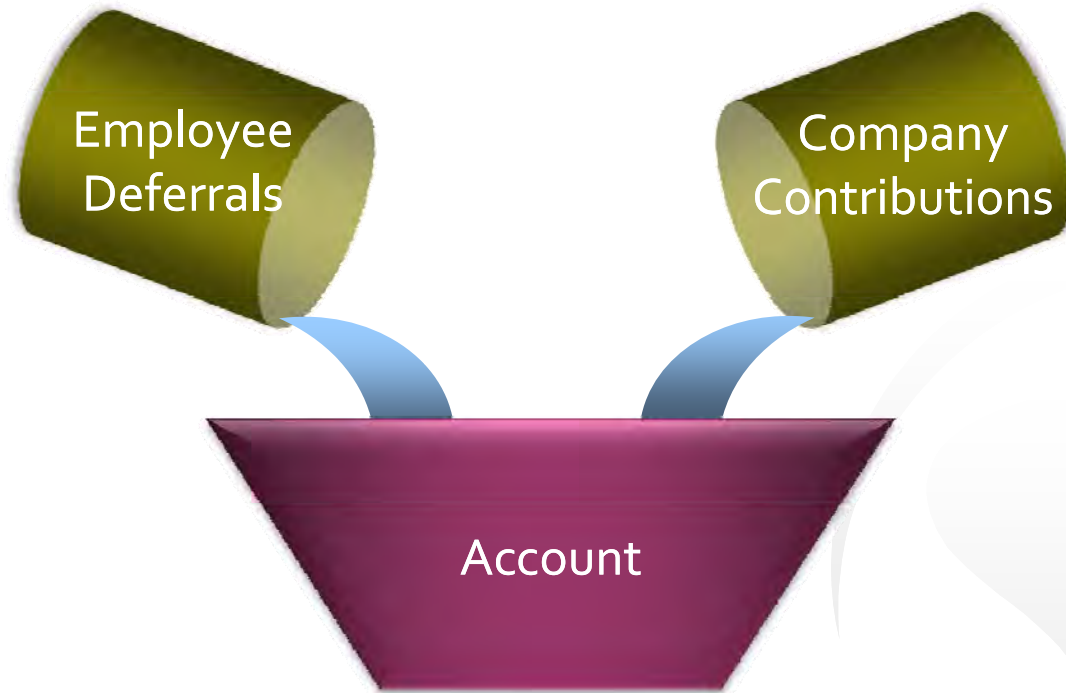


The 4 Basic Components of a Deferred Compensation Plan (DCP)



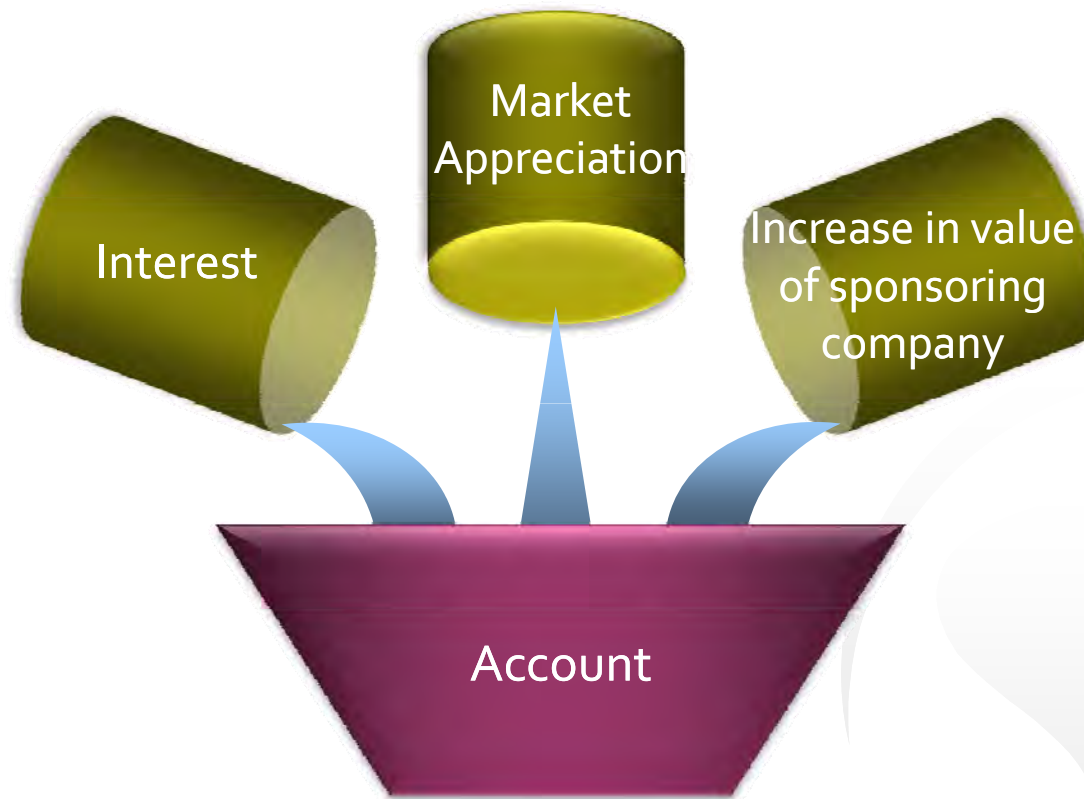
The Account

A liability on the books of the sponsoring company



The Appreciation

The gains (or losses) credited to the Account



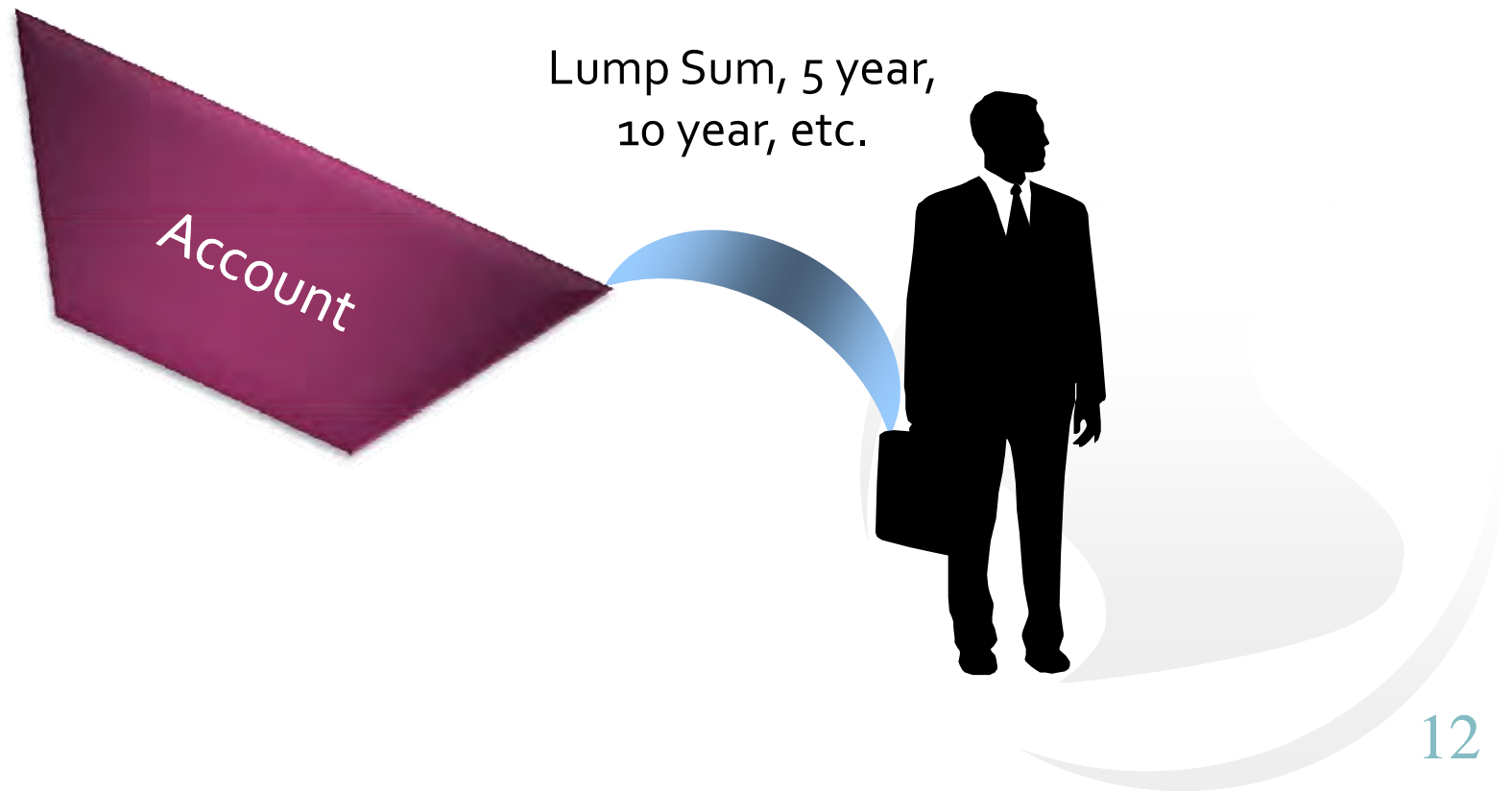
Vesting

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
- 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?



Why?

- 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
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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

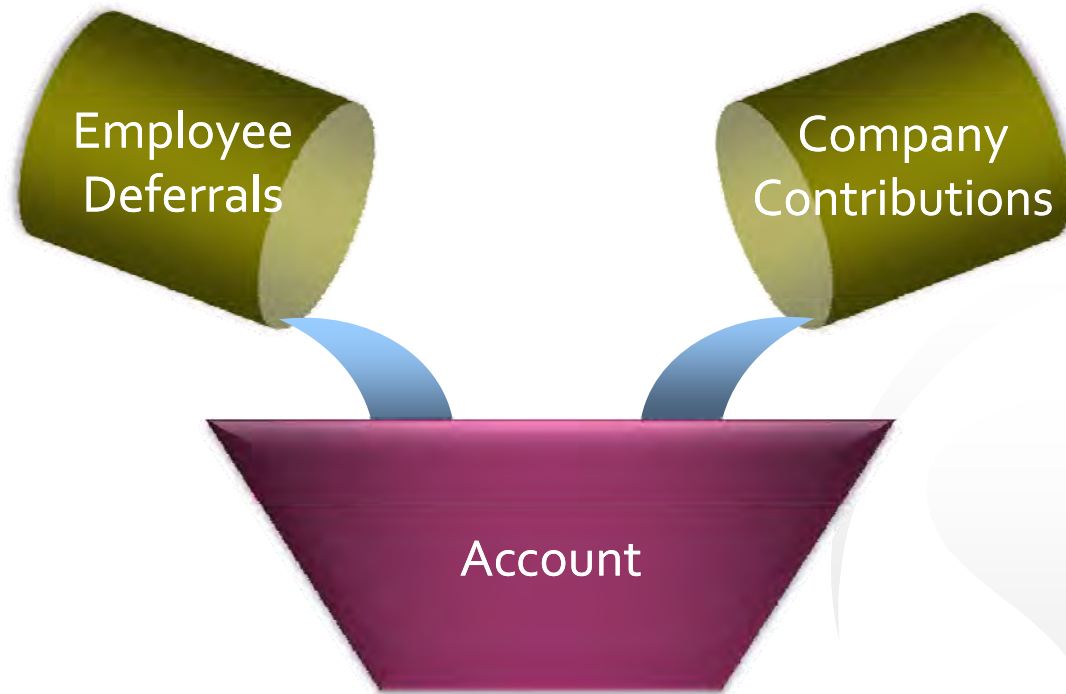
- Identify one or two key drivers of company performance (e.g., revenue and/or income goal)
- Establish factors that calculate contributions to employees' accounts as targets are met
- Factors and targets can be company based, or vary by department or employee

Option #2: Phantom Stock Investment Account

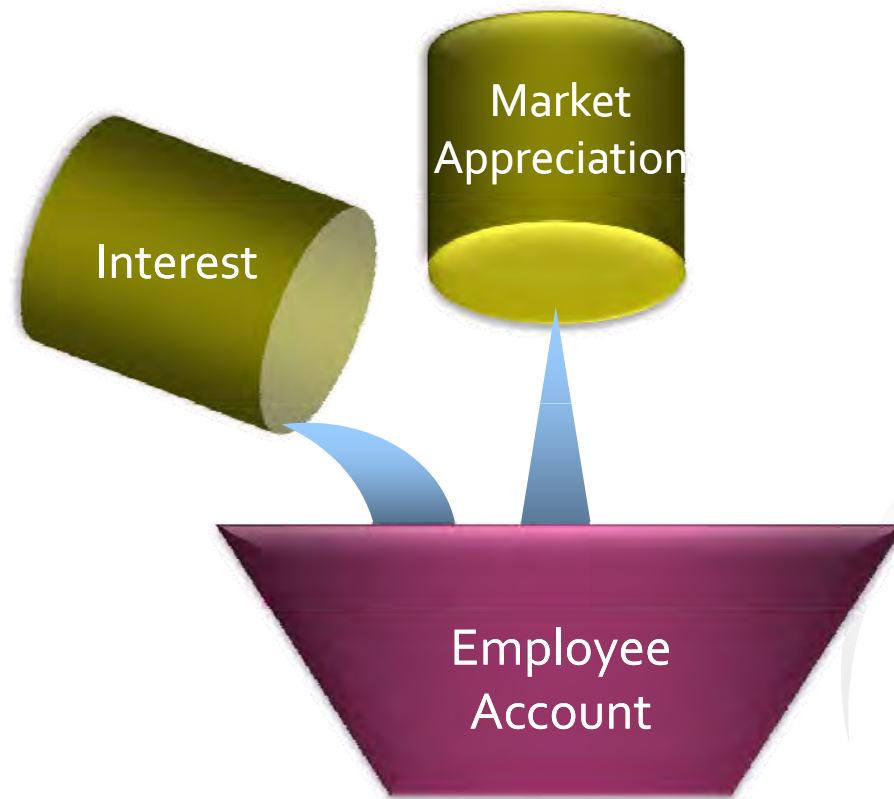
- Establish company “phantom share price”
- Credit earnings to the deferral plan tied to change in the share price
- Employee “account” may remain “self-directed”
- Company “account” would reflect changes in value of the sponsoring company

The Account

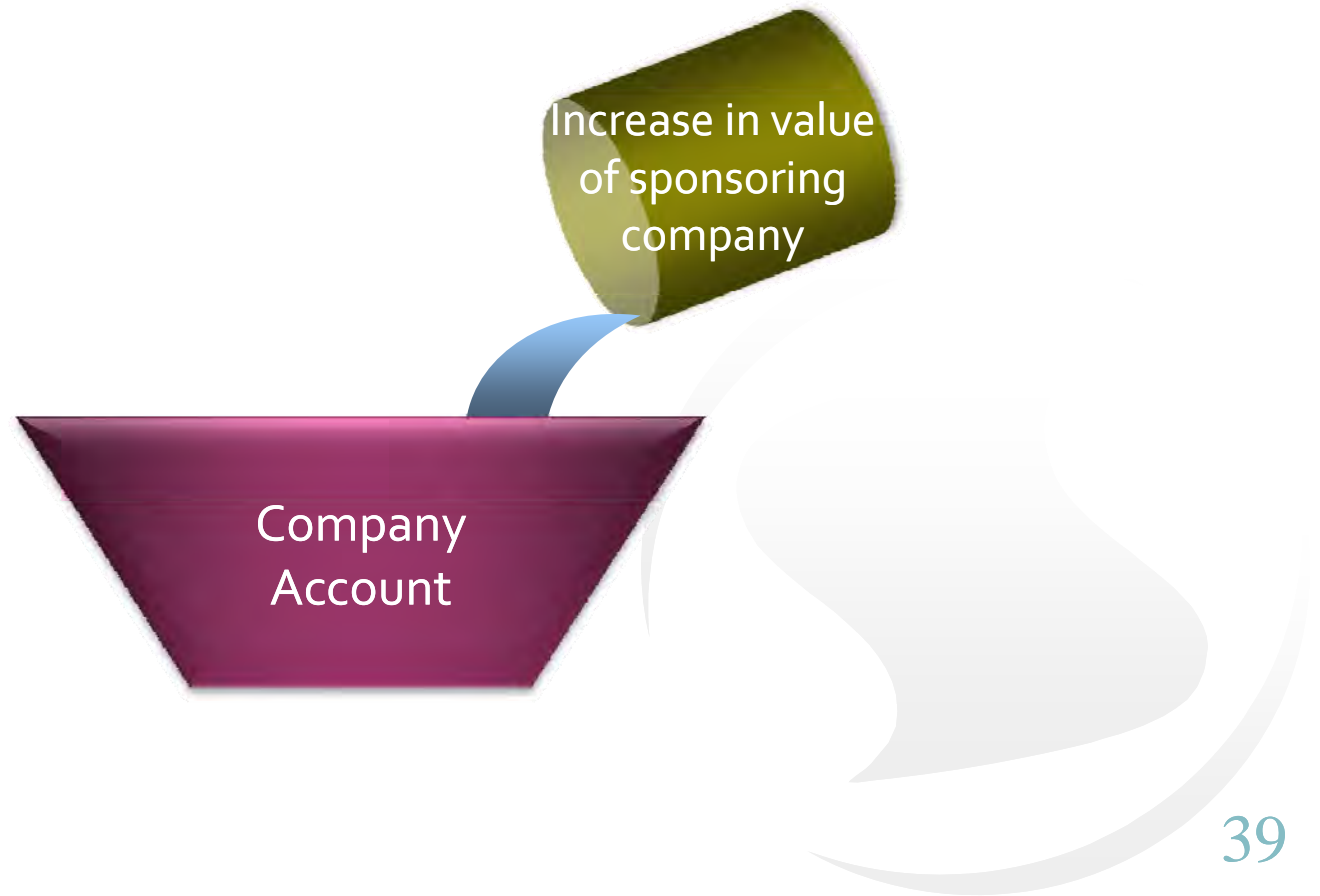
Two sources of funds



Employee Account



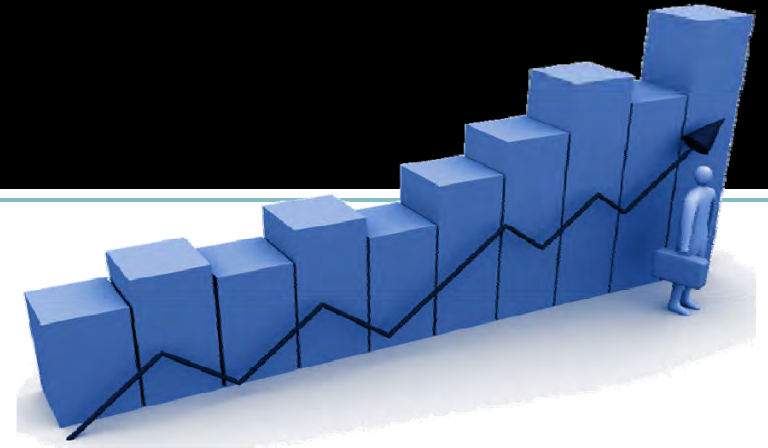
Company Account



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



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

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

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

Let's follow the tax impact of the matching investment

				\$19,228	
				X 40%	
				<hr/>	
				\$7,691	tax <u>cost</u>
\$7,691					
Tax benefit	—	\$7,691		=	\$0
		Tax Cost			

Right

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?



Complimentary Offer

DCP Feasibility Study

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



Next Online Seminar:

“Creating an Ownership Mentality without Giving Away Equity”

To be held on:
Tuesday, June 26th, 2012

Check out our NEW website:
www.PhantomStockOnline.com

The screenshot shows the Phantom Stock website homepage. At the top left is the logo "Phantom Stock The Equity Alternative" with a green arrow pointing up and to the right. To the right of the logo is a dark green navigation bar with white text: "KNOWLEDGE CENTER", "TOOLS", "BUILD A PLAN", "BLOG", "ABOUT US", and "CONTACT". In the top right corner, it says "POWERED BY VISIONLINK".

The main content area features a large light gray banner. On the left, there are three stacked green arrow-shaped buttons pointing right, labeled "WHAT IS IT?", "WHAT WILL IT CHANGE?", and "WHERE DO I BEGIN?". To the right of these buttons, the text "A way to share ~~equity~~ Value" is displayed, where "equity" is crossed out and "Value" is written in red cursive. In the top right corner of the banner, there is a red play button icon and the text "Phantom Stock Watch overview".

Below the banner is a row of four white boxes, each with a title, an icon, and a short description:

- KNOWLEDGE CENTER**: Icon of a blue circle with a white 'i'. Description: "Explore our wiki and find the answers to your Phantom Stock questions."
- TOOLS**: Icon of a brown briefcase. Description: "Decide whether Phantom Stock is a fit for your company."
- BUILD A PLAN**: Icon of crossed wrench and screwdriver. Description: "For 'do-it-yourselfers.' Follow this guide to create your own plan."
- BLOG**: Icon of an orange RSS symbol. Description: "Read the latest discussions about Phantom Stock and other value sharing strategies."

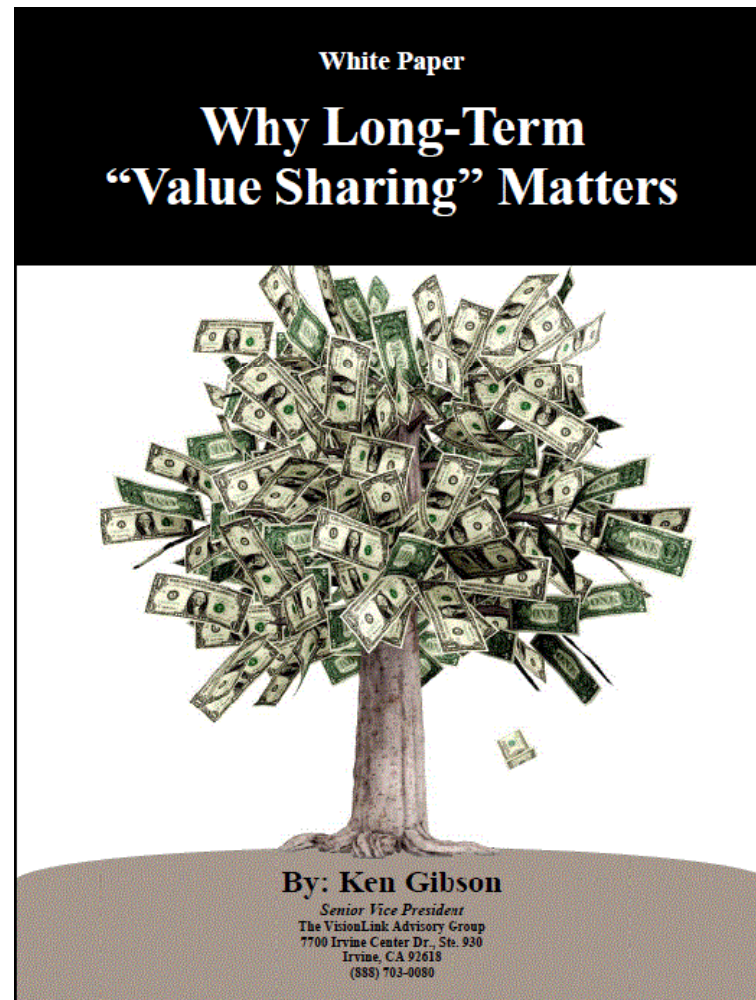
At the bottom of the page is a dark green footer bar with white text: "Knowledge Center Tools Build a Plan Blog About Us Contact" on the left and "© 2010 PhantomStockOnline.com" on the right.

www.VLadvisors.com

The screenshot shows the homepage of The VisionLink Advisory Group. At the top left is the logo, which includes a globe icon and the text "THE VISIONLINK ADVISORY GROUP". To the right of the logo is a "CLIENT login" section with fields for "User:" and "Password:" and a "Login" button. Below the login section is a phone number "(888) 703 - 0080" and social media icons for RSS, Facebook, Twitter, and LinkedIn. A dark blue navigation bar contains the following links: Home, About Us, Client Profile, Information and Resources, Client Locations, Events, Blog, and Contact Us. The main content area features a large image of a man in a suit. On the left side of this image are three dark blue buttons: "Incentive Plans", "Think Like Owners", and "Top People Management". In the center of the image is a lightbulb icon and the text "How Do I Get My Employees to Think Like Owners?". Below the main image is a section titled "Strategic Compensation Development and Management Firm" with a text input field for a webinar invitation list and a "Join" button. At the bottom of this section, it says "VisionLink enables mid-market companies to achieve".

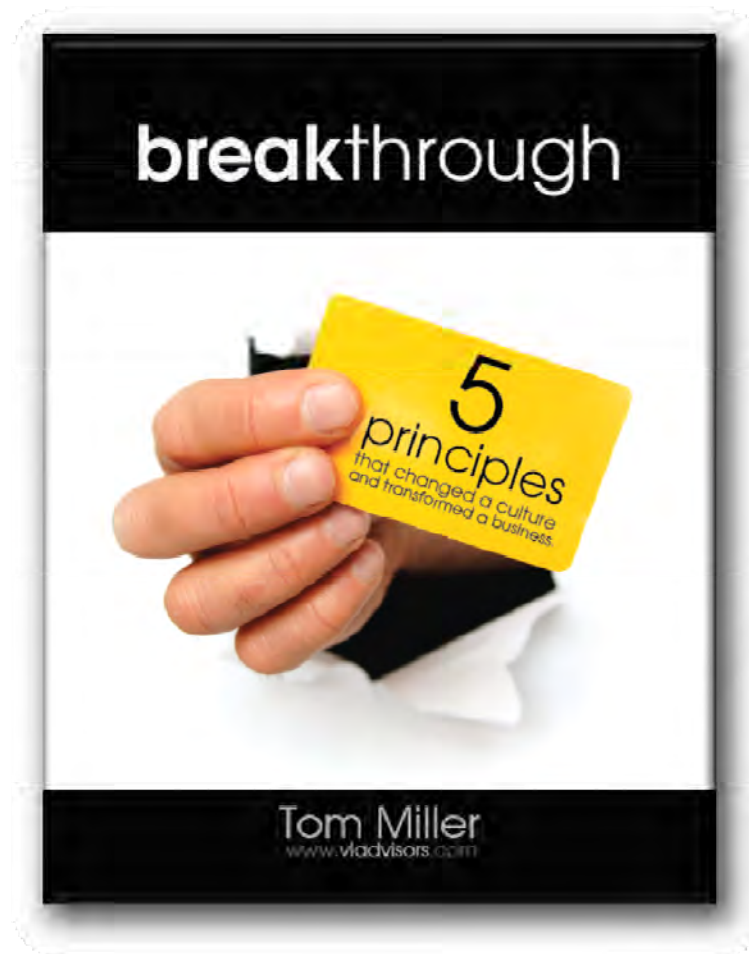
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Thank you for attending

Please complete our brief survey immediately following our presentation.

We value your input.

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

Thank you!

Tom Miller

President

(949) 265-5700

tmiller@vladvisors.com



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