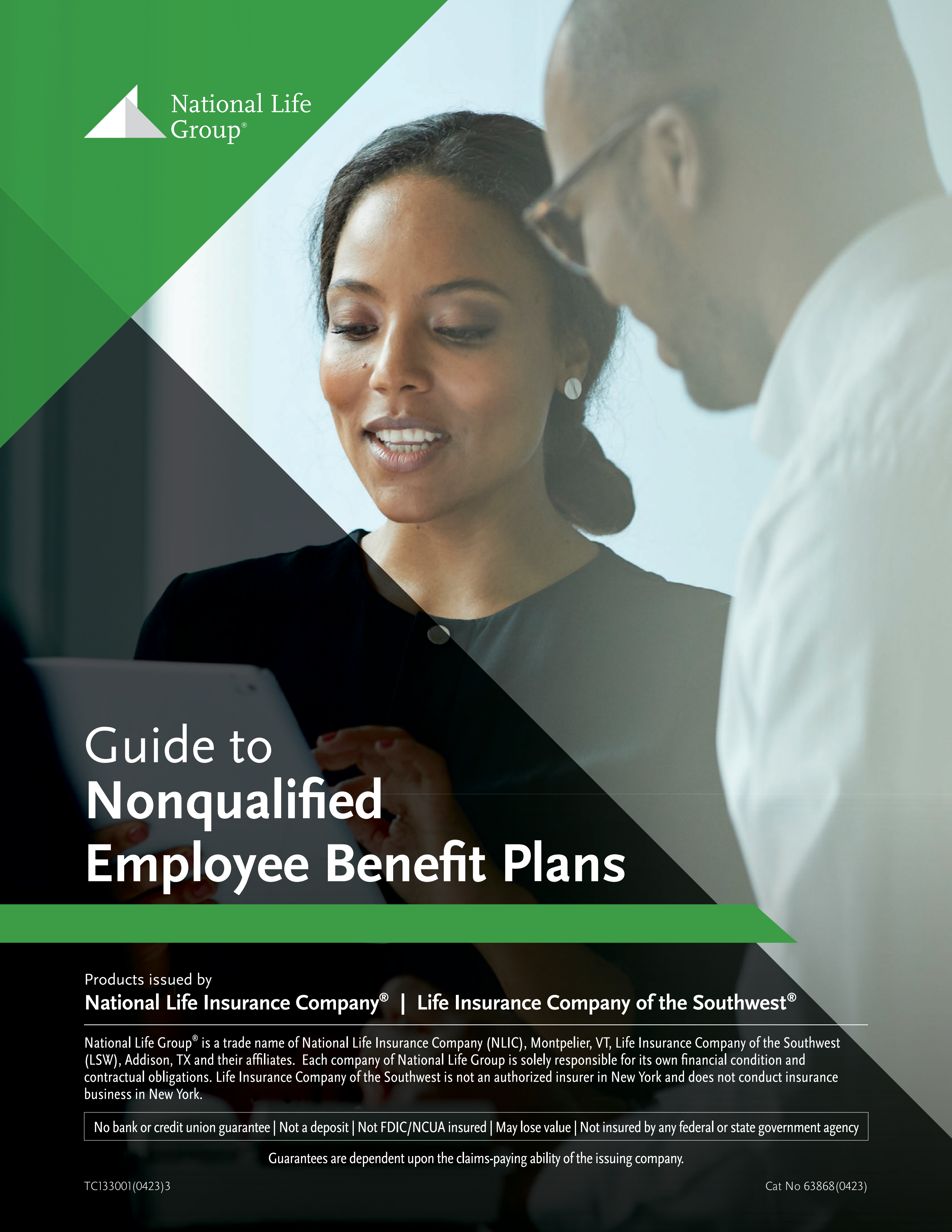

Guide to **Nonqualified Employee Benefit Plans**

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Guide to Nonqualified Employee Benefit Plans

In addition to sponsoring a qualified retirement plan for all employees, small business owners may offer nonqualified employee benefits to their key employees. These benefits can be very valuable to key employees, and provide a way for employers to attract, motivate, reward, and retain their top talent.

To understand the importance of nonqualified employee benefit plans, it is necessary to recognize the differences between qualified and nonqualified plans. The table below highlights some of the key differences.

	Qualified	Nonqualified
ERISA Classification	Pension Benefit Plan	Welfare Benefit Plan
Purpose	Allow participants to build resources for retirement. Recruit and retain all employees.	Recruit, protect, reward, and retain key employees.
Coverage	All employees must be included under ERISA with limited exceptions. No discrimination allowed.	Select group of management or highly compensated employees -- employer must discriminate.
Contribution Limits	IRS imposes contribution limits for employers and employees.	Generally no contribution limits.
Contribution Flexibility	Contributions and benefits must be proportionately equal for all plan participants, sometimes requiring exclusion of highly compensated employees.	Employer can discriminate and reward certain key employees at a higher level than others.
Taxation	Participant subject to income tax in the future when benefits are received. Tax-deferred growth.	Depends on type of plan.
Deductibility	Employee and employer contributions are generally deductible, as well as set up costs up to certain limits.	Depends on entity tax status, plan chosen, and who is covered (owner vs. employee)
Documentation and Administration	Third Party Administration and ERISA Reporting required for most plans (SEP and SIMPLE IRAs excepted).	Corporate resolution and written plan document. Level of required administration varies based on the type of plan.
Types of Plans	• SEP & SIMPLE IRAs • Defined Contribution Plans – 401(k) Plans – Profit Sharing Plans • Defined Benefit Plans – Traditional defined benefit plans – Cash balance plans – 412(e)(3) plans	• Executive Bonus • Split Dollar • Nonqualified Deferred Compensation

The table above highlights the most commonly used nonqualified employee benefit plans. Each of these plans is further compared on the next page. Employers must consider the characteristics of each plan when determining which plan meets their overall goals and objectives.

	Executive Bonus / §162 Plan	Split Dollar: Loan Regime	Split Dollar: Economic Benefit Regime	Nonqualified Deferred Compensation (Elective or Supplemental)
Overview	Business pays premiums to provide life insurance coverage for key employee.	Life insurance purchased on employee's life; death benefit and cash value are shared.	Life insurance purchased on employee's life; death benefit is shared.	Provides supplemental retirement, death, and/or disability benefits to key employee.
Objective	Provides life insurance protection to owner or key employee with business dollars.	Provides life insurance to owner or key employee with business dollars. Minimal cost to employee.	Provides life insurance for owner or key employee with business dollars. Minimal cost to employee.	Employer promises to pay key employee income at a predetermined future date.
Life Insurance Owner and Beneficiary	Owner or key employee owns policy and designates beneficiary.	Employee is owner of policy and collaterally assigns policy to business; employee designates beneficiary for employee's portion of death benefit.	Business is the owner and endorses a portion of the death benefit to the employee. Employee designates beneficiary for employee's portion of death benefit.	Business is owner and beneficiary.
Premium Payor	Business	Business	Business	Business
Employer Features	• Plan may discriminate. • Premiums may be tax-deductible to business as a compensation expense. • Simple and easy to implement. • Minimal plan administration. • No IRS approval is needed.	• Plan may discriminate. • Golden handcuffs to retain key employee. • No IRS approval is needed. • Business will receive return of premium amounts as loans and interest due at death or rollout.	• Plan may discriminate. • Golden handcuffs to retain key employee. • No IRS approval is needed. • Business recovers premium outlay at death or rollout. • Business will own and control the policy as a balance sheet asset.	• Plan may discriminate. • Golden handcuffs to retain key employee. • Costs may be recovered by business. • No IRS approval is needed.
Employee Features	• Tax-deferred cash value accumulation may be used for supplemental retirement income.[1] • Life insurance protection. • Completely portable. • Plan can offset limits on benefits from qualified plans.	• Death benefit income tax-free to beneficiary. • Employee owns and controls the policy. • Cash value net of business interest in policy belongs to employee. • Low personal cost to employee. • Plan can offset limits on benefits from qualified plans.	• Death benefit income tax-free to beneficiary. • Minimal tax cost to employee. • All policy rights can be rolled out to employee at retirement. • Plan can offset limits on benefits from qualified plans.	• Supplemental retirement income.[1] • Benefits may be customized for each participant. • No reportable income until benefits received. • May provide survivorship benefits. • Plan can offset limits on benefits from qualified plans.
Points to Consider	• Bonus may place key employee in a higher individual income tax bracket. • Can be designed as a single, double, or net bonus.	• Loan interest set at market rates either as a term note or demand note. • Subject to ERISA and treated as Welfare Benefit Plans. Plan must be in writing with a named fiduciary. • Generally not subject to 409A rules. Must have expectation for loan repayment and account for annual loan interest.	• Economic benefit reportable as taxable income to employee; could be significant in later years of policy. • Subject to ERISA and treated as Welfare Benefit Plans. Plan must be in writing with a named fiduciary. • Generally not subject to 409A rules.	• Business deduction is delayed until benefits are actually paid. • Taxable to key employee when benefits are received. • Survivorship benefits are taxable income to key employee's beneficiaries. • Subject to 409A rules.
Income Tax Considerations	• Premiums may be tax-deductible to business as a compensation expense. • Employee reports premium as taxable income. • Could use double bonus to cover employee's income tax liability. • Death benefit is generally income tax-free to beneficiaries.	• Premiums are not tax-deductible to business. • Loan interest if paid by employee is taxable to business and cannot be deducted by the employee. • Loan interest is considered imputed income if not charged or if below market interest rates are used. • Loan principal repayment is tax-free to business. • Death benefit generally income tax-free to beneficiaries. • Outstanding loans are an asset to the business.	• Premiums are not tax-deductible to business. • Employee taxed on economic benefit equal to the term insurance value of the employee's portion of the death benefit. • Death benefit generally income tax-free to beneficiaries; if business owns policy, must comply with §101(j) to avoid income tax on death benefit.	• Premiums are not tax-deductible to business. • Premiums are not taxable as income to key employee. • Benefit payments are deductible by business when paid to employee. • Death, disability, or retirement benefits are taxable to employee and/or beneficiary when received. • Business must comply with IRC §101(j) notice and consent requirements to avoid income tax on death benefit.
Estate Tax Considerations	May be included in employee's estate.	May be included in employee's estate.	May be included in employee's estate.	Present value of payments to key employee's beneficiary is included in key employee's estate.
Appropriate Business Organization	**For key employees:** all entity types. **For business owners:** Appropriate for owners of C corporations and LLCs taxed as C Corporations. Not appropriate if the entity is an S corporation, a partnership, an LLC taxed as an S corporation or a partnership, or a sole proprietorship.			

1 Policy loans and withdrawals reduce the policy's cash value and death benefit and may result in a taxable event. Surrender charges may reduce the policy's cash value in early years.

2 Assuming the notice and consent requirements of IRC §101(j) are met prior to issuance of the policy.

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