Non-Qualified Deferred Compensation

- Rewarding & Retaining Key Executives
- Supporting an ESOP Succession Plan
- Balancing the Costs and Benefits of Current and Deferred Compensation

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Conceptual Overview

- Deferred compensation is an agreement to pay compensation at some future date:

  Retirement; Death; Disability; Term of Service
- Non-qualified: The agreement and any 'funding' do not qualify for a corporate tax deduction until the compensation is paid or the benefit otherwise inures to the participant.
- Adopted for a select group: Management or highly compensated employees defined by key position.
- The plan is not an informal pension or severance pay plan.
- It avoids problems associated with ERISA, such as non-discrimination, restrictive contributions.
- A new IRS code provision, IRC §409A, now governs these plans and care must be taken in the design.
- When used with a Subchapter S ESOP, care must be taken to comply with IRC §409(p).

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Advantages to Employee

- Leverage through the use of the 'corporate pocketbook.'
- Shifts tax liability to a later date and perhaps a lower tax bracket.
- Can provide financial support for the family in case of death at low cost (PS 58).
- Provides income separate from qualified plan(s) after end of employment.

Advantages to Employer

- Selective both with respect to participants and terms of participation
- May recoup costs
- Provide or supplement pension benefits
- Costs may be predictable
- Possible gain to employer
- Can help manage/fund ESOP repurchase obligation
- Can support an internal family or management ownership transition
- Better risk management for company and ESOP fiduciaries
- No obligation to include future employees
- Corporate control of assets
- Recruit/retain/reward top executives
- Benefits are 'equity equivalents' where considerable stock is already committed to an ESOP.

Types of Deferred Compensation

Defined Contribution Model
(Recommended in ESOP Environment)

- **Based on salary reduction or in addition to compensation**
- **Amount deferred is a known quantity: Percentage of salary or flat dollar amount.**
- **Benefit is not necessarily known (whatever the investments become).**

Defined Benefit Model

- **Salary continuation after retirement.**
- **Benefit is defined: Percentage of salary or flat dollar amount.**

Funding the 'Unfunded' Benefit

Uses of Corporately Owned Life Insurance (COLI)

- Employer should be applicant, owner, beneficiary and premium payor
- Participant has no ownership
- Tax-deferred inside cash accumulation
- Tax-free death benefit (potential AMT)
- AMT is only an issue if regular corporate income tax is low and sales are above a specific amount - if AMT is paid, unlimited carryover
- Cost-free benefit - proceeds may be used to recover employer costs such as the loss of use of corporate funds, the premiums paid and the after-tax costs of the benefits.
- Participant shareholders (including ESOP stock) are insured to cover both buy/sell and ESOP stock repurchase obligations.

Protecting Employee Benefit Security

- **Benefit must be exposed to a 'substantial' risk of forfeiture - it cannot be non-forfeitable.**
- **Benefit cannot be vested or funded.**
- **It can be vested in the sense that years of service can be tied to ultimate benefit.**

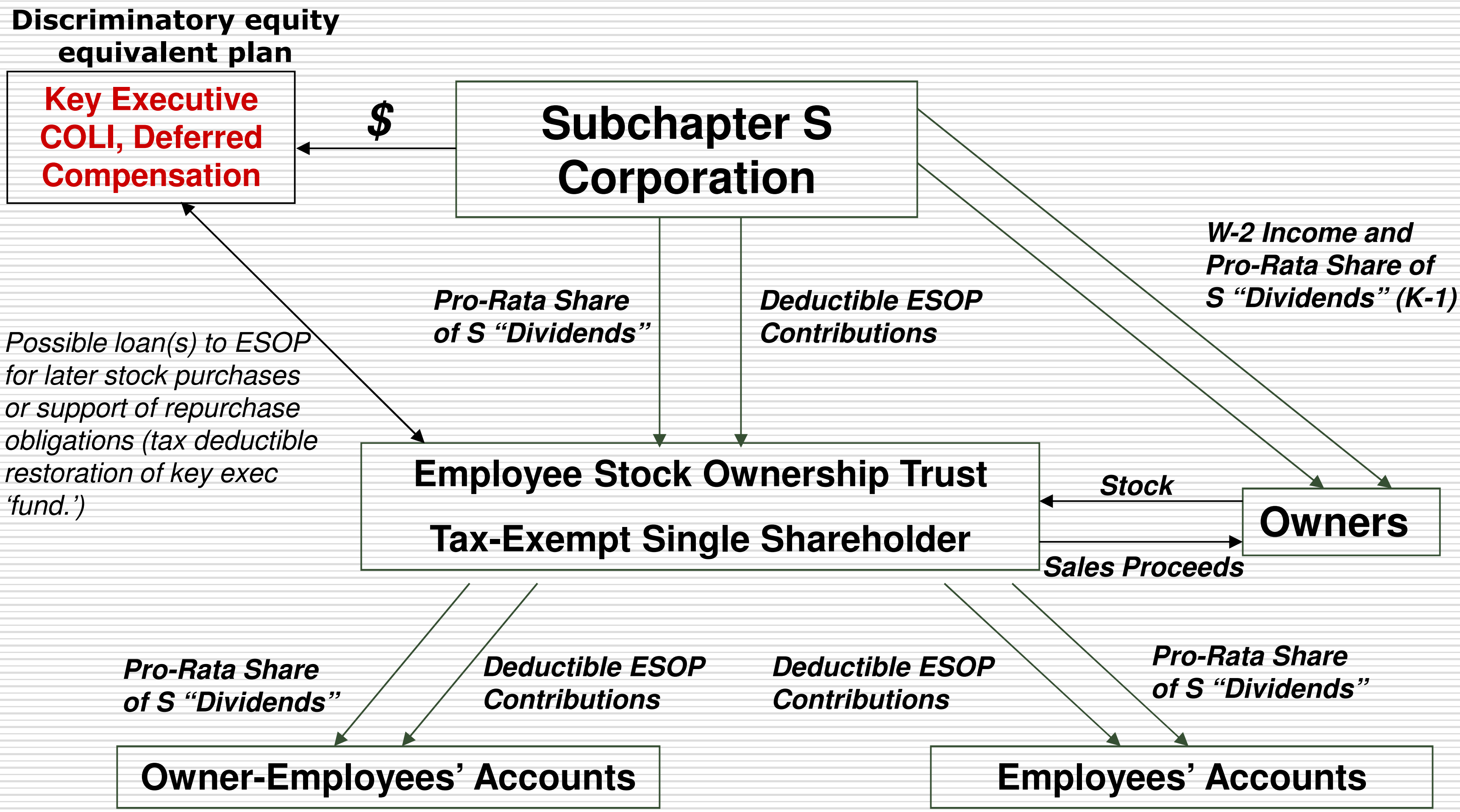
Protecting Employee Benefit Security

- While deferred compensation arrangements cannot be formally funded, they can have some security:
- Rabbi Trust. Irrevocable trust established by employer.
- COLI policy in Rabbi Trust remains reachable by employer's creditors in event of bankruptcy.
- Participants have no rights to RT assets and their interest and rights are limited solely to those specified in their NQDC agreement.
- RT not typically used in an ESOP environment, since assets cannot support repurchase obligations and have a greater impact on value.
- RT keeps successor management honest.

Impact of Deferred Compensation on Stock Value

1. Negatively impacts stock value (ESOP) if the agreements are adopted and no ‘funding’ provisions are made.
2. Defined contribution model with COLI ‘funding’ repositions assets on balance sheet with little or no hit to value.
3. ESOP fiduciaries are prudent when conservative COLI is used:
   - Deferred compensation assets are subordinated to ESOP repurchase requirements
   - ESOP account balances of key executives can be protected - stock repurchase is funded.
   - ESOP company is financially sheltered against loss of key exec.

What Some S Corporations are Doing: The Partially or Entirely Tax-Exempt Operation



Note: The IRS counts key executive deferred compensation as a type of 'synthetic equity' for the Sub S IRC §409(p) anti-abuse testing. This is not typically an issue for properly designed plans with over 20 to 30 participants. For smaller plans, both the qualified (ESOP) plan and the non-qualified (deferred compensation) plan will need future coordination to comply with this interpretation of EGTRRA 2001 as well as IRC 409(A).

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