Harnessing the Power of 401(k) Plans

401(k) Plans — An Overview

In the past decade, no retirement plan has become more popular with large and small companies than the 401(k).

A 401(k) plan is a retirement savings plan offered by a corporation to its employees. The plan allows eligible employees[1] known as plan participants, to contribute a portion of their annual income[2] to an account in their own name. Contributions reduce each participant's taxable income, and all earnings potentially grow tax-deferred until withdrawn.[3]

Some employers who offer 401(k) programs make matching contributions. A "matching" contribution is when an employer contributes a portion of each eligible participants' deferral amount to a separate account based on a pre-determined formula.

Employers can also combine a 401(k) plan with a profit-sharing plan. In a profit-sharing plan, all eligible employees receive a profit-sharing contribution from the employer, regardless of whether they contribute to the program. Some plans may require participants to contribute at some minimum level in order to qualify.

Profit-sharing contributions generally range from 0%-15% of an employee's salary. Employers can determine the percentage based on a number of factors, including the amount they would like to contribute or other employees are deferring, fees for plan maintenance, and the costs of employee funding.

[1] Usually those who have at least one year of service and work more than 1000 hours annually.
[2] Subject to applicable limits.
[3] Withdrawal of earnings are taxed as ordinary income and may also be subject to a 10% federal income tax penalty if taken before age 59½.

Major Benefits of a 401(k) Plan to Corporations

- Helps attract worthy candidates for employment
- Helps retain valuable employees
- Is cost-effective compared to other qualified plans
- Has relatively modest set up and maintenance costs
- Allows corporations to deduct contributions made on their employees' behalf (including profit sharing, employee deferrals and matching contributions)

Major Benefits of a 401(k) Plan to Employees

- Is a relatively easy and painless way to build wealth for retirement
- Allows eligible employees to reduce their current income tax liability
- Enables employees to watch all earnings that have the potential to grow tax-deferred until withdrawn

Which Companies Are Eligible to Establish 401(k) Plans?

Companies can establish a 401(k) plan regardless of their particular business structure. Recent law changes have even made it possible for many non-profit organizations to establish 401(k) plans. Companies can also establish 401(k) plans, regardless of the number of employees that they have.

Remember, the amount that certain highly compensated employees can contribute to a 401(k) plan generally depends on the amount contributed by other employees.

The more all employees participate in a 401(k), the better it is for highly compensated employees. But business owners should not be discouraged from establishing a 401(k) if they believe participation will be low. They can often use the profit-sharing option to increase their own contribution to the plan.

Strategies for Executive Benefits

Executive Benefits Plans — An Overview

All corporations interested in the long-term success of their business should know the importance of Executive Benefits Plans. These plans help corporations:

- Recruit key managers
- Retain key employees
- Reward select employees for outstanding performance
- Improve employee morale
- Give executives additional incentive to grow the business
- Concentrate on developing business-building strategies

Additional Advantages Of Executive Benefits Plans

Executive Business Plans also offer corporations other advantages, such as:

A Sense of Control

A company may choose the participants, plan design and the amount of corporate and/or executive contributions.

Potential Exemption from IRS Approval and Minimal ERISA Requirements

Since Executive Benefits Plans are generally unfunded and structured exclusively for key executives, they may not have to comply with most ERISA requirements nor seek Internal Revenue approval.

No Contribution Limits or Discrimination Requirements

Contributions to these plans are generally unlimited, providing preferential treatment to select executives.

Low Set-Up and Administration Costs

Most Executive Benefits Plans can be relatively easy to establish and maintain. No annual reporting is required, and bookkeeping is usually simple. Moreover, vesting can be nonexistent, or by company's desired schedule.

Tax-Deferred Growth

Generally, all contributions, company matches and earnings are taxed to the executive at the time of distribution.

Major Advantages Of Executive Benefits Plans To Employees

Senior-level managers find Executive Benefits Plans attractive for many reasons:

- Executive Benefits Plans provide benefits that go beyond traditional raises or bonuses.
- These plans can help executives save money on taxes today and build wealth for the future through potential tax-deferred growth of earnings.
- In most cases, Executive Benefits Plans are not subject to contribution limits.
- These plans offer executives tremendous flexibility in securing their financial futures.

Business Continuation and Succession Planning

This type of planning is vital to help ensure that your business survives in the event of a life cycle change, i.e. death, disability, or retirement. This can mean keeping the family business in the family or, in the case of non-family businesses, helping to ensure the orderly transfer of business interests.

Specifically, we provide the following resources for guidance on the various planning strategies and funding techniques, specifically geared to the desired goals of the company. These goals can include succession planning, the selling of a business or key executive benefit plans. Potential strategies and services include:

Cross Purchase Buy-Sell
Information and strategies on ways to set up and fund a business succession agreement between key executives within the company.

Trusteed Buy-Sell
Information and strategies on ways to set up and fund a business succession agreement through a trust.

Wait and See Buy-Sell
Information and strategies on ways to set up and fund a business succession agreement when it is unclear who the successors are.

Stock Redemptions
Strategies and techniques for funding a plan to redeem the stock of a shareholder upon retirement, death or disability.

Main Benefit Of Executive Benefits Plans

The main reason for the popularity of executive benefits plans is that they don't discriminate against highly compensated executives. In fact, these plans allow a corporation to provide valuable benefits designed specifically for the highly compensated team.

Executive benefits plans help executives deal with lost opportunities created by governmental regulation and limitations of qualified plans, including 401(k) plans, pension plans and profit-sharing plans.

Types of Executive Benefits Plans

There are many different types of executive benefits plans. Below is a brief description of each one and its main benefits:

Supplemental Executive Retirement Plans (SERP) mirror or supplement a specific retirement plan.

Main Benefits

- Employee contributions are usually not required.
- Employees pay no federal income taxes on the benefits until they are received.

Deferral Plans allow for pre-tax contributions which "mirror" 401(k) contributions lost under non-discrimination limitation rules. Contributions can, and often do, substantially exceed these lost contributions. The company can establish the contribution limit at any level that it desires.

Main Benefits

- Employees reduce their current income tax liability.
- Any contributions and earnings grow tax-deferred.
- Employer can make matching contributions to replace lost contributions.

Executive Bonus Plans enable select executives to own cash value life insurance.

Main Benefits

- Tax-deferred accumulation.
- Death benefit is income tax-free to personally named beneficiary of the executive.
- Executive controls the life insurance policy.

Cost-Sharing Plans (Split Dollar Life Insurance Plans) whereby the company and executive share the cost and benefits of a cash value life insurance policy.

Main Benefits

- Executive can receive permanent life insurance coverage.
- Executive can receive cash value accumulation.

Deferral Plans Can Kick in Where 401(k)s Leave off

With an executive benefits plan, companies can make sizable contributions on the behalf of their employees each year. A traditional retirement plan, however, has annual contribution limits, which greatly limit the amount that a highly compensated executive can invest annually.

An employer-funded retirement benefit to reward and retain highly compensated key executives.

A supplemental executive retirement plan (SERP) is an employer-sponsored non-qualified deferred compensation plan. It allows employers to provide highly compensated key employees with additional retirement benefits beyond those provided by qualified plans (401(k), IRA, etc.). A SERP is financed solely through employer contributions – the employee does not contribute to the plan.

Through a SERP, employers can help highly compensated executives alleviate their worries of having a potential retirement income shortfall by providing additional retirement income. Employers benefit from a SERP because it provides incentive to the executive to continue working for the business long term (i.e., a "golden handcuff").

A SERP is typically offered in addition to a qualified plan to recruit, retain, and reward talented employees. Consider how some of the key features of a SERP plan stack up against qualified plans:

KEY FEATURES

	QUALIFIED PLAN	SERP
Freedom to choose key employees for participation	**No** – all employees must be included in plan	**Yes** – can handpick select key employees to participate
Plan acts as a "golden handcuff"	**No** – employee retains full account value upon termination from company	**Yes** – a vesting schedule may also be added added to strengthen the incentive
Subject to income limitations	**Yes**	**No**
Subject to contribution limitations	**Yes**	**No** – employer may provide as large of a benefit as they would like, plan is noncontributory for the employee[1]
Immediate income taxation to employee	**No** – qualified plan funds are typically tax-deferred	**No** – if properly structured, employee will not have to pay taxes on the benefit until actually received

Putting a Plan into Action

1. Identify the Key Employees

The employer chooses which key employee(s) to participate in the plan. Because a SERP is not subject to the discrimination rules associated with qualified plans, **the employer is free to reward select employees in varying amounts and participation levels.**

2. Execute the Agreement

The employer and employee enter into an agreement, whereby: (A) the employer promises to pay the employee income in the future (e.g., at retirement); and (B) the employee agrees to continue working for the employer. The amount of future income may be contingent upon a variety of factors, such as: the length of service, the employer's profitability, and other employee compensation or benefits the employee receives.

The contract also specifies how the future SERP benefit will be determined, generally using one of two methods:

Defined Contribution

- Employer will credit a specific dollar amount annually to the employee's SERP account (plus interest)
  - Example: Employer contributes $10k per year until retirement and will credit the account 4% interest annually

Defined Benefit

- Employer will pay the employee income based on:
  - Flat dollar amount (e.g., $50k per year for 10 years starting at retirement)
  - Percentage of salary (50% of final salary for 10 years starting at retirement)
  - Formula (e.g., benefit equals 50% of the average of the employee's final three years of salary)

3. Consider Including a Survivor Benefit

SERP plans often provide for the payment of the accrued benefit amount to the employee's family in the event of the employee's pre-retirement death or disability.

Funding the Plan

Although a SERP plan may be informally funded several ways, many employers choose to purchase a permanent life insurance policy on the life of the key employee to help the company pay for future benefit payments and to recover costs of the plan. When informally funded with life insurance:

- The policy is an asset of the business, which is the policy owner, premium payor, and the beneficiary.
- The employee pays no costs associated with the policy, but must consent to the insurance policy on his/her life.

Life insurance has multiple tax advantages that make it useful to the employer to informally fund a SERP plan, such as: 1. the policy cash value grows tax-deferred, 2. the policy cash value can be accessed income tax free, and 3. the death benefit is received income tax free.

Additional uses for the life insurance include:

- **KEY PERSON COVERAGE:** The life insurance death benefit also may be used as coverage for the business to replace the key employee during working years.
- **BUY-SELL PLANNING:** Depending on the corporate structure, the death benefit and/or cash value also may be used to buy out the key employee's ownership interest in the business at his/her termination from the company to fulfill the terms of an entity-redemption buy-sell plan.
- **PRE-RETIREMENT DEATH BENEFIT:** During working years the employer can provide the employee with an income-tax free survivor benefit via the death benefit. One of the ways to provide this is through an endorsement split dollar arrangement in which the business will endorse all/or part of the death benefit and the employee will pay tax on the economic benefit cost (i.e., the "rental charge"). To maximize this benefit to the employee, the employer may consider making a bonus of the rental charge (a "double bonus"), so that the employee has no out of pocket expenses.

Key Benefits

FOR EMPLOYERS

- **Flexibility:** Employer can select which employees will participate in the plan and determine the benefit for each employee.
- **Golden handcuffs:** Employer can impose a vesting schedule, creating "golden handcuffs" and giving the executive an incentive to stay with the company.
- **Cost recovery:** When informally funded with life insurance, the death benefit is generally received income-tax free and can provide plan cost recovery.
- **Tax deduction:** Employer receives a tax deduction at the time the retirement benefit is paid.

FOR EXECUTIVES

- **Supplemental, employer-funded retirement income:** A SERP can be used to supplement qualified plan savings with additional retirement income for highly compensated employees.
- **Pre-retirement death benefit:** Executive may also receive a pre-retirement death benefit for his/her family.
- **Protection:** The additional annual retirement income and/or survivor benefit will help to ensure that the employee's loved ones are protected.
- **Tax-deferral:** If properly structured, the employee will not have to pay income taxes on this benefit until received.[2]

Securing and Funding SERPs and Deferral Plans

Securing

Rabbi Trusts allow specific assets to be segregated by the company to pay plan benefits to the participants. The trust assets, treated as company assets, remain on the company's balance sheet and are subject to the claims of the company's creditors. Thus, if the employer becomes insolvent or bankrupt, the employees under the non-qualified retirement plan will be unsecured general creditors of the employer. Additionally, any taxable income generated by the trust is considered taxable income of the company. Assets in the Rabbi Trust may only be used to pay plan benefits or to pay creditors in the case of insolvency or bankruptcy.

Funding

Companies may adopt various informal funding techniques to pay for plan liabilities and still maintain an unfunded status.

Corporate Owned Life Insurance (COLI) is the most common funding method. With COLI, a company buys life insurance policies on the lives of the executives and names itself as the beneficiary.

The company cannot deduct the premiums as a business expense. It can, however, list the policy's cash value as an asset on the balance sheet, and simultaneously provide current retirement benefits. Additionally, the potential tax-deferred growth of the cash value may help offset plan liabilities and produce a positive earnings impact.

With life insurance as a funding vehicle, a company may be able to recover all the costs of establishing and maintaining its supplemental benefits plan.

WNLLC Offers Expertise in Executive Benefits Plan Design and Administration

Setting up and administering a supplemental benefits plan requires a knowledgeable staff of trained professionals and state-of-the-art technology. WNLLC has the resources, knowledge and experience to provide for plan administration needs in a cost-effective and timely manner. They offer a wide range of solutions and services for companies interested in establishing executive benefits plans. These include:

Plan Administration Services

- As-Sold Illustrations
- Plan Participant Statements (Benefit tracking statements)*
- Benefit and Plan Accounting Reports*
- Communication, Documentation

Trust Services**

- Setting up Rabbi Trusts
- Setting up Secular Trusts

Policy Administration Services***

- Installation
- Enrollment
- Benefit Payment Processing

Executive Compensation Planning

- Deferrals, SERPS
- Cost-Sharing & Bonus Plans

Cost Analysis

Analysis of funding alternatives to reduce corporate and executive costs

Funding Design

Specific expertise in COLI product design to address benefit liabilities