John Hancock INSURANCE

Salary Deferral

CLIENT SNAPSHOT

BUSINESS PLANNING

A salary deferral plan is a type of employer-sponsored non-qualified deferred compensation plan available for highly compensated executives. Under a salary deferral plan, a key executive agrees to defer a portion of his/her compensation and the employer agrees to return the deferred amounts, with interest, at a future point in time.

A salary deferral plan is a non-qualified plan, which means the employee is allowed to defer as much income or compensation as the plan permits and the plan is not subject to qualified plan limits or caps. Accordingly, employees ordinarily participate in deferral plans when their current income substantially exceeds their current needs. Elective deferred compensation is designed as a supplemental benefit, so that key employees have an opportunity to accumulate wealth for retirement with tax deferred savings in excess of their qualified plan contributions.

How it Works

STEP 1

The employer decides which key executives to include in the plan.

STEP 2

Each participating employee and the employer enter into a deferral agreement, whereby the employee agrees to defer a portion of his/her compensation for the current year with an expectation to make additional deferrals of income in future years. The employer will agree to repay the money with interest at a specified time, usually at retirement. The employer may choose to match the employee's contributions to the plan, in whole or in part.

STEP 3

The employer decides how interest will be credited to the employee's deferral account and what options, if any, to offer. For example, the employee may be given phantom investment options with results applied to the deferral account.

STEP 4

The employer may choose to informally fund the plan. Salary deferral plans may be funded in several ways, but are commonly informally funded with a life insurance policy owned by the business on the employee's life.

STEP 5

At retirement, the employer can access the life insurance policy cash value via tax-free loans and withdrawals to pay the retirement benefit. At the time the benefit is paid, it will be taxable income to the employee and tax deductible to the employer.

Key Benefits

FOR THE EMPLOYEE

- **Deferral of taxation:** If properly structured, the employee will only pay income taxes when he/she actually receives the retirement benefit. Pre-tax retirement contributions maximize the compounding of savings. Moreover, the employee may receive tax benefits if he/she is in a lower marginal income tax when the deferred payments are received.
- **Supplements income from qualified plan savings:** Provides key executives with a vehicle to make tax-deferred savings beyond what he/she could contribute in a qualified plan.
- **Matching contributions:** An employer may choose to match an employee's contributions, thus increasing the value of the benefit received in retirement.
- **Investment options:** The employer may offer phantom "investment options" that align with the employee's investment goals and then allocate the plan assets (owned by the employer) in accordance with these goals.

FOR THE EMPLOYER

- **Increased competitiveness/loyalty:** Enhances a key executive's total compensation package.
- **Flexibility:** Deferral plans are flexible in terms of plan design, coverage, and implementation within the rules of §409A.
- **Golden handcuffs:** The employer may add a vesting schedule on employer contributions to the plan to encourage a key employee to stay with the company on a long-term basis.
- **Discrimination:** The employer may handpick the employees to participate in the plan and is not subject to the discrimination rules associated with qualified plans.
- **Cost recovery:** If informally funded with life insurance, the income tax-free death benefit can provide the employer with cost recovery.[1]
- **Ease of administration:** Minimal IRS, ERISA, accounting and other reporting/ regulatory requirements.

Important Considerations

- **Income Taxation:** If properly structured, the employee will only pay income taxes when he/she actually receives the retirement benefit. At that time, the employer may take a corresponding deduction. Note that the premium payments on a life insurance policy are not deductible to the employer.

- **Creditors:** Because a salary deferral plan is a non-qualified deferred compensation arrangement, plan assets may not be segregated (like in a qualified plan) without causing taxation to the employee. If the business becomes bankrupt and is unable to repay the benefit in the future, the employee will be considered an unsecured, general creditor of the business and will not receive preferential treatment in recovering his/her benefit.

- **Insurance Ownership and §101(j):** If the plan is informally funded with life insurance, the employer owns and is the beneficiary of a policy on the employee's life – the employee has no rights to the policy. When life insurance is owned by an employer on the life of an employee, §101(j) of the tax code requires that certain conditions and Notice and Consent requirements be met to keep the death benefit proceeds income tax-free.

- **§409A:** Section 409A of the Internal Revenue Code applies to all non-qualified executive benefit plans that provide for the deferral of compensation, such as a salary deferral plan. Failure to comply with Section 409A may subject the employee to immediate income taxation of the deferred amounts as well as interest and a 20% excise tax on the taxable income.

- **ERISA:** The possible application of ERISA should be considered for all non-qualified executive plans, including a salary deferral plan. In most instances, a salary deferral plan may be exempt from most ERISA requirements as a "top hat" plan. If ERISA applies, advisors should note that they may be considered a fiduciary and should take appropriate steps to comply with ERISA requirements, including conflict of interest rules.

Conclusion

A salary deferral plan can be a simple, flexible way for employers to reward a key executive's hard work and loyalty to the company, especially in cases where qualified plan income and contribution limits can hinder the executive's ability to fully save for retirement. Key employees should consider participating in a salary deferral plan if they are looking to bridge the gap between the tax-deferred retirement income they are eligible to save in qualified plans and the amount of retirement income they will need.

Talk to your financial professional to determine how a Salary Deferral Plan might work for you.

1. At the employee's retirement, the employer may be able to recover the cost of the benefit from the potential policy cash value via policy loans and withdrawals. Loans and withdrawals will reduce the death benefit and the cash surrender value, and may cause the policy to lapse. Lapse or surrender of a policy with a loan may cause the recognition of taxable income. Withdrawals in excess of the cost basis (premiums paid) will be subject to tax and certain withdrawals within the first 15 years may be subject to recapture tax. Additionally, policies classified as modified endowment contracts may be subject to tax when a loan or withdrawal is made. A federal tax penalty of 10% may also apply if the loan or withdrawal is taken prior to age 59½. Cash value available for loans and withdrawals may be more or less than originally invested. Withdrawals are available after the first policy year.

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Life insurance death benefit proceeds are generally excludable from the beneficiary's gross income for income tax purposes. There are few exceptions such as when a life insurance policy has been transferred for valuable consideration.

Loans and withdrawals will reduce the death benefit, cash surrender value, and may cause the policy to lapse. Lapse or surrender of a policy with a loan may cause the recognition of taxable income. Policies classified as modified endowment contracts may be subject to tax when a loan or withdrawal is made. A federal tax penalty of 10% may also apply if the loan or withdrawal is taken prior to age 59 1/2.

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