

Overlooked Plans Can Benefit Key Employees

Every thriving business has key employees, those individuals who affect the success of the organization. "These days, finding and retaining good people has become a critical challenge for Southern California business owners and managers," explains Leo Thomas, manager Coastal Financial Partners Group's executive compensation practice in Los Angeles.

"Raises, bonuses and traditional benefit or retirement plans can only take you so far and they no longer create the long-term ties that bind key individuals to your company;" Thomas notes. "Regrettably, few business owners and managers are aware of the array of affordable and flexible plans that offer substantial opportunity to financially reward and retain key employees as well as business owners."

"Traditional pension plans, 401(k) or Simplified Employee Pension (SEP) plans are technically referred to as qualified plans," Thomas explained. "While they offer significant tax advantages and retirement-savings benefits for employers and employees, these plans generally require that most or all full-time employees be eligible in order to qualify for their special tax treatment."

Thomas notes that creative pension plan design can still make it possible to selectively reward key personnel. There are limits however to what a qualified plan can accomplish. As a result, a growing number of businesses are taking advantage of several forms of nonqualified retirement plans, allowing top earners to set aside as much as they would like.

A Selective Employee Retirement Plan

One of the most attractive and little-known plans, according to Thomas, is the Selective Executive Retirement Plan or SERP. "The SERP provides the ability to accumulate significant retirement benefits for selected, highly compensated employees according to the terms of a private agreement between the individual and the employer," he says. "With a SERP, the employer may make all contributions, the employee may defer compensation, or a combination of both may be utilized."

Also known as nonqualified deferred compensation plans, SERPs allow the individual to avoid current income taxation on the deferral or employer contribution amount. "A trust (often known as a 'rabbi' trust; so named after the retirement plan provided for a rabbi by his congregation) is sometimes used to own the contribution amount," Thomas explains. "This trust provides an additional layer of security for an individual who may be concerned about the impact of a future change of company ownership or management." Often a permanent individual life insurance policy is selected to informally finance SERP retirement benefits due to the unique combination of tax characteristics and guarantees offered.

A Golden Handcuff Bonus Plan

The drawback of most employer-paid bonus plans commonly utilized by businesses is that once the money is paid, the key employee can take his or her money and move to a competitor," Thomas says. "For companies looking to reward workers and tie them to the company for a designated period of time, a 'golden handcuff' or restrictive bonus plan offers an alternative that can be extremely effective."

One plan design utilized provides a current tax deduction to the employer and allows the employee to have access of the funds according to a vesting schedule determined by the employer. For example, the employee could be fully vested - able to receive 100 percent of the funds - after 15 years or upon reaching age 65. "To compensate for the employee's perceived loss of immediate access to the cash, the plan can contain a guarantee that the bonus arrangement will continue in the event of his or her death or disability," Thomas notes.



Supercharged Retirement Account

A third type of benefit plan that is increasing in popularity actually shares the cost and benefit of a tax-advantaged financial vehicle between both the business and the key employee. "Until recently, 'split-dollar' life insurance policies were utilized mainly by a handful of key executives - often those with multi-million dollar compensation packages," Thomas adds. "Now, more and smaller employers are offering the benefit below their top-management ranks to reward highly valued workers and keep them from going elsewhere."

While the death benefits provided by a split-dollar policy can be generous, that's not often the plan's main attraction. Essentially, a split-dollar plan may be designed to function as a supercharged retirement account without a cap on yearly contributions. The employer can pay the lion's share of the premium with after-tax dollars - the equivalent of what they would give as an annual bonus. When the plan is ultimately terminated, the company actually gets its contribution back. Meanwhile, much of the aggregate premium grows tax-deferred in a specially designed, permanent life insurance policy.

"Unlike the cash buildup in a traditional qualified retirement plan, the buildup in a split-dollar policy can be tapped by the recipient without penalty before age 59 1/2," Thomas says. "What makes the split-dollar plan the equivalent of a supercharged retirement account is the ability to structure withdrawals as policy loans so there are no current income taxes." Many executives utilize split-dollar plans to create wealth for their family and heirs. Business owners also use the plan to cover estate taxes on their business or to fund a buy-sell agreement.

While the use of nonqualified plans does provide employers with the ability to reward key employees on a selective basis without the reporting required for most qualified plans, the rules governing these plans are continually reviewed and are subject to change. "Establishing a private agreement between a company and its key employees can be relatively simple if you understand the rules," Thomas states. "This is certainly one time when even a minor mistake could turn your good intentions to provide a reward into very costly results. It's always advisable to seek professional advisors who are knowledgeable, experienced and creative."

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