make contributions in excess of the amount allowed for profit-sharing plans — as much as 25%. Money purchase plans have low administrative costs but differ from profit-sharing plans in that they require an employer to make an annual contribution based on a fixed percentage of eligible compensation. While the increased contribution maximum in a money purchase plan may be advantageous to the employer, the employer *must* decide upon an amount and make that same contribution each year, regardless of profitability.

How an Executive Compensation Plan Works

Executive compensation plans are an excellent means for an employer to reward key employees. There are a wide variety of plans to consider, both on a qualified and nonqualified basis. Here's a hypothetical example of how an executive compensation plan can help retain and reward a key employee:

Tim is a 45-year-old married man with three children. He is a very talented individual who has been with his employer for a number of years. His employer, Gannett Express, considers him to be a valuable asset and would like Tim to remain with the company until normal retirement age. However, Gannett Express realizes that Tim might be lured away by a competitor who can offer somewhat better pay and benefits.

To create a long-term incentive for Tim to stay, the company and Tim enter into a written agreement whereby the company agrees to pay either retirement or death benefits to Tim in exchange for his promise to remain with Gannett Express.

The agreement states that if Tim stays until retirement, the company will pay Tim $20,000 a year for ten years after his retirement. If Tim should die before he retires, the company will pay his named beneficiary $20,000 a year for ten years. If he should die during the first ten

years of retirement, the company will pay the beneficiary $20,000 a year for the number of years remaining in the agreement.

The company will informally fund this unsecured promise with the purchase of $200,000 of life insurance on Tim's life. The company will completely control and own the policy.

Everyone Wins

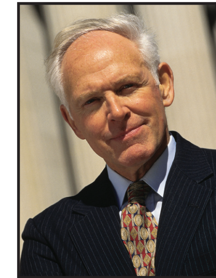
Using this executive compensation arrangement, Gannett Express wins because it will receive greater assurance of Tim's commitment to stay until retirement. In addition, the benefits paid by the company as reasonable additional compensation are an ordinary business expense that may be tax deductible to the company.

Tim also wins. He gains an additional source of retirement income that he did not have prior to the establishment of the deferred compensation arrangement. If he dies prematurely or during the first ten years of retirement, he gains an immediate payment to his beneficiary.

For both Tim and the company, an overall feeling of goodwill is generated by the new arrangement — truly a win-win solution.

A Plan Professionally Tailored to Your Needs

While the above hypothetical study describes how a basic nonqualified executive compensation arrangement can work, it is important to realize that numerous variations on the basic plan abound. Because of the variety and complexity of executive compensation arrangements, it is best to research available options thoroughly in order to accomplish specific goals and objectives.



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Title

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Executive Compensation

Strategies for Rewarding Key Employees

many companies owe much of their success to a few **key employees** — typically the brightest, most talented, most valuable, and often hardest to replace. Because unique, high-performing individuals can mean the difference between the success and failure of a business, it is important to develop a strategy that adequately rewards these valued individuals. Key executives must be compensated competitively, sometimes above and beyond compensation offered to the rank-and-file employees, in order to provide them with incentive to stay with the firm.

There are a number of vehicles — known as **executive** or **deferred compensation plans** — available to help an employer reward key employees.

Nonqualified Executive Compensation Plans

Nonqualified deferred compensation plans are flexible arrangements generally used to reward executives and key employees with benefits beyond those offered to the majority of employees. Nonqualified plans are not subject to the IRS nondiscrimination rules that govern qualified plans. In general, nonqualified plans allow employees to defer payment of taxes on deferred compensation until such time as the income is actually received. Employers, therefore, must wait to take a tax deduction for contributions until the year in which the employee takes income from the plan. There are many different types of deferred compensation arrangements, including the following:

- **Deferred Bonus Plans** simply postpone an employee's receipt of a portion of bonus income until a future year, allowing the employee to defer income tax payments until a later time. The hope is that income from the bonus will be recognized, perhaps at the time of the employee's retirement, when the employee may be taxed at a lower rate.

- **Executive Bonus Plans (Section 162 Bonus Plans)** are used by employers to compensate key employees by paying the premiums of a **life insurance** policy on the life of the employee. The premiums are tax deductible to the employer, and the plan is easy to create and administer. Executive bonus plans are an effective means of attracting and retaining key employees — the executive owns the policy and any cash values, and the policy is portable in the event of a change in employers.

- **Excess Benefit Plans** provide certain employees with benefits in excess of those provided under an employer's qualified plans. Typically, the benefits under an excess program are those that the employee would have earned under the employer's qualified pension or profit-sharing plans, if there were no limitations on contributions to qualified plans. There is no limit to the amount of benefits that may be paid out under an excess plan.

- **Phantom Stock Plans** are unfunded, nonqualified deferred compensation arrangements with characteristics that are similar to stock option plans. Under a phantom stock plan, an employee's deferred compensation is converted into an equivalent number of stock units. Shares are not purchased or issued, and confer no ownership or voting rights, but the employee's phantom stock account will continue to increase as additional units are awarded. This provides a benefit to the employee without the company giving out any actual stock. At the end of the deferral period, the employee is compensated for the stock at a price per share equivalent to the value of the company's stock at the time the shares were credited to his or her account, thereby tying the value of the employee's phantom stock account to the company's performance. Units of stock may be awarded on any criteria selected by the employer, including service tenure, company profitability, and attainment of sales and performance goals.

- **Split-Dollar Insurance Arrangements** are nonqualified fringe benefits that have historically served key executives. Split-dollar is not a type of policy but, rather, a way to share the costs and benefits of a single life insurance policy. Traditional split-dollar life insurance arrangements are generally defined as the sharing of premium payments, rights of ownership, and death proceeds between the employer and the insured employee. The employer essentially funds these nonqualified plans, while the employee is responsible for a small portion of the premium called the "economic benefit."

On September 17, 2003, the Internal Revenue Service (IRS) finalized changes to the rules governing split-dollar arrangements, essentially placing restrictions on the valuation methods used in determining economic benefit and clarifying all split-dollar arrangements for the purpose of understanding any tax consequences. The IRS has ruled that if the employer owns the policy (endorsement), the economic benefit is taxable to the employee, and if that ownership is eventually transferred to the employee, the employee would be taxed upon the policy's cash surrender value. Alternatively, if the employee owns the policy (collateral assignment), then any premium payments made by the employer are treated as loans and are subject to taxation.

These amended regulations apply to all split-dollar arrangements entered into after September 17, 2003, as well as those existing on or prior to this date and subsequently materially modified. Although the IRS eliminated tax benefits allowed in the past, split-dollar arrangements can still work for employees seeking more insurance than they could otherwise afford and for employers who wish to provide specific life insurance benefits for key employees.

Section 409A

The American Jobs Creation Act of 2004 enacted more stringent rules for deferred compensation plans under Section 409A, and on April 10, 2007, the IRS issued final regulations on the scope of Section 409A. This legislation tightens restrictions on distributions, deferrals, and the timing of benefit payments. Noncompliance will result in penalties. While some plans may already comply with the changes, it is important to review your arrangement to see if revision is necessary.

Other Benefit Options

Although nonqualified plans are more popular for providing high levels of executive compensation, certain qualified plans can be used to improve benefit offerings. **Qualified plans** conform to IRS regulations concerning coverage of employees, reporting to participants and to the government, and benefit limits. Qualified plans have certain advantages. For instance, employer contributions to the plan are tax deductible to the employer, plan assets are safe from the employer's creditors, and investment income generated within the plan is not currently taxed. The following are types of qualified benefit plans.

- **Profit-Sharing Plans** are a type of defined contribution plan that offers the employer both flexibility and low administrative costs. There is no minimum contribution, and a company can decide on a year-by-year basis how much, or how little, to contribute to the plan. The maximum contribution to the plan is 25% of compensation paid to eligible employees. **Stock bonus plans** are a form of profit-sharing plan, but they differ in that benefits are distributed to employees as shares of employer stock.

- **Money Purchase Plans** are similar to profit-sharing plans, but they allow the employer to