Nonqualified Executive Compensation: 401(k) Excess Plans
About the Plan, How It Works, Considerations and How to Fund

WHAT IS A 401(K) EXCESS PLAN?
A 401(k) excess plan is an employer–sponsored nonqualified deferred compensation plan designed to attract and retain key executives. Much like an employer’s qualified 401(k) plan, the excess plan allows the executive to defer a portion of his or her salary on a pre-tax basis, and the employer may choose to match the salary deferral. Unlike a qualified 401(k) plan, the excess plan is offered only to select key employees. At an executive’s retirement or another specified date, the employer will begin payment of the executive’s account balance, which may be tax deductible for the employer.

WHO MAY BE INTERESTED IN A 401(K) EXCESS PLAN?

EXECUTIVES
• Wanting to maximize their qualified plan contributions
• Looking for supplemental retirement income
• Receiving funds from their qualified 401(k) plan due to top hat testing
• Preferring to defer paying taxes on income they don’t currently need

BUSINESSES
• Looking to provide substantial benefits to key executives
• Needing an executive retention strategy
• That are top heavy

HOW DOES A 401(K) EXCESS PLAN WORK?
• An executive enters into an agreement with the employer to defer an amount of compensation to a future date, thereby deferring current income taxes as well, in return for retirement. The employer has the option of making a matching contribution to the executive’s account balance. This is similar in design to the qualified 401(k) plan that is often already provided by employers.

• The employer will create an accounting entry in its financial statements that represents the executive’s account balance. The executive’s account is an unsecured promise by the employer to pay the executive a future benefit.
• Many employers choose to purchase a life insurance policy on the executive’s life, naming itself owner and beneficiary of the policy. The policy is a bookable asset to the employer and may offer tax deferred growth, as well as death benefit protection. Please note that the life insurance policy is not the plan; it is merely an informal funding vehicle utilized by the employer to accumulate the funds necessary to pay the benefits due under the plan. The executive must give written consent to the life insurance coverage. The employer will typically use the employee’s deferrals to pay the premiums of the insurance policy.

• At the executive’s retirement, the employer pays the executive due compensation. If life insurance was used, payments can be made via tax-free distributions of the cash value accumulated within the life insurance policy. The payments from the plan will be taxable income for the executive and tax deductible for the employer.

• In the event of the executive’s death, the employer will receive a tax-free life insurance death benefit. If the employer has not completed the payments due to the executive under the terms of the agreement, the employer may use the death benefit to pay the executive’s heirs the remainder due any excess to be used as the employer wishes.

WHY CONSIDER A 401(K) EXCESS PLAN?

AVOID THE FOLLOWING GOVERNMENT BENEFIT RESTRICTIONS WITH A “NONQUALIFIED” PLAN

• Compensation cap for qualified plan contributions and benefits
• Code Section 415 contribution and benefit limits
• Elective deferral limits
• Matching contribution limits
• After-tax contribution limits
• Reporting requirements
• Nondiscrimination requirements
OFFER IMPROVED EMPLOYEE BENEFITS

- Efficient way for employees to save for retirement after qualified plan opportunities are exhausted
- Excluded compensation (bonuses, incentive cash payments) for qualified pension plans may be part of nonqualified plans
- May be used to facilitate early retirement

HOW CAN LIFE INSURANCE FUND A 401(K) EXCESS PLAN?

- Employer pays premiums with employee deferrals
- Employer is the owner and beneficiary of the insurance policies
- Funds accumulate tax-deferred in life insurance
- Tax-free distributions from life insurance cash values may be used to pay benefits
- Employer receives insurance benefit tax free at employee’s death
- Employer recovers all outlays:
  - Premium payments
  - Retirement benefits
  - Corporate cost of money

Plan results are hypothetical only. Actual results will vary due to changes in contributions and withdrawals, income tax brackets, and investment performance.

This report makes reference to concepts which have significant legal, accounting and tax implications. Our comments are intended to convey our general understanding of the applicable principles, but are not intended as legal, accounting or tax advice. We recommend that you consult your legal, accounting and tax advisors for application of these concepts as they relate to your specific factual situation. Securities offered through ProEquities, Inc. A registered broker-dealer, member FINRA & SIPC. National Benefits Group is independent of ProEquities, Inc. 5280-96
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**Frequently Asked Questions**

**MINIMUM EMPLOYEE REQUIREMENTS FAQs**

Are there a minimum number of employee participants required for a 401(k) excess plan?

No. “Nonqualified” plans are not subject to the participation requirements typically associated with traditional qualified retirement plans. No minimum number of employees is required, and the employer has complete discretion in determining eligibility for the plan.

Are there a maximum number of employees required for a 401(k) excess plan?

No. In fact, there are corporations with this type of plan in place for hundreds of employees. However, deferrals are usually limited to the top layers of an employee’s compensation, those amounts which are subject to top marginal income tax rates.

**INCOME LIMITATIONS & EMPLOYEE ELECTIONS FAQs**

Is there any limit on the amount of income employees may defer?

No. Employees may, theoretically, defer up to 100% of total compensation. The only limits are those imposed by the employer establishing the plan.

When do employees have to decide how much to defer?

Employees need to complete their deferral elections prior to the end of each calendar, with two exceptions. The first exception is the first plan year, during which employees may make deferral elections within the first 30 days. The second exception is with performance-based bonuses, for which employees may make elections six months before the bonus can be determined.

**REPORTING FAQs**

Are there complex reporting and disclosure requirements for 401(k) excess plans?

Not necessarily. The Department of Labor requires a letter with plan identification information when the plan is established. NBG will provide a sample letter to use. Public companies may have additional proxy disclosure requirements for named officers.
TRUSTS AND 401(k) EXCESS PLANS FAQs

Can an employer use a trust to help secure its promise to pay deferred compensation benefits in the future?

Yes. The employer can establish a trust and deposit employee deferrals in accordance with the provisions of the trust. Funds will be held by the trustee for the benefit of plan participants.

How are funds placed in the trust treated by the employer for tax purposes?

Amounts contributed to the trust are not deductible by the employer until they are subject to taxation for the employee. Typically this occurs when retirement payments begin. The trust is generally structured as a “grantor” trust so that all taxable income and/or tax deductions generated by the trust are attributed to the employer. Any interest or investment income on trust assets is taxable to the corporation. If life insurance is used, the tax deferral associated with life insurance generally eliminates corporate taxes on trust income.

How are employees taxed on income they defer and on the interest or investment income accruing to the trust?

All employee taxes are deferred until the employee is in “constructive receipt” of the funds, either because payments have been made directly to the employee, or because the money has been available to the employee without restriction.

EMPLOYEE FAQs

Are employee deferral account balances subject to the claims of general creditors?

Yes. In order to obtain favorable tax treatment, plan assets are subject to the claims of general creditors of the employer.

Can employees assign their benefits under the plan?

No, they may not.

Are employees required to make irrevocable decisions about the timing of retirement and retirement payments from the plan, or is there flexibility?

There is some flexibility for employees in determining the timing of payments from the plan. The employee makes an initial election at plan inception and is generally allowed to postpone distributions as long as the new election precedes the calendar year of the originally scheduled distribution. Payments may be accelerated only in case of death, termination of employment, change of company ownership or other limited circumstance outlined in the plan documents.
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Case Study: Comparison of Salary Paid and Deferred

For the most common tax situation, a deferral strategy produces better financial results than taking receipt of current compensation, paying taxes and developing an outside investment program. The following example illustrates the economics for a 45 year-old who defers $10,000 per year for five years against receipt of income. In both scenarios, withdrawals are made for 15 years beginning at retirement.

CASE STUDY: 45 year-old, defers $10,000 annually for five years

<table>
<thead>
<tr>
<th></th>
<th>Receipt of Salary</th>
<th>Deferral of Salary 401(k) Excess Plan</th>
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<tbody>
<tr>
<td>Deferred salary</td>
<td>$50,000</td>
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<tr>
<td>Income taxes @ 40%</td>
<td>($20,000)</td>
<td>($0)</td>
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<tr>
<td>Funds available for investment</td>
<td>$30,000</td>
<td>$50,000</td>
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<tr>
<td>Pre-tax return</td>
<td>8.0%</td>
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<tr>
<td>After-tax return*</td>
<td>6.4%</td>
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<td>Accumulation at age 65</td>
<td>$91,990</td>
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<tr>
<td>Annual benefit</td>
<td>$9,136</td>
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<td>Annual income tax @ 40%</td>
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<td>($8,697)</td>
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<td>Annual received</td>
<td>$9,136</td>
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<td>Payout years x15 years</td>
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<tr>
<td>TOTAL AFTER-TAX BENEFIT</td>
<td>$137,040</td>
<td>$195,675</td>
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*Illustrated 20% tax rate for taxable investment accounts

RESULTS: Deferral of salary option increases after-tax benefit by $58,635 in 15 years

ADDITIONAL CONSIDERATIONS

EXECUTIVE
- The distributions from the 401(k) excess plan will be considered taxable income.
- If the 401(k) excess plan provides a survivor benefit, the executive’s excess plan account balance will be included in his or her taxable estate.

BUSINESS
- A 401(k) excess plan is subject to the requirements of IRC Section 409A. Failure to meet the requirements of IRC Section 409 will result in substantial tax penalties for the executive/participant.

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