Weighing the Options for Informally Funding Non-qualified Benefits

EXECUTIVE SUMMARY

Informally funding deferred compensation programs can offer advantages to both participants and companies. The practice can help support a company's promise to pay future benefits to plan participants, while minimizing income statement volatility.

Choosing the right informal funding mechanism can help mitigate the risks associated with non-qualified plans. Companies can use an irrevocable rabbi trust to offer greater protection for a plan's account balances. Company stock, corporate annuities, corporate-owned life insurance (COLI) and mutual funds are all assets that can be used for funding within the rabbi trust. To determine the best asset option, companies must evaluate each vehicle based on their impact on cash flow, earnings, asset/liability tracking, flexibility, after-tax return, and security. While other asset classes can be used as funding vehicles, many have significant drawbacks related to these considerations and should only be looked at on a case-by-case basis. While there is no perfect informal funding solution, conducting a rigorous assessment can help companies make the best choice for themselves and their participants.

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The instability of the national economy has caused increased scrutiny and regulation of executive compensation in recent years. Public outrage over corporate corruption has led the federal government to enact more laws expanding their role in curbing perceived abuses. Rating agencies began casting a negative eye on corporate balance sheets with unfunded benefit liabilities, such as SERPs, deferred compensation plans, and 401(k) excess arrangements. This article focuses on the strategic considerations and importance of informally funding non-qualified benefits in light of these issues.

UNDERSTANDING INFORMAL FUNDING

To preserve their tax-deferred status, non-qualified benefits cannot be formally funded. To do so would create immediate taxation for the executive, even though actual benefits may not be immediately received. From a participant's perspective, a lack of funding creates a risky proposition. A company's promise to pay benefits, without funding to back the promise, isn't very valuable to a participant after a change of control, a management change of heart, corporate bankruptcy, or simply when sizable benefits become due and cash flow is tight. Informally funding executive benefits secures the incentive value of the plan to attract and retain key executives, and preserves the value of the benefit as a savings tool for the participants.

Informal funding can also offer advantages to companies. Unfunded plans can cause volatility to the income statement, as well as a negative drag on earnings. Companies set aside assets for future distribution with the intention of having available cash to pay on benefit liabilities when they eventually come due. Also, corporate boards are increasingly supporting the concept that current management should be responsible for funding its own benefit costs, rather than deferring those costs to future generations.

EVALUATING YOUR INFORMAL FUNDING OPTIONS

While the assets of a non-qualified plan cannot be secured in the same way those of a qualified benefit plan (e.g. 401(k)) can be, choosing the right informal funding mechanism can significantly mitigate the risk. An informally funded, irrevocable rabbi trust that holds the assets used to secure the non-qualified benefit payments owed to participants can protect a plan's account balances. In the case of bankruptcy or insolvency, however, participants' plan assets are subject to claims of the company's general creditors.

Once the rabbi trust is established, companies must then decide which asset is best suited for funding the trust. Among those commonly considered for informally funding a non-qualified plan include:

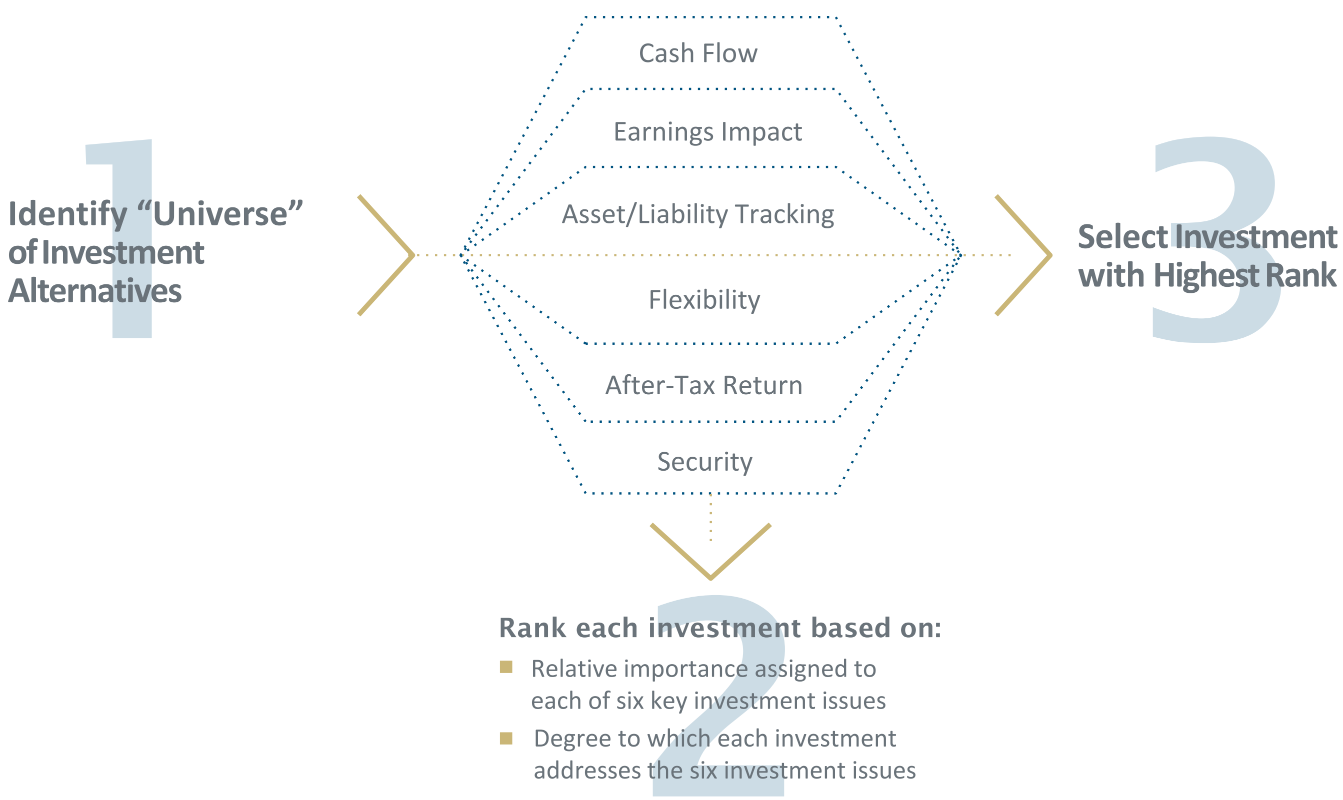
- Company stock
- Corporate annuities
- Corporate-owned life insurance (COLI)
- Managed portfolios/mutual funds

Deciding how to informally fund non-qualified plans is a complex process requiring careful evaluation of the asset attributes that best align a company's financial position and objectives. Factors such as cash flow, earnings impact, asset/liability tracking, flexibility, after-tax return and security must all be weighed with corporate priorities in mind. Although no asset will provide a perfect funding solution, companies can narrow the field based on an assessment of these major financial attributes:

- **Directional Alignment with Market Movements:** All four informal funding asset categories generally respond to changes in market conditions and economic cycles in the same directional manner as plan liabilities. This is important, as it allows a company to better hedge against volatility in benefit-related expenses and helps ensure sufficient assets are available to pay benefits as they come due.
- **Impact on Cash Flow:** All four funding options can be viewed favorably with regard to a company's short- and long-term cash flow requirements. Company stock likely requires the least up-front cash.
- **Impact on Earnings:** COLI earns the highest marks for earnings impact. With all gains and losses flowing through to the income statement on a tax-deferred basis, this funding alternative creates a comparable offset for the benefit expense.
- **Access to Values:** All of these funding options provide for access to the asset values. Mutual funds are the most liquid. Company Stock is liquid but dependent upon the market. Annuities and COLI can be converted to cash via contract features to access cash values via loans, withdrawals or surrenders.
- **Flexible Deposit Options:** Any of these funding options allow some degree of flexibility to increase investment size or deposits over time, as benefit costs do not always grow in a predictable fashion (e.g., new participants are added, salaries increase, etc.).
- **Tax Consequences of Changing Asset Mix:** To effectively track benefit liabilities, a company may want to periodically move or reallocate assets. Purchasers of variable COLI can initially select and periodically reallocate across a broad range of asset classes (including common stock, fixed income, real estate, and others). There is no taxation on gains due to the tax-deferred treatment of cash value build-up inside the COLI product. Transferring company stock or mutual funds will, however, create a taxable event in most circumstances.
- **Ability to Distribute Cash when Benefits are Due:** A managed portfolio can be structured to match benefit payments, however, managing for tax efficiency adds complexity and additional costs. Both corporate annuities and COLI can be structured to match the relative value needed for benefit payments at the time of distribution, subject to the terms of the policy contracts. Company stock does not allow for a timing advantage due to the unpredictability of the stock value based on current market conditions.

- **Ease of Distribution:** As the timing and size of benefit payments are not always predictable, the ability to easily distribute discrete "pieces" of the investment is important in selecting the right informal funding vehicle (i.e., an asset that provides access to amounts varying in size and frequency over time). Large corporate annuities complicate distribution flexibility due to their significant lot size.
- **Security of the Asset:** The four funding options discussed here are considered relatively secure based on the fact that they are approved by the IRS for placement in a rabbi trust. Corporate annuities and COLI portions of these assets are subject to the claims paying ability of the sponsoring insurance carrier (depending on the type of product purchased). The use of other funding vehicles associated with more risk or limited liquidity may compromise a company's ability to pay benefits when distributions come due.
- **Tax Effectiveness:** Company stock, COLI and mutual funds offer funding options with minimal tax impact. With the exception of COLI, the tax advantage may be inversely related to the ability to offer an income statement offset or a significant base rate of return. Once the choices have been narrowed based on security and flexibility, a careful analysis of total return that includes tax effectiveness, income statement effectiveness and timing of cash flows must be conducted.

INVESTMENT CONSIDERATIONS



INVESTMENT ISSUES MATRIX

This matrix summarizes some of the key characteristics and features of company stock, corporate annuities, COLI and mutual funds as informal funding options.

INVESTMENT ISSUE	CHARACTERISTICS OF INVESTMENT FOR BENEFIT FUNDING PURPOSES	Company Stock	Corporate Annuities	Corporate-Owned Life Insurance	Managed Portfolio Mutual Funds
Cash Flow	Favorable short- and long-term cash requirements (1)	■	■	■	■
Earnings Impact	Ability to generate positive impact to "offset" benefit expense		(2)	■	(3)
Asset/Liability Tracking	Value of asset tracks emerging benefit costs	(4)	■	■	■
Flexibility	Access to values	■	■	■	■
	Flexible deposit options	■	■	■	■
	Ability to change asset mix without tax consequences		(2)	■	
	Ability to distribute cash coincident with timing of benefit payments		(2)	■	■
	Ease of distribution (e.g., in "small pieces")	■		■	■
After-Tax Return (5)	Risk-adjusted after-tax return potential	■		■	■
Security	Can be deposited into rabbi trust with favorable IRS ruling	■	■	■	■
Total "Score"		6	5	10	8

(1) Company stock would likely require the least amount of upfront cash

(2) Only immediate annuities have tax deferral

(3) Ability improved if auditors allow classification as "trading."

(4) Desired match possible if liabilities are company stock-based.

(5) Assuming "standard" is tax-exempt bond.

SELECTING THE RIGHT FUNDING VEHICLE FOR YOUR SITUATION.

Engaging in a rigorous assessment process helps companies prudently evaluate the financial issues surrounding informally funding non-qualified executive benefits in order to make well-informed decisions about which investment(s) best meet their overall objectives. The informal funding vehicles reviewed here – corporate annuities, company stock, managed portfolios/mutual funds and COLI – have all received favorable IRS rulings for placement in a rabbi trust, and can help provide companies and plan participants alike with the confidence of knowing serious consideration has been given to balancing cash flow demands with benefit obligations, and to that end, that assets are targeted for future distribution.

Notes on Variable Annuities

Variable annuities are long-term investments designed for retirement. The value of the investment options will fluctuate and, when redeemed, may be worth more or less than the original cost. Withdrawals and other distributions of taxable amounts, including death benefit payments, will be subject to ordinary income tax. If withdrawals and other distributions are taken prior to age 59½, a 10% federal penalty may apply. A withdrawal charge may also apply.

Withdrawals will reduce the value of the death benefit, surrender value and any optional benefits. All guarantees are subject to the claims-paying ability of the issuing company and do not apply to the underlying investment options.

Variable annuities have contract limitations, fees, and charges which include, but are not limited to, mortality and expense risk charges, sales and surrender charges, administrative fees, and charges for optional benefits such as lifetime income riders.

It is possible to lose money in a variable annuity purchased with an optional rider. Optional riders may be irrevocable and expire without use.

If buying a variable annuity to fund a retirement plan that already provides tax deferral (such as a 401(k) plan or IRA), you should do so for reasons other than tax deferral, as you will receive no additional tax advantage from the variable annuity.

Variable annuities are offered by prospectus only which can be obtained by contacting Mullin Barens Sanford Financial. The prospectus contains information about the product's features, risks, charges and expenses, and the investment objectives, risks and policies of the underlying portfolios, as well as other information about the underlying funding choices. Read the prospectus and consider this information carefully before you invest.

The materials are designed to convey accurate and authoritative information concerning the subject matter covered. However, they are provided with the understanding that Mullin Barens Sanford does not engage in the practice of law, or give tax, legal, or accounting advice. For advice in these areas please consult your appropriate advisors.

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