

Nonqualified Deferred Compensation

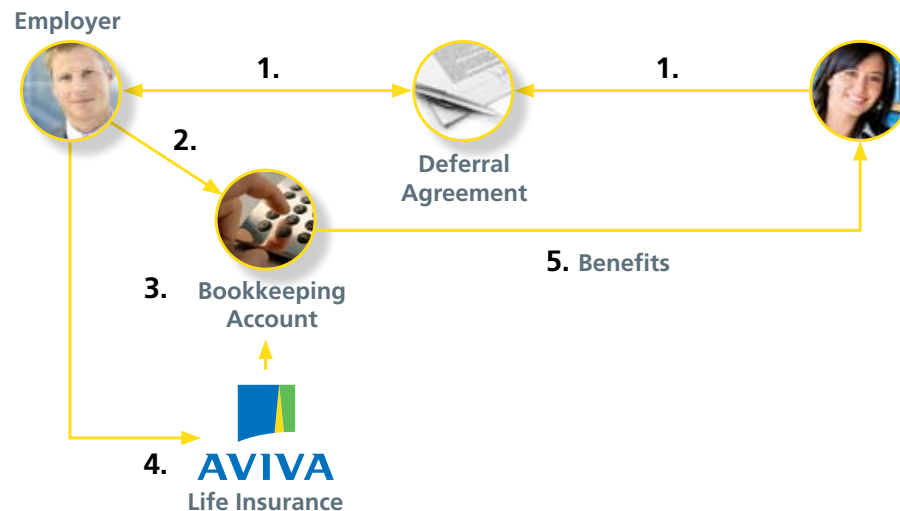
A Deferred Income Plan



Nonqualified Deferred Compensation – What is a deferral plan?

A nonqualified Deferred Income Plan is an agreement between an employer and an executive. The term nonqualified means it is not a payment received from a qualified plan, such as a defined benefit plan or 401(k) plan. It provides a selective executive benefit which generally supplements the retirement income available from qualified plans. The executive and employer would:

- Enter into a contractual agreement to defer future compensation in exchange for the payment of retirement income.
- Before the beginning of each year the executive must elect to defer a portion of compensation prior to performing the services. The deferrals are credited to the executive's bookkeeping account for each executive, for which interest is credited based on a formula in the agreement.
- The employer purchases a cash value life insurance policy on the executive's life. The employer is the owner and beneficiary of the policy. The policy provides a death benefit and tax deferred accumulation of cash value. The employer cannot deduct the premium payments. This is key employee life insurance coverage.



1. Employer and executive enter into a contractual agreement to defer compensation.
2. Executive elects to defer a portion of compensation prior to performing the services.
3. Deferrals, any matching contributions and stated interest earnings are credited to a bookkeeping account in the executive's name.
4. Employer purchases a key employee life insurance policy on the executive's life. The policy creates informal funding for the benefit liability.
5. At retirement, disability or death, a benefit is paid to the executive, or a named beneficiary, in an amount that generally reflects the balance of the bookkeeping account.

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Why nonqualified deferred compensation?

Some highly-compensated executives may have discretionary income that can be deferred to avoid current income taxation. Deferred compensation arrangements aim to defer executive income tax until the executive is presumably in a lower tax bracket.

In addition, reverse discrimination occurs with highly-compensated executives due to the restrictions of contribution dollars for 401(k)s, IRAs and other qualified plans. Qualified plans can never discriminate in favor of certain employees. Nonqualified deferred compensation arrangements present a viable alternative, allowing the employer to select who will participate, making this one of the most popular executive benefits.

How nonqualified deferred compensation works.

The employer decides on the plan provisions. The plan might provide survivor benefits in the event of a pre-retirement death. The plan provisions are formulated into a legal agreement between employer and executive and a resolution is read into the corporate minutes. Executives defer taxes (excluding FICA tax) until they actually receive benefits, at which time the employer would receive a tax deduction.

Informal funding with life insurance

To achieve intended tax results the plan must be an unsecured and unfunded promise to pay benefits. No employer assets can be tied directly to the plan or put beyond the reach of the employer's creditors. Many employers, however, do "informally" fund these arrangements. The most common vehicle used is cash value life insurance. The employer would be the owner, premium payer and beneficiary of the policy.

Nonqualified deferred compensation with life insurance

In the prior example, the employer purchases permanent life insurance on the life of an executive in amounts sufficient to fund promised payments at death. The pre-retirement death benefit can be paid in a series of payments. At retirement, the policy's cash value would be accessed to recover the after-tax cost.

Advantages to Employer

- Select specific executives to receive supplemental retirement benefits -- with minimal ERISA reporting requirements.
- Employer controls the plan, policy and cash value.
- Life insurance cash values accumulate income tax deferred.
- Retirement or Survivor Benefits paid are tax deductible to Company.
- Employer can structure the agreement to provide for cost recovery plan costs.

Advantages to Executive

- Agreement can be customized to meet the each executive's individual needs.
- Cash value accumulates on an income tax-deferred basis and is an asset of the company.
- The agreement can be self-completing in the event of the executive's death.
- The executive can compensate for the reverse discrimination associated with qualified plans.

¹ If the policy lapses or is surrendered, the IRS will tax distributions received over the life of the policy and at termination that are in excess of total premiums paid.

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