How Family Businesses Can Make Effective Decisions about Executive Benefits Plans

Businesses run by families or a small number of partners may have very different cultures from the Fortune 1000, but they share at least two things in common.

- Their most important asset is their management team.
- They compete for the same management talent.

What are the chances of smaller, closely held businesses winning that competition?

Overwhelmingly, compensation in family businesses is based on salary, bonus, and perks. Every increase in these three will add strain to every family business's biggest concern-cash flow.

Meanwhile, the executives in smaller companies are hit the hardest by regulatory limits on retirement plans. They can easily hit the ceiling on contributions, and if the employees do not contribute at a high enough level, their own contributions can drop below even the ceilings.

That leaves one choice for valuable executives-to build their personal net worth and retirement income with after-tax dollars. Which means the company in turn is victimized by its compensation program, because executives are now focused on their personal bottom line, instead of the company's bottom line.

Congress came to the aid of executives and companies by allowing the highly compensated to build retirement income outside the qualifications and limitations of broad-based pension plans. Because the qualifications do not apply to these plans, they are referred to as non-qualified plans. Properly structured and informally funded non-qualified benefit programs allow businesses to better manage their most important asset-the talent and leadership of their executive teams.

CEOs and CFOs in smaller companies often know they have a problem and have heard presentations about non-qualified executive benefits programs, but they perceive the solution as incredibly complicated. Without the layers of management that big public companies have, they tend get pulled into day-to-day firefighting and leave complicated, long term projects like this on the back burner.

Here are some guidelines to relieve you of this misconception and move the problem to front burner.

For all the vaunted creativity available in executive benefits design, the essential design options can be reduced to four decisions.

- Who should be selected for participation?
- Should the program focus on allowing participants to defer income and therefore avoid current taxes?
- Should the company to provide the benefit outright or to contribute above the participants' amount to increase tax-deferred growth?
- How should the program be documented and administered?

An executive benefit plan is based on a contractual agreement between the company and the participants to pay future benefits. The plan specifies how the primary and additional benefits are structured, where the money will come from, how the money will be invested, as well as the governing security measures. There are two general categories of plans-salary continuation and deferred compensation.

A salary continuation benefit is usually referred to as a Supplemental Retirement Plan (SERP). A SERP represents an unsecured promise to pay additional salary amounts at a future time and can be structured either as a defined benefit or defined contribution plan. The benefit can be either a fixed amount, a percentage of final salary, or can be based on a formula that takes other factors into account. Or, the plan can provide defined contributions with the ultimate benefit determined by the contributions plus earnings. SERP's are financed completely by the company, and the participants make no contribution out of current salary.

The second basic category is usually called a deferred compensation plan, in which the participants defer current contributions until a future time. The retirement benefits are based on the deferrals plus earnings. The growth of these plans, like the defined contribution SERP, is tied to indices, allowing participants to formulate their own investment strategies. As an incentive to participants, the company may match a portion of the deferrals.

In both plan structures, participants do not incur income tax until the benefit is actually received. Participants defer taxes on both compensation and growth, restoring the advantages of company retirement plans before Congress set its limits on the highly compensated.

However, removing the ERISA qualifications for these plans in turn removes the guarantees that make qualified retirement plans so secure. So, in effect, risk has been transferred to the participant. However, proper plan design mitigates these risks through the use of trusts, adding a layer of protection for contingencies.

On the company's side of the agreement, there is no deduction for ordinary and necessary business expense for plan contributions, until such time as they are includable in the taxable income of participants. And the question must then be answered, where will the money come from?

For a plan to maintain its non-qualified status-remaining free of the headaches, limitations, and fiduciary requirements of qualified plans-it cannot be formally funded as an ERISA plan is required to be. Is it prudent for companies to implement non-qualified plans and simply wait a decade or two to find out if their cash flow is adequate to pay the benefits? That might produce a plan that looks good for the company short term, but what happens when the day to pay comes? What kind of legacy would such a plan leave for the future management of the company?

In small-to-medium companies, paying the benefits out of cash reserves is probably shortsighted. The benefit obligation will increase substantially in 20-30 years, while corresponding growth might not coincide with the need for funds. And equally important, executives are not likely to put their own money into a plan without a secure picture of the future. A more secure alternative is to informally fund the plan through either investments or corporate owned life insurance (COLI) or a blend of both.

The company can select a group of mutual funds, allowing the participants to allocate accounts among the funds. The company can either invest directly or simply credit the executives the funds' performance and manage the investment by another strategy. Using COLI the corporation pays the benefits by withdrawing money from policies until the company has recovered its basis in the policy. Then tax-free loans from the cash value are utilized. At the ultimate death of the participant, the death benefit goes back to the company, balancing its outlay.

Both strategies need to be carefully analyzed from the perspective of tax consequences. Investment growth is taxed at the corporate tax rate. When growth is credited to the participant, the company must achieve that growth, plus the amount of the tax. Otherwise, the difference comes out of the general assets of the company.

COLI offers the tax advantages traditionally associated with life insurance policies. Earnings within the policy are not taxable until withdrawn, so the cash surrender value will grow each year without being reduced by income taxes. Policy loans can be utilized to pay benefits, generally without taxable gain to the corporation, as long as the guidelines for life insurance contracts are met. Death benefits are received by the corporation free of income tax liability.

The growth of policy cash values and death benefits may have an impact on Alternative Minimum Tax calculations during the course of the plan, as these do not escape consideration as income for the calculation of AMT liabilities each year. If the company receives death benefits from the policies that are large in comparison to overall income, there could be additional income tax liability. However, the company could take deductions in future years for the AMT paid due to these proceeds.

Whatever the informal funding decision, an equally important issue is plan administration, and too many companies leave that as an afterthought. Indeed, executive benefit plans are often represented as trouble-free since IRS, DOL and SEC reporting regulations are minimized. However, no less important than reporting to the IRS is reporting to the participants and the company's financial officer on a regular basis.

The flexibility inherent in these plans makes such reporting too complicated for the internal resources of most companies, large or small. In addition, each report needs an analysis and recommendation component if the plan is to achieve performance results long term. Therefore, the objective analysis of an outside expert resource is imperative and an investment in administrative services will vital to the success of the program.

Another common problem is inadequate communication. To avoid a lot of downtime explaining the plan to participants, businesses get by with a booklet and a short rollout meeting. Left to their own efforts for retirement planning, most executives would demand complete decision-making information and consultation. A company-sponsored plan should provide them with more critical details, not fewer. This is true in the initial enrollment and continues in periodic reporting, if participants are expected to utilize and value the plan.

Another get-by strategy that raises dangers is inadequate plan documents. Business owners generally want to use their own attorneys because these advisors know the company better than an outsider could. But knowing the company is usually not as critical as knowing the nuances of the agreements of an executive benefits plan. Client attorneys should be involved in the decision-making process from the start. But if they do not have particular expertise and experience in executive benefit planning, they should have access to a legal specialist who does. If the plan documents are incorrectly drafted or if the required DOL letter is not completed and sent, the plan is not in compliance and heavy tax or penalty consequences loom on the horizon.

Finally, an executive benefits plan has a potential lifespan of many decades, and it will not be exempt from change. Changing circumstances in the company, changes in the financial environment, changes in regulation are inevitable, and all of them have consequences for the plan. A proactive review process-including input from internal resources and the outside advisory team-is an absolute necessity for the success of the plan. There is no point capturing missed opportunities today and letting them become problems a few years from now.