Fixed index universal life insurance

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Allianz Life Insurance Company of North America

# Nonqualified **deferred compensation** plans

## A cost-effective way to reward and retain employees

### A nonqualified deferred compensation plan (NQDC) allows your employees to set aside money – or benefits – that they can access later, under the conditions specified by the plan.

Fixed index universal life insurance **CAN HELP FUND** AN NQDC PLAN.

When properly structured, nonqualified benefit plans allow employees to defer income taxation until the benefits are paid.

These plans can be an effective employee retention tool if a vesting schedule applies, because employees will be required to wait until the specified time period to realize the payment and/or benefit offered by the plan.

### Consider using life insurance to informally fund the obligations of an unfunded NQDC plan.

Nonqualified benefit plans may be funded or informally funded with various products, including life insurance. To help pay promised benefits under the plan, you may decide to purchase a cash value life insurance policy on the employee, such as a fixed index universal life (FIUL) insurance policy.

An FIUL policy used to informally fund an NQDC plan can provide a death benefit to the employer; this, in turn, is used to pay a survivor benefit under the NQDC plan to the employee's family or other chosen beneficiaries.

In addition, the cash value accumulation in a life insurance policy is income-tax-deferred. And when retirement benefits are due to the employee under the NDQC plan, the cash value accumulation may be used by the employer through tax-free policy loans or withdrawals[1] to pay the employee the promised benefits.

As the employer, you begin by determining whether a nonqualified plan is right for you. You should discuss with your attorney the legal documents required to establish the plan. Your attorney will create those documents for you.

If you decide to use informal funding for your NQDC plan, your company could then purchase a cash value life insurance policy on your key employee. Your company owns the policy, pays the premium on the policy, and is the beneficiary of the policy. Over time, the policy's potential cash value accumulation may provide informal funding for the NQDC plan's retirement benefit.

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**Must be accompanied by the *Understanding fixed index universal life insurance* brochure (M-3959) or the appropriate product brochure.**

[1] Policy loans and withdrawals will reduce the available cash value and death benefit and may cause the policy to lapse, or affect guarantees against lapse. Withdrawals in excess of premiums paid will be subject to ordinary income tax. Additional premium payments may be required to keep the policy in force. In the event of a lapse, outstanding policy loans in excess of unrecovered cost basis will be subject to ordinary income tax. If a policy is a modified endowment contract (MEC), policy loans and withdrawals will be taxable as ordinary income to the extent there are earnings in the policy. If any of these features are exercised prior to age 59½ on a MEC, a 10% federal additional tax may be imposed. Tax laws are subject to change and you should consult a tax professional.

Product and feature availability may vary by state and broker/dealer.

M-5117

NQDC plans
OFFER **TAX BENEFITS**
to you and your employees.

When your employee reaches retirement age, your company, as the policy owner, may access any available cash value through loans and withdrawals, and use them to assist in paying agreed-upon benefits to your employee.

If the employee dies after the policy loans and withdrawals have started, your company could pay the employee's family or other selected beneficiaries any remaining death benefit owed to them as provided in the NQDC plan document.

If the employee dies before retirement benefits begin, your company would receive a death benefit that is generally income-tax-free.[1] If the NQDC plan promised a survivor benefit, your company would then pay this benefit to your employee's beneficiaries. (Generally, this survivor benefit could be equal to the amount deferred by the employee into the NQDC plan.) Your company would then retain any remaining death benefit minus any policy loans or withdrawals taken.

NQDC plans are
**FLEXIBLE** AND OFFER **VALUABLE** BENEFITS.

Keep in mind that any benefits paid to your employee (or the employee's beneficiaries) are fully taxable to them as ordinary income, and are subject to payroll taxes. Also, since life insurance is an underwritten product, any strategy that includes life insurance as the informal funding vehicle is contingent on the health and financial underwriting of the insured.

## Benefits of nonqualified deferred compensation plans

**They give you flexibility.** With nonqualified deferred compensation plans, you can design a plan that helps meet each employee's specific needs. That enables you to offer a more attractive plan to employees who are most critical to your business – while giving you control over which benefits are offered in the NQDC plan. It also allows you to select those key employees whom you wish to include in the NQDC plan.

**They're a valuable benefit.** NQDC plans, when informally funded with a life insurance policy, can offer necessary survivor benefits for your key employee(s). A survivor benefit can become a part of your employee's overall financial strategy.

**They can help reduce employees' annual income tax liability.** As long as employees are participating in an NQDC plan, they won't pay taxes on any income they defer or on any income promised to them, until it is actually paid to them from the plan at some point in the future.

**They help high-performing employees feel appreciated.** This, in turn, may encourage your employees to stay with your company longer because the longer they contribute to the plan, the greater their benefit pool may be.

**They're cost-effective.** Once they're set up, nonqualified deferred compensation plans are relatively easy to administer and maintain. Any costs associated with the maintenance of these plans are generally tax-deductible for your business, as are any benefit payments when you make them to employees.

**They help publicly traded companies.** Nonqualified deferred compensation plans help publicly traded companies provide qualified performance-based compensation that is not subject to the annual deduction limit.

[1] An employer-owned life insurance policy is subject to the requirements of Internal Revenue Code 101(j) in order to obtain an income-tax-free death benefit. In general, those rules require that before the policy is issued, the employer must provide the insured with a written notice of the life insurance, obtain a written consent from the insured, and provide the IRS with ongoing annual reporting regarding policy ownership. Consult with an attorney for application of those rules to a specific situation.

## Hypothetical example of an NQDC plan using life insurance

Gary works for Synergy Corporation (Synergy). He makes $300,000 per year and is looking for life insurance protection for his family. Synergy gives Gary the option of participating in a nonqualified deferred compensation plan. Gary elects to defer 10% of his annual income, or $30,000.

Using Gary's deferred income, Synergy purchases a fixed index universal life insurance policy and pays $30,000 into the policy each year for 20 years.

**Step 1.** Gary and Synergy work with an attorney to create a benefit structure (e.g., how much income will be deferred, whether Synergy will contribute money, how it will be invested, when Gary can collect it, how it will be paid out, etc.). If Synergy offers a survivor benefit through the NQDC plan, they will also discuss the policy's death benefit.

Synergy may consider attaching a vesting schedule to the benefit structure, as an extra incentive for Gary to stay with the company. The specifics of this benefit structure are drafted into a binding legal document. The parties will work with their respective tax advisor or attorney to ensure that the plan document conforms with Internal Revenue Code section 409A requirements.

**Step 2.** Gary defers part of his compensation on a pre-tax basis. Synergy pools the money to fund the promised benefits. If life insurance is used, policy loans[1] may be available to fulfill the obligation to Gary.

**Step 3.** When allowed by the plan, the funds or benefits are disbursed to Gary or his beneficiary(ies). These payments are usually tax-deductible for the business and become taxable income to Gary (as the recipient).

## The result

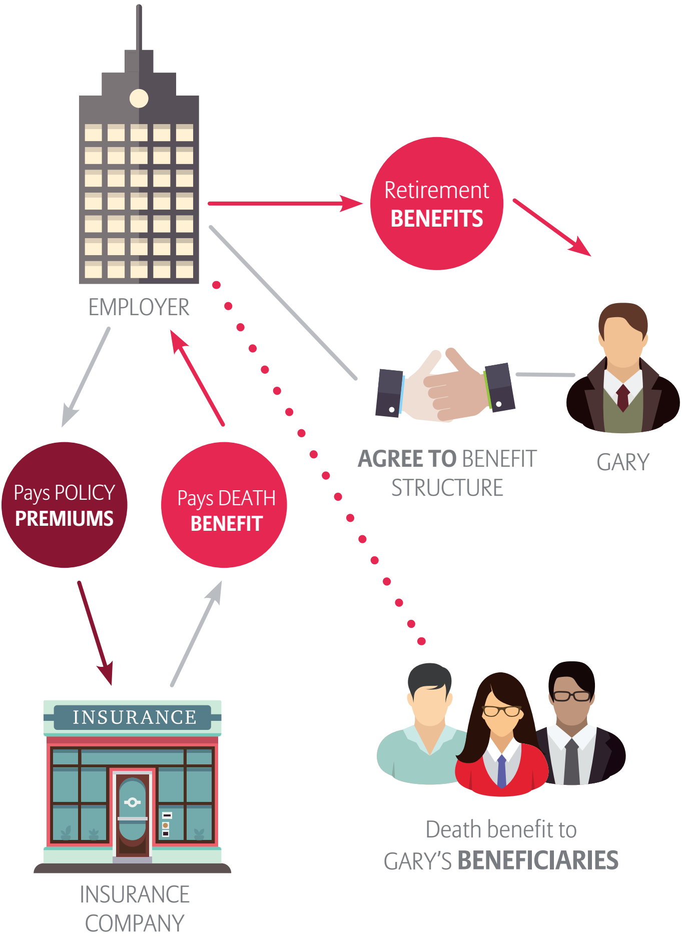
In this NQDC plan, Synergy is the owner and beneficiary of Gary's life insurance policy, and pays the premium using Gary's deferred compensation. If Gary were to die prior to retirement:

- Synergy would receive an income-tax-free death benefit.
- Gary's plan beneficiary would be paid a survivor benefit equal to the amount deferred in Gary's plan (fully included in taxable income).
- Synergy would retain any remaining death benefit.

If Gary were to reach retirement age, Synergy would access the policy's available cash value through policy loans[1] and pay Gary the amount promised for his retirement.

This hypothetical example is provided for illustrative purposes only. The character is fictional and not an actual Allianz client.

[1] Policy loans and withdrawals will reduce the available cash value and death benefit and may cause unintended consequences, including lapse or taxable events. Please see the full loan and withdrawal disclosure within this material for details.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COMPANY
Death benefit to
GARY'S BENEFICIARIES

## Special considerations of NQDC plans

- There are notice and consent requirements for employer-owned life insurance that all parties will need to review and sign, plus provide ongoing reporting to the IRS regarding policy ownership.
- Any financial vehicle used to fund plan obligations is subject to company creditors.
- NQDC plans may be offered only to a select group of employees of C corporations and S corporations.
- The business can contribute to the plan, if desired, whether or not the employee actually defers salary to the plan.
- All parties should consult with their attorney and tax advisor to discuss their NQDC plan situation.

**Could an NQDC plan be a good strategy for your business?** Talk to your financial professional and request a personalized illustration of a nonqualified deferred compensation plan with obligations funded by life insurance.

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