Executive Privilege

409A non-qualified deferred compensation plans

A turnkey retirement planning supplement for select employees

Products and financial services provided by
American United Life Insurance Company®
a OneAmerica® company
1 **Retirement for Key Employees**

Many employers offer qualified plans to help employees save for retirement. While these plans generally provide a sufficient vehicle for most workers to save for retirement, they tend to fall short for highly compensated employees (HCEs). IRS regulations and non-discrimination tests limit the amount of money that HCEs can defer into qualified plans.

The chart below illustrates the impact these limits have on the potential for HCEs to replace income at retirement. As salaries rise, the percentage of income that can be deferred falls. *The end result is that HCEs are left with an income deficit to fill at retirement.*

2 **Attracting, Retaining and Rewarding Key Employees**

Employers constantly face the challenge of attracting and retaining key employees. The fact is that top people have many options, and tend to stay where they are appreciated and appropriately rewarded. But such rewards need to be *mutually beneficial* for employer and employee. In today’s competitive economy, employers need to find ways to reward key personnel for performance that satisfies company goals.

### One solution

**409A Non-Qualified Deferred Compensation Plans**

409A plans allow key employees to defer income for retirement and can help employers motivate, reward and retain their top personnel. These plans avoid many of the restrictions inherent in qualified plans, offering the following advantages:

- **Discriminatory** — Employer selects the key employees who can participate.
- **Unlimited** — Participants can defer an unlimited amount of income, including bonuses.
- **Pre-tax** — Participant contributions are made on a pre-tax basis.

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**Retirement deficit for HCEs**

*Graph assumptions: Starting at age 45 and based on 2006 internal revenue code (IRC) limits, maximum 401(k) contributions assuming 3 percent annual salary growth with a 4 percent employer match. Highly compensated employee contributions are capped at 7 percent and subject to the 2006 maximum compensation limit of $220,000. 401(k) assets earn 8 percent in all years and generate retirement income, depleting all assets, from age 65 through age 85. Estimated social security retirement benefits assume no future increases in prices or earnings. Source information from the Annual Statistical Supplements to the Social Security Bulletin at http://www.ssa.gov/SSA_Home.html*
Employee/Employer contributions

Not only can 409A plans accommodate employee deferrals but they can also allow, or be exclusively funded by, employer contributions. The following example illustrates how 409A plans can be structured to uniquely reward employees for their service to the company.

- **A rewarding example** — a 409A plan could pay a bonus to select employees at a specified time. The bonus could be subject to a graded vesting schedule or paid only if the employee completes the service. Additionally, the terms of the bonus and vesting schedule can vary by employee. Employer-funded 409A plans give companies considerable flexibility in offering a bonus plan that specifically targets their business needs.

Comparison of 401(k) plans and 409A plans

Following are some of the fundamental differences between 401(k) plans and 409A plans:

<table>
<thead>
<tr>
<th></th>
<th>401(k) plans</th>
<th>409A plans</th>
</tr>
</thead>
<tbody>
<tr>
<td>Can plan participants be selected on an individual basis?</td>
<td>No</td>
<td>Yes¹</td>
</tr>
<tr>
<td>Can participants be limited to a select management group?</td>
<td>No</td>
<td>Yes¹</td>
</tr>
<tr>
<td>How much can a participant defer?</td>
<td>$15,000²</td>
<td>No limit</td>
</tr>
<tr>
<td>Can the employer contribute to the plan?</td>
<td>Yes</td>
<td>Yes</td>
</tr>
<tr>
<td>Does the employer receive a deduction for contributions?</td>
<td>Yes</td>
<td>No</td>
</tr>
<tr>
<td>Does the employer receive a deduction when benefits are paid?</td>
<td>No</td>
<td>Yes</td>
</tr>
<tr>
<td>Are contributions and earnings income tax-deferred to the participant?</td>
<td>Yes</td>
<td>Yes</td>
</tr>
<tr>
<td>Are participant benefits protected from employer bankruptcy creditors?</td>
<td>Yes</td>
<td>No</td>
</tr>
<tr>
<td>Are loans available to plan participants?</td>
<td>Yes</td>
<td>No</td>
</tr>
<tr>
<td>Is there an income tax penalty for distributions prior to age 59½?</td>
<td>Yes (10%)</td>
<td>No</td>
</tr>
<tr>
<td>Can participants roll money to an IRA?</td>
<td>Yes</td>
<td>No</td>
</tr>
<tr>
<td>Who pays the costs of plan administration?</td>
<td>Employer</td>
<td>Employer</td>
</tr>
</tbody>
</table>

1. 409A plans must be limited to a select group of management or highly compensated employees.
2. $15,000 in 2006; participants age 50+ can make additional “catch up” contributions ($5,000 in 2006) if the plan allows.
3. While non-qualified plans may include a variety of distribution options, IRC §409A has strict rules regarding the timing of making and changing contribution and distribution elections.

409A plan advantages

The Jobs Creation Act of 2004 established Internal Revenue Code §409A, which now governs most non-qualified deferred compensation plans. 409A plans are exempt from the vesting, funding, participation and fiduciary requirements of ERISA as long as they are offered only to a select group of management or highly compensated employees and a one-time statement is filed with the Department of Labor.

409A plan distributions

Aside from retirement, death, disability and separation of service, 409A plans can be structured to offer the following unique distribution events without penalty to the participants:

- **Specified dates** — Future distribution dates can be specified in the plan. For example, a participant could plan to take a distribution 10 years after his/her enrollment to finance a vacation home.
- **Specified events** — Certain specified events can trigger distributions. For example, the plan could specify that distributions be made during years when participants have children attending college.
- **Change in ownership/control** — The plan can allow for distribution of all participant assets if the company experiences a change in ownership or control.
- **Unforeseeable emergency** — Distributions can be made if participants experience an unforeseeable financial emergency.

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**Employee benefits**

Employees may defer an unlimited amount of their salaries and/or bonuses on a pre-tax basis, and any earnings attributable to these deferrals are credited on a tax-deferred basis. Below is an example of how much money could be accumulated and taken as retirement income if earnings are set aside pre-tax and allowed to grow tax-deferred in a 409A plan versus after-tax earnings growing in a taxable investment.

**409A plan vs. savings plan**

Assumptions: Age 45, 8% return, 32% tax bracket

<table>
<thead>
<tr>
<th></th>
<th>409A plan</th>
<th>Savings plan</th>
<th>Period</th>
</tr>
</thead>
<tbody>
<tr>
<td>Annual contributions</td>
<td>$15,000</td>
<td>$10,200</td>
<td>Years 1-20</td>
</tr>
<tr>
<td>Total annual contributions</td>
<td>300,000</td>
<td>204,000</td>
<td>Years 1-20</td>
</tr>
<tr>
<td>Account value at retirement (gross)</td>
<td>713,358</td>
<td>362,875</td>
<td>Age 65</td>
</tr>
<tr>
<td>Account value at retirement (after-tax)</td>
<td>485,084</td>
<td>362,875</td>
<td>Age 65</td>
</tr>
<tr>
<td>Annual retirement income (after-tax)</td>
<td>66,937</td>
<td>45,527</td>
<td>Years 21-30</td>
</tr>
<tr>
<td>Total retirement income (after-tax)</td>
<td>669,370</td>
<td>455,270</td>
<td>Years 21-30</td>
</tr>
</tbody>
</table>

**Employer benefits**

A 409A plan can be structured to help companies attract, retain and reward key employees. Employers may choose who participates in the plan from among their highly compensated and/or management employees. Employers can elect to match employee deferrals or make discretionary contributions into the plan. Such contributions can be subject to a vesting schedule that may differ for each employee. In fact, employers can discriminate as to who is allowed to participate in the plan as well as to what extent — all on an annually discretionary basis.

**Non-qualified deferred compensation**

409A plans are non-qualified plans and, therefore, exempt from ERISA vesting, funding, participation and fiduciary requirements. This means that employers may discriminate as to who participates in the plan and to what extent. In order for contributions to be made on a pre-tax basis, however, non-qualified plans must not allow participants to hold a beneficial interest in plan assets. To achieve this, 409A plan benefits must be an unsecured promise to pay from the general assets of the employer.

C-corporations are the best candidates for 409A plans because owners as well as key employees can participate. Note that while 409A plans may not directly benefit owners of pass-through entities (i.e., S-corporations, LLCs, partnerships, sole proprietors, etc.), they can benefit non-owner employees. Tax-exempt and governmental employers may adopt non-qualified plans, but additional rules apply under IRC §457.
**Plan structure**

**Deferral plan vs. SERP**

409A plans may be structured to accept employee and/or employer contributions, as follows:

- **Deferral plan** — allows employees to defer salary and/or bonus compensation into the plan; employees are always 100% vested in the plan benefits based on their own deferrals.
- **Supplemental executive retirement plan (SERP)** — allows only employer contributions and generally involves some type of vesting schedule for plan benefits.
- **Combination plan** — a combination of a deferral plan and a SERP; for example, an employer may offer to match employee deferrals.

**Defined benefit vs. defined contribution**

Another design consideration for 409A plans is whether to offer a defined benefit or defined contribution plan:

- **Defined benefit plan** — pays a specific benefit to participants at time of distribution. These plans are usually SERPs and do not specify contribution amounts. *Example plan benefit:* “Each participant receives $500,000 after ten years of plan participation.”
- **Defined contribution plan** — allows contribution values to accumulate in a hypothetical account for each participant. Participants may be allowed to allocate the value of their hypothetical accounts among a variety of indices based on the performance of selected investment options and/or fixed returns. Plan benefits for each participant are based on the value of his/her hypothetical account at time of distribution. *Example plan benefit:* “Each participant receives a monthly benefit for ten years based on the value of his/her hypothetical account at retirement.”

**Hypothetical account vs. notional asset reserve**

Defined contribution plans may be structured to base their benefits on account values determined according to the following methods:

- **Hypothetical account** — participants may allocate the value of their hypothetical accounts among a variety of indices based on the performance of certain investment options and/or fixed returns. The employer will often mirror these allocations in the plan’s funding vehicle.
- **Notional asset reserve** — allows the values of assets, like mutual funds or corporate-owned life insurance for each participant, to become the values used to determine the participant’s benefits. This is a popular design for plans with a small number of participants and/or employers that do not want the possibility of a discrepancy between hypothetical account and plan funding vehicle values.

**Rabbi trust**

An inherent risk of a 409A plan is that an employer might be financially unable to pay plan benefits at time of distribution. To reduce this risk, a Rabbi trust may be adopted to hold plan assets. The trust prevents the employer from using plan assets for purposes other than paying plan benefits, but does not protect the assets from creditors in the event of a bankruptcy. Rabbi trusts are often used in deferral plans but are less frequently used in SERPs.

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4. Depending on the funding vehicle and the employer’s funding commitment, plan assets and liabilities can become mismatched over time.
FUNDING
409A plans cannot truly be “funded” like a qualified plan. Qualified plan assets are generally held in trust for the participants. Non-qualified plan assets remain a general asset of the employer (or held in a Rabbi trust owned by the employer) and must be subject to the claims of company creditors. There is no requirement to fund a non-qualified plan; however, most companies choose to set money aside to meet future plan liabilities. Non-qualified plans are typically “informally funded” in one of the following three ways.

Unfunded
Since there are no requirements for a 409A plan sponsor to establish a reserve to pay future benefits, one funding option is to simply pay plan benefits when due from cash flows. This is increasingly the least desirable funding option for employers. Plan benefits are a legitimate debt of the company for which a sufficient reserve should be established. Additionally, the nature of the plan and the often unique relationship between the company and participants typically mandates some type of informal funding.

Taxable assets
Unless the employer chooses to informally fund its 409A plan with an asset that is tax-exempt or tax-deferred, any income or gain on plan assets is taxable to the company. This is true even if a Rabbi trust holds the plan assets for the employer.

“Taxable assets” may comprise almost any asset, including equity investments such as mutual funds. The obvious disadvantage to funding a 409A plan with taxable assets is that the company must pay taxes each year on any gain. Additionally, since employee deferrals are pre-tax and build tax-deferred for the participant, this means that the plan assets and liabilities can become increasingly mismatched to the company’s disadvantage over time.

Tax-deferred assets
Since 409A plan assets are held as a general asset of the employer, many companies choose to fund these plans with tax-deferred assets. The most common tax-deferred 409A plan funding vehicle is corporate owned life insurance (COLI).

COLI not only provides tax-deferral on any gain, but account values can be withdrawn from the policy to pay plan benefits on a first-in first-out (FIFO) basis. This means that at any point in time, an amount equal to the premiums paid can be taken from the policy tax-free. Additionally, any gain can be borrowed from the policy without creating a currently taxable situation.

If a COLI policy is held until death, the proceeds are paid to the company tax-free. COLI proceeds can be used to pay participant death benefits, provide key person insurance and/or reimburse the company for the 409A plan costs.
Our Executive Privilege 409A program brings together all legal, funding and administrative elements of a non-qualified deferred compensation plan, and consolidates them into one easy-to-establish, turnkey package. Leveraging the widely recognized expertise in employer-sponsored retirement plans of American United Life Insurance Company® (AUL), a OneAmerica company, Executive Privilege offers a wide variety of unique features and benefits.

**EXECUTIVE PRIVILEGE FUNDING VEHICLE**
A flexible premium variable universal life (FPVUL) insurance policy serves as the primary funding vehicle for Executive Privilege 409A plans. In addition to providing the inherent tax advantages of life insurance, a FPVUL offers a variety of benefits that make this type of policy well-suited for corporate ownership.

**Key person and split dollar arrangements**
Corporate owned life insurance can be structured to provide multiple benefits to owners and beneficiaries. For non-qualified plans, COLI can serve as the plan’s informal funding vehicle and provide life insurance for a variety of needs and beneficiaries. For instance, the policy proceeds could be structured not only to reimburse the employer for all plan costs but provide key person insurance as well. Another option would be to pay a portion of the proceeds to the participant’s spouse under a split dollar arrangement. Under such an arrangement, the spouse could receive a benefit equal to what the participant intended to save for retirement if he/she had lived and continued to contribute to the plan.

**PLAN DEVELOPMENT & ADMINISTRATION**
One of the first steps to installing a 409A plan is the company’s adoption of a plan document. A sample plan document is provided but a practicing attorney must generate an executable version. AUL has contracted with McCamish Systems, LLC, a nationally-recognized third party administrator (TPA) in non-qualified plans, to provide plan administration services. McCamish Systems will prepare a customized fee quote based on the features of the plan. Other steps to installing a plan include:

- If desired, an enrollment meeting may be held with prospective participants to review plan features.
- Each participant completes a joinder agreement and any related insurance applications.

For more information about Executive Privilege, please visit [www.oneamerica.com/executiveprivilege](http://www.oneamerica.com/executiveprivilege).
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