Reward Key Employees with

Deferred Compensation Plans

Reward your employees. Protect your business.

Regardless of how big or small your business is, you probably have at least one employee that you can't function without—and in many cases, it's you.

Traditional qualified retirement plans like 401(k), SEP IRA, or Simple IRA plans provide important benefits. But for higher earners or executives, these plans do not allow large enough contributions to help them meet their retirement goals—or to significantly reduce income taxes. Deferred compensation plans let you provide more substantial benefits to the employees that make the most meaningful contributions to your business. They can also be an effective way to recruit, reward, and retain top talent.

And there are a number of options to meet the distinct needs of your employees—and your business.

Employees earning $150,000 can save less than 12% of their salaries with traditional 401(k) plans, hardly enough to generate the 70-90% of their income that experts say will be needed in retirement.

Help Key Employees Reduce Current Taxes

Taxes only seem to go in one direction—up—especially when looking at taxes for high earners and business owners. Recent tax changes have hit this group the hardest, significantly reducing their take home pay. Deferred compensation plans can allow employees to defer more income, helping them reduce current taxes and save more for retirement.

A Taxing Situation

While many individuals may not be affected by recent tax changes, high earners are feeling the pinch. Increases in FICA and the continued existence of the Medicare 3.8% surtax impact this group the most. Additionally, the American Taxpayer Relief Act (ATRA), increased the marginal tax rate for high earners, as well as the tax rate on long-term capital gains and dividends. Taken together, these taxes have created a knockout punch that is hitting high earners very hard. Deferred compensation plans give business owners the ability to offer employees an additional pre-tax retirement savings benefit—in order to potentially minimize or avoid some of these taxes.

The Retirement Income Gap

Financial experts tend to agree that maintaining your lifestyle in retirement will require 70-90% of your pre-retirement income. But with qualified plan and Social Security limits, how is an executive supposed to meet this goal? Consider that Social Security was designed to provide supplemental retirement income, not to replace large incomes. Additionally, qualified plans cap the dollar amount you can contribute. So with both Social Security and qualified plans, the more you earn, the less you can replace. For example, at current limits:

- An employee who makes $50,000 per year is able to contribute up to 35% of their salary and will have Social Security replace 47% of their salary during retirement.*
- An employee earning $300,000 per year is only able to contribute 5.8% of their salary and will only receive about 12% of their pre-retirement income from Social Security during retirement.*

The more you earn, the less you can save with a 401(k)**

* This example is provided for illustrative purposes only. It is based on 2014 Cost of Living Adjustment (COLA) limits and retirement at age 67 in 2014.
** Illustration only shows elective deferrals. Savings could be greater if client is over age 50 and/or if the plan has a profit sharing component.

Deferred compensation plans enable you to help employees lower their current income and save more for retirement — creating the potential to reduce current taxes, close the retirement gap and ensure loyalty.

Deferred Compensation–Immediate Benefits

Put simply, deferred compensation plans can become the competitive advantage your business needs. Not only do they provide the opportunity to lower taxable income for key employees, but they also enable more money to be saved for retirement (which in turn leads to more tax-deferred growth). They also help your business recruit, retain and reward key employees—including you.

Ability to Tailor Offering

One of the most important differences between deferred compensation plans and traditional qualified plans is that a deferred compensation plan provides the flexibility for you to select just a few key employees (or just one) to participate without having to worry about ERISA, complex administration, or other tests. So, who are key employees?

- A select group of management or highly valued employees
- Highly compensated employees
- A group that represents no more than 15% of your workforce

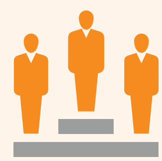
Go for the Win-Win

Benefits Provided	Deferred Compensation Plans	Qualified Plans
Ability to defer current income	X	X
Ability to reduce current income taxes	X	X
Tax-deferred growth of values	X	X
Benefits tax-deductible by business when made		X
Benefits tax-deductible by business when paid	X	
No limits on contributions and/or retirement benefits	X	
Flexibility to select who receives benefits	X	
Ability to customize terms to each employee	X	
Potential to recoup plan costs	X	
No required minimum distributions at age 70 ½	X	

Tailor a Plan to Meet Your Needs

There are a number of deferred compensation plan options available to your business. While some plans are funded by employees, others can be funded by the business, or a combination of both. These plans are sometimes referred to as "golden handcuffs" because they enable the business to make the plan benefits conditional on tenure, performance and other requirements—helping to ensure loyalty. You can completely customize these conditions to the needs of your business. Plus, the plans remain assets of the business until the benefits are paid.

Shared Benefits of All Deferred Compensation Plans

	
The Business	**Key Employee**
Can select which employees can participate	There are no limits on how much can be saved toward retirement
Not subject to restrictions of qualified plans	Deferred amounts are not subject to income taxation until received.
No IRS approval is needed	Helps fill the retirement income gap
Flexibility to customize plan	Gain the potential for tax-deferred growth of contributions
Eligible for tax deduction in the years benefits are paid to the employee	Can provide disability or survivor benefits before retirement
Can recoup plan costs when life insurance is used as funding vehicle	Can reduce employees' current adjusted gross income

60% of business professionals believe a strong benefits package is very important in attracting and retaining quality employees—compared to only 38% who believe a high base salary is very important.[1]

[1] Harvard Business Review Analytic Services, 2011

Deferred Compensation Plan Options

You can design a deferred compensation plan to fit your own needs—and those of your employees. Each type of plan offers numerous shared advantages and a few unique ones as well.

Salary Deferral Plans

Salary deferral plans are a type of defined contribution plan that works much like a traditional 401(k) plan to allow employees to defer current income for future benefits.

Unique Advantages

Employees are able to defer more of their salary than a traditional qualified plan allows, enabling them to potentially reduce their current taxable income, and exposure to the 3.8% Medicare surtax, while building additional retirement savings to help close the retirement income gap.

How They Work

1. The employee makes contributions by reducing their current salary (and current income taxes)
2. Because the contributions are made with deferred income, your employees are immediately vested[2]
3. The deferred amounts are held by the business and paid to the employee at retirement. The benefit amount is based on how the account value grows.
4. The business takes a tax deduction when the benefits are paid to the employee
5. If the employee passes away before—or potentially after—retirement, their family may receive a death benefit

[2] All plan contributions are considered an asset of the business and may be subject to creditors or forfeiture.

401(k) Overlay Plans

Sometimes referred to as 401(k) mirror plans, 401(k) overlay plans are very similar to traditional 401(k) plans—and can be used as the primary retirement plan.

Unique Advantages

These plans offer the same benefits as the deferral plans previously described. In addition, they enable your business to make contributions and create a vesting schedule for those assets.

How They Work

1. The employee makes contributions by reducing their current salary (and current income taxes)
2. Your business also makes contributions—whether matching or not
3. The employee is fully vested in their own contributions at all times
4. The business' contributions can be subject to a vesting schedule (as described in the plan document)[2]
5. The deferred amounts are held by you and paid to the employee at retirement. The benefit amount is based on how the account value grows.
6. The business can take a tax deduction when the benefits are paid to the employee
7. If the employee passes away before—or potentially after—retirement, their family may receive a death benefit

Defined Contribution Plans

Supplemental employee retirement plans (SERP) are defined contribution plans that provide retirement income for employees. It is important to note that the contribution is defined, while the end benefit will depend on asset growth.

Unique Advantages

All contributions are made by the business, so employees receive an attractive, supplemental retirement income benefit.

How They Work

1. The business creates an agreement with the employee that defines:
    a. The contributions that the business will make on their behalf
    b. When the business will begin paying the benefits and for how long
    c. Any conditions that need to be met to receive the benefits—like years of service, performance goals or other criteria
2. The business makes the contributions as defined
3. The business pays the benefits at the agreed upon time. The benefit amount will depend on the amount and duration of contributions, investment earnings, vesting and other factors[2]
4. The business takes a tax deduction when the benefits are paid to the employee.
5. If the employee passes away before—or potentially after—retirement, their family may receive a death benefit

Defined contribution plans are those where the contribution being made is a "defined" or set amount.

Defined Benefit Plans

SERP defined benefit plans are funded by businesses and provide employees with a specified amount of income in retirement. In other words, the business agrees to provide a certain dollar amount or a set percentage of salary for a defined period of time (such as 10-20 years of retirement).

Unique Advantages

Like defined contribution plans, these plans are funded by businesses and provide employees with guaranteed income in retirement. Agreeing to pay some income later, rather than more income now helps your employees to avoid additional income taxes, capital gains tax and the Medicare surtax, while providing them with an agreed upon level of supplemental retirement income.

How They Work

1. The business creates an agreement with the employee that defines:
    a. The benefit amount the business will pay them at retirement—typically a set amount or a percentage of their final salary
    b. When the business will begin paying the benefits and for how long
    c. The conditions that need to be met to receive the benefits—like years of service, required consulting after retirement, performance goals or other criteria
2. The business pays the benefits as defined
3. Your business can take a tax deduction when the benefits are paid to the employee
4. If the employee passes away before—or potentially after—retirement, their family may receive a death benefit

Note that with these plans, you are required to pay the benefit whether or not you have adequate funds set aside. And all funding methods are not created equally (see page 13 for additional details).

Defined benefit plans are those where the ultimate benefit being paid is a "defined" or set amount.

Which Plan is Right for You?

There are several options and a number of considerations to think about in order to determine which type of plan may be right for you, your key employees and your business. This chart offers a high level overview of the plan options. Your financial professional can help you select the most appropriate plan.

Deferred Compensation at-a-Glance

	Deferral Plan	401(k) Overlay / Mirror Plan	Defined Contribution Plan	Defined Benefit Plan
How it Works	Employee defers a portion of their salary for future benefit	Employee defers a portion of their salary for future benefit The business can choose to match contribution or provide a discretionary amount	The business agrees to make specified contributions to the plan	The business agrees to pay the employee a specified benefit amount at a future date, typically retirement
Who Funds the Plan	Employee	Employee and Business	Business	Business
Benefit Amount Paid	Based on investment earnings, if any	Based on investment earnings, if any or set rate of return depending upon plan	Based on investment earnings, if any or set rate of return depending upon plan	Defined when the plan is created Can be a set amount or based on percentage of salary or other criteria
Vesting *Contributions are considered an asset of the business and may be subject to creditors or forfeiture*	100% immediate	Employee contributions are 100% immediate Business contributions are based on schedule	Based on schedule	Based on schedule
Key Benefits for Employees	Reduces employee's current adjusted gross income Opportunity for tax-deferred savings	Reduces employee's current adjusted gross income and provides additional tax-advantaged compensation to employee Opportunity for tax-deferred savings	Additional tax-advantaged compensation to employee Opportunity for tax-deferred savings	Additional tax-advantaged compensation to employee that provides defined amount or % of income replacement at retirement Opportunity for tax-deferred savings
Key Benefits for the Business	The business receives a tax-deduction when benefits are paid	Ability to offer a 401(k) type plan without the same level of reporting or government oversight	Can use vesting schedules or other criteria to create loyalty with "golden handcuffs"	Can use vesting schedules or other criteria to create loyalty with "golden handcuffs"

Options for Tax Exempt Organizations

457 plans enable tax-exempt organizations to make contributions on behalf of their highly paid employees in order to help them reduce current income taxes and save more for retirement:

- Eligible plans under IRC 457(b) limit the amount of contributions, but defer taxes until the income is received
- Ineligible plans under IRC 457(f) have no contribution limits, but require taxes to be paid when employees are fully vested

Comparing the Funding Options

Just as there are a number of deferred compensation plan options, there are a number of ways to fund the plans. Some may help you provide even more benefits to your employees (or yourself). This grid will help you compare some of the options and your financial professional can help you determine what makes sense for your specific needs.

	Funding Type			
Benefits Offered	**Life Insurance** Plan contributions are used to purchase a life insurance policy on the employee.	**Investment Account** Investment accounts can take many forms and can be invested in stocks, bonds, cash, or other financial assets.	**Cash Flow** Using current cash flow to pay for plan benefits (assumes you will have enough cash flow when benefits are due to be paid).	**Annuities** Plan contributions are used to purchase an annuity.
Income-Tax-Free Growth of Assets				
Potential to Recoup Plan Costs from Policy Proceeds				
Income-Tax-Free Death Benefits				
Ability to Offer Disability Benefits				
Cost Effective				

Other Considerations

There are a number of federal tax and other considerations that both businesses and employees should take into consideration when establishing deferred compensation plans. Your tax advisor and Financial Professional can help you better understand all of your options.

Who is Deferred Compensation Right For?

Deferred compensation plans may be a good fit for small, family-owned or privately held businesses looking to attract, reward and retain executives and other key employees. Depending on the type of company entity, however, these types of plans may be more—or less—attractive. You should consult your tax advisor.

Plan Administration

Although they are not subject to ERISA, the IRS does have rules and filing requirements for deferred compensation plans. To help ensure compliance and avoid any potential consequences for breaking these rules, consider:

- Hiring an attorney to draft your plan agreement
- Consulting a tax advisor
- Using a third party administrator (TPA) for plan administration

Tax Deductions

Regardless of the funding type selected, contributions are not tax-deductible to the business until the benefits are paid to the employee. And with the exception of a 457 ineligible plan, employees are taxed when the benefits are received. Currently, employees will have to pay Social Security payroll taxes (FICA/FUTA) on deferred amounts in a 457 ineligible plan when they become vested in them.

Plan Assets are Business Assets

In all instances, the assets in a deferred compensation plan are considered business assets until they are paid as benefits to the employee. This means that the assets are subject to any creditors of the business. In order to help provide some protection for plan assets, consider using a Rabbi Trust (see sidebar).

Adding Security to Deferred Compensation Plans

Establishing a Rabbi Trust for your plan can help provide peace of mind for employees. Rabbi trusts are irrevocable, so the trust cannot be revoked due to ownership changes, company changes of heart or changes in your company's financial condition. Additionally, these trusts ensure the assets cannot be used for purposes other than paying participant benefits. However, the assets are still subject to the business' general creditors.

Protecting Your Business

Your business cannot function without your key employees. And today, keeping them loyal and productive means helping them to reduce their significant tax burden—and close the retirement income gap.

Deferred compensation plans let you select the employees you would like to reward. All of the plans enable your employees to save far more for retirement than traditional qualified plans. And, when funded using life insurance, you and your employees can truly maximize your options—and your benefits.

Of course, with so many good choices, it can be challenging to determine which one is right for your situation. Your financial professional can help you find the right solution to help your business attract, reward and retain key employees.

Our Noble Purpose

Since 1847, Penn Mutual has been driven by our noble purpose – to create a world of possibilities, one individual, one family and one small business at a time. As an original pioneer of mutual life insurance in America, we believe that purchasing life insurance is the most protective, responsible and rewarding action a person can take to build a solid foundation today and create a brighter future for generations to come.

Life insurance policies contain exclusions, limitations, reductions of benefits and terms for keeping them in force. Accessing cash values may result in surrender fees and charges, may require additional premium payments to maintain coverage, and will reduce the death benefit and policy values. Loans are income tax free as long as Policy is not a "modified endowment contract" (MEC) and policy must not be surrendered, lapsed, or otherwise terminated during the lifetime of the insured. All guarantees are based upon the claim-paying ability of the issuer.

This information is not intended to be comprehensive legal advice on deferred compensation plans. Any reference to the taxation of life insurance products in this material is based on Penn Mutual's understanding of current tax laws which are subject to change. You should obtain qualified tax counsel relative to your particular financial situation.

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