EXECUTIVE SUMMARY

Many companies offer nonqualified benefits programs such as deferred compensation and supplemental executive retirement plans (SERP) to their executives and top employees. While these programs are not eligible for funding through secured qualified plans, companies can opt to informally fund them in an effort to improve benefit security, minimize P&L volatility and maintain accountability. The evaluation of alternative methods for funding for these programs typically comes down to the use of: (i) mutual funds and/or (ii) corporate-owned life insurance (COLI), due to its tax and accounting advantages.

The use of a mutual fund approach appears very straightforward in the sense that mutual funds have become part of everyday life, and since the majority of nonqualified deferred compensation (NQDC) plans outwardly appear to emulate 401(k) plans. Furthermore, many 401(k) plan platforms may be willing to record-keep this type of plan for no additional out-of-pocket fee; be aware, that this approach can make it difficult to identify costs to the Plan.

By comparison, the use of COLI is seemingly more complex. There is still a similar array of investment choices available, but they are held inside the chassis of specially designed, institutional insurance policies; typically, to fund these programs a company purchases and holds life insurance policies, covering the lives of the nonqualified plan participants. The company pays the premium, owns the cash value of the policy, and becomes the beneficiary of the insurance. Like any financial instrument, COLI has potential risks that must be balanced with the important advantages it offers companies and plan participants.

The following materials attempt to further explain both strategies while also debunking the many misconceptions of each.
INTRODUCTION

Medium and large-sized companies frequently offer various nonqualified benefit programs such as deferred compensation plans to their valued employees and executives. For the company, the liabilities resulting from these plans can start out small, but may grow exponentially within a short period. To offset the financial impact of these liabilities to the company, and to provide greater benefit security for participants, many employers have chosen to informally fund their nonqualified benefit programs.

WHY INFORMALLY FUND EXECUTIVE BENEFITS?

Before looking specifically at either strategy, it is important to understand why employers choose to fund nonqualified plans in the first place. There are three primary reasons:

1. Provide a Competitive, Secure Benefits Package — The federal government limits a company’s ability to provide executive benefits through fully funded and secured qualified plans. As a result, companies must find other ways to deliver benefit security to valued executives and ensure the competitiveness of their compensation plan. Unfunded nonqualified plans are an option, but they do present the risk that adequate funds will not be available at the time the participant wants to receive the monies. For an executive who may have more than 90% of his/her total retirement income at stake in this kind of plan, funding provides important peace of mind.

2. Minimize Profit and Loss (P&L) Volatility — Unlike qualified plans, nonqualified plans cannot be formally funded via segregated trust assets. As a result, companies must separately maintain the benefit liabilities and accruals on the books without a direct financing offset. By informally funding (also referred to as financing or hedging) these costs, companies can minimize the impact of volatility in the financial markets, which could hamstring shareholder value by negatively impacting a company’s P&L during a given reporting period. The assets used to hedge also typically mirror the costs associated with the benefit liabilities which results in no net impact to the P&L.

3. Maintain Accountability — While companies are not required to set aside or earmark assets to pay future benefit promises, many feel it is the right thing to do. This approach avoids “Social Security syndrome,” minimizes burden on future management to pay benefits, and reduces the risk that cash will not be available.

WHY INFORMALLY FUND WITH MUTUAL FUNDS?

When funding nonqualified liabilities, using products that offer tax-favored returns may be unnecessary. This could be the case if:

- The company is not a normal tax-payer.
- The company only has a very short-term view/time horizon they are focused on.
- A plan has been frozen and is winding down, or has insufficient participation to warrant the potential financial advantages of a tax-favored strategy.

HOW DO MUTUAL FUNDS IMPACT THE COMPANY’S FINANCIALS?

The purchase of any investment or financial instrument has associated costs. An employer typically purchases mutual funds through cash flow funds. There is no immediate change to the balance sheet because both are assets.

A company earns income from dividends, realized gains, as well as any unrealized appreciation in the market value of equity mutual funds, as well as interest, coupons and/or appreciation in fixed income funds.

From a cash flow perspective, the company is taxed on the income/gain that is realized within the portfolio, which means that as participants rebalance their portfolios and continue to be credited with tax-deferred returns, their reallocation may trigger additional taxes for the company. In essence, the company must continually subsidize the cost of the plan by paying taxes on the mutual fund assets along the way, while continuing to credit tax-deferred returns to participants’ accounts.
Further, since corporations don’t receive the same favorable capital gains treatment as individuals, the tax cost/subsidy—at ordinary corporate tax rates—can be meaningful, particularly at times of significant run-ups in the financial markets.

Finally, from an accounting perspective, mutual funds are commonly held as “Trading Securities” under FAS 115, or using the “Fair Value Method” under FAS 159. In both cases the company marks the value of the funds to market, and must book a commensurate tax liability, irrespective of whether or not any gains were actually realized.

WHY INFORMALLY FUND WITH COLI?

When funding nonqualified liabilities, using products that offer a tax-advantaged yield makes sense. The tax benefits of COLI include:

- Reducing taxes on invested assets, increasing after-tax returns and enhancing shareholder value.
- Income tax advantages over alternative investment options¹ including:
  - Tax-deferred growth of cash value²
  - Tax-free reallocation within policies³
  - Tax-free receipt of death proceeds⁴
- Low net-cost loans and withdrawals⁵
- The ability to access COLI cash values via tax-free loans and withdrawals for cash flow flexibility
- Favorable accounting and P&L treatment relative to taxable investments

In general, the reaction to COLI is positive. Executives can take comfort in knowing that a company’s cash flow demands won’t disrupt their benefits, while employers know that assets will be available for distribution. The coverage costs the employees nothing, but makes the employer more financially viable. As a result, when employees are asked for the required consent to coverage, many of them do so without issue.

HOW DOES COLI IMPACT THE COMPANY’S FINANCIALS?

Similar to mutual funds, an employer typically purchases COLI through cash flow funds, and there is no immediate change to the balance sheet because both are assets. Over time, because COLI earns an after-tax rate of return that may be higher than similar taxable investments, income statements will indicate additional income that translates into increased net worth.

A company earns COLI income from two sources: (i) any growth of the cash value of the policy as a result of gains in the underlying investments, and (ii) the insurance proceeds paid to the company when insured employees die. From an accounting standpoint, these are typically recorded as “Other Assets” and “Other Income.” COLI policies produce financial statement income for the company if the cash surrender value exceeds the cumulative premiums paid. The net after-tax income earned may be higher than the return available of that for many alternative investment products.

THE RISKS OF COLI

As with any financial vehicle, COLI has potential risks that balance its rewards. Companies should consider:

Changes to the Taxation of Life Insurance — Historically, life insurance has generally enjoyed “grandfathering,” where tax changes apply prospectively to new policies acquired after the date the legislation is enacted.

Carrier Insolvency — Variable life policy assets are held in a separate account and are not subject to the claims of general creditors.

Performance of a Selected Product/Carrier — This is mitigated by the fact that companies transfer from one COLI policy/carrier to another via IRC §1035 tax-free exchange.

Inability to Deduct Losses in Down Market — COLI is a long-term investment. The lack of short-term deductions is offset by longer-term advantage of tax-deferred buildup on gains.

Definition of Life Insurance — The carrier will certify that the policy qualifies as a contract of life insurance under current regulations.

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¹ Assuming a regular tax situation
² Subject to IRC §7702 and §817
³ Rev. Rul 82-54
⁴ Subject to IRC §7702 and §101
⁵ Subject to IRC §7702, §7702A and §72
## COMPARING COLI TO TAXABLE INVESTMENTS

<table>
<thead>
<tr>
<th></th>
<th>TAXABLE INVESTMENTS</th>
<th>VARIABLE COLI</th>
</tr>
</thead>
<tbody>
<tr>
<td><strong>GENERAL</strong></td>
<td>Mutual Funds</td>
<td>Individual life insurance contracts</td>
</tr>
<tr>
<td></td>
<td>Monies invested in an array of taxable investment vehicles (equity based, bond based, etc.) at investment owner’s discretion</td>
<td>Cash value invested in sub-accounts (equity based, bond based, etc.) at policy-owner discretion</td>
</tr>
<tr>
<td><strong>TAXATION:</strong></td>
<td></td>
<td></td>
</tr>
<tr>
<td><strong>INVESTMENT EARNINGS</strong></td>
<td>Realized gains are taxable</td>
<td>Not taxable unless policy is surrendered</td>
</tr>
<tr>
<td></td>
<td>Previously unrealized gains are realized and taxable</td>
<td>Not taxable</td>
</tr>
<tr>
<td></td>
<td>Partial tax exclusion may be available</td>
<td>Not taxable</td>
</tr>
<tr>
<td></td>
<td>At liquidation, previously unrealized gains are realized and taxable</td>
<td>At death, proceeds are received income-tax free (significant reduction of long-term plan costs)</td>
</tr>
<tr>
<td><strong>REALLOCATION AMONG FUNDS</strong></td>
<td></td>
<td></td>
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<tr>
<td><strong>DIVIDENDS</strong></td>
<td></td>
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<tr>
<td><strong>PROCEEDS AT LIQUIDATION/DEATH</strong></td>
<td></td>
<td></td>
</tr>
<tr>
<td><strong>EARNINGS IMPACT</strong></td>
<td>Realized and unrealized gains flow through to Income Statement (assets are marked to market); deferred tax liability booked on unrealized gains(^7)</td>
<td>All earnings flow through to income statement (offsetting annual benefit costs) although no tax-deferred liability is booked</td>
</tr>
<tr>
<td></td>
<td></td>
<td>Death proceeds in excess of already recognized cash surrender value are recognized in earnings</td>
</tr>
<tr>
<td><strong>RABBI TRUST INCLUSION</strong></td>
<td>Favorable IRS ruling</td>
<td>Favorable IRS ruling</td>
</tr>
<tr>
<td><strong>LIQUIDITY</strong></td>
<td>Yes</td>
<td>Yes(^8)</td>
</tr>
<tr>
<td><strong>TAX EFFICIENCY</strong></td>
<td>Can be structured to be more tax efficient, but the investor gives up direct control</td>
<td>Life insurance is inherently efficient from both a tax and an earnings perspective</td>
</tr>
</tbody>
</table>

Investing in mutual funds involves risk, including possible loss of principal.

Bonds are subject to market and interest rate risk if sold prior to maturity. Bond values will decline as interest rates rise and bonds are subject to availability and change in price.

Variable Universal Life Insurance/Variable Life Insurance policies are subject to substantial fees and charges. Policy values will fluctuate and are subject to market risk and to possible loss of principal. Guarantees are based on the claims paying ability of the issuer.

No investment strategy assures a profit or protects against a loss.

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\(^6\) Assuming a regular tax situation, and subject to IRC §7702, §7702A, §101, §72, and 817, FASB Technical Bulletin 85-4, and Rev. Rul. 82-54

\(^7\) When assets are categorized as “Trading.” However, in an effort to be more conservative, accounting firms are increasingly requiring that the investments be classified as “Available for Sale,” resulting in only realized gains flowing through P&L.

\(^8\) Life insurance provides liquidity upon death of the insured. Policy loans and/or withdrawals are available, but can reduce benefits received upon death. In addition, early withdrawals may trigger tax penalties.
DO COMPANIES PROFIT FROM DEATH BENEFITS?

One concern around COLI stems from the perception that a company “profits” from the death of the executives who are insured. Ultimately, the employer does receive a tax-free death benefit, which it is legally entitled to, given the consents it must receive from the executives it insures. The benefit is then used to finance nonqualified executive benefits that cannot be formally funded, which is to say, to make payments to executives due distributions from their plan. Once a death benefit is paid, the company loses the future tax benefits of the policy. Furthermore, in the event an insured executive dies while still actively employed, the policy can provide “key person” proceeds to help the company defray the costs of finding and hiring a suitable executive as a replacement.

Finally, life insurance is a known retirement savings vehicle. Many executives employed by small and large companies alike have independently purchased individual life insurance with the idea of using the tax-advantaged cash value to save for retirement. In fact, life insurance tax law recognizes this legitimate use of insurance. By doing the same thing as an executive group within a company structure enables additional advantages to accrue to the executive and the company – product pricing and distribution costs are typically improved and guaranteed issue insurance is usually available. Moreover, in a group situation, the company will typically recover many of its costs from the death benefit.

Because COLI can reduce taxes on invested assets – essentially increasing after-tax returns and enhancing shareholder value – the company is taking a more efficient approach to something executives might choose to do on their own.

CONCLUSION

As companies evaluate nonqualified plan funding vehicles, many find that practicality narrows the field to mutual funds, COLI, or a combination of both. With its tax advantages and ability to deliver value to participants and shareholders, many employers have found COLI to be the preferred choice for informal funding some or all of their nonqualified benefits plan liabilities.

Sheridan Road Financial is highly qualified and prepared to help you evaluate how each of these alternatives would work for your company/plan(s).

Investors should consider the investment objectives, risk, charges and expenses of the mutual fund, variable annuity contract and the variable annuity sub-accounts carefully before investing. The prospectuses and, if available, the summary prospectuses contain this and other important information about the mutual fund, variable annuity contract and variable annuity sub-accounts. You can obtain prospectuses and summary prospectuses from your financial representative. Read carefully before investing.

Securities offered through LPL Financial, Member FINRA/SIPC. Investment advice offered through Sheridan Road Advisors LLC, a registered investment advisor. Sheridan Road Advisors, LLC and Sheridan Road Financial, LLC are separate entities from LPL Financial.

The information contained herein is not intended to be a substitute for specific individualized tax or legal advice. We suggest you discuss your specific situation with a qualified tax or legal advisor.
Sheridan Road Advisors, LLC ("Sheridan Road", the "Company", or the "Firm") is an independent, objective, and holistic institutional investment consulting firm that provides Retirement Plan Consulting Services, Executive Benefits and Wealth Management Services. We oversee approximately $10.5 billion in assets and serve more than 260,000 participants in our retirement plans. Sheridan Road focuses on both corporate and tax-exempt defined contribution and defined benefit retirement plan consulting with approximately 80% of the total assets under management coming from these services.

Sheridan Road currently works with approximately 230 retirement plan clients across more than 20 states representing virtually every market segment and industry group. Our clients’ retirement plans range in size from the middle-market (< $50 million) to the institutional plan market (> $1 billion). The Company has offices in Chicago, Indianapolis, Milwaukee, Minneapolis, Nashville, New York, and Tampa to better service our client base.

Securities offered through LPL Financial, Member FINRA/SIPC. Investment advice offered through Sheridan Road Advisors, a registered investment advisor. Sheridan Road Advisors and Sheridan Road Financial are separate entities from LPL Financial.

About the Author

Brian Ellerman has over 25 years of experience consulting on, designing, and implementing various types of supplemental and nonqualified benefits programs as well as qualified retirement plans and benefits financing strategies. Brian works with clients across the country, and works primarily out of Sheridan Road’s Chicago and Northbrook offices.