HOW TO SELECT the BEST DEFERRED COMPENSATION PLAN

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WHAT DO YOU NEED TO KNOW?

Compensating employees is one of the key concerns facing the business owner/manager today. Pensions and other retirement plans long have been part of the compensation picture. But changes in tax laws, an ever-expanding variety of deferred compensation options and workers' increasing expectations have all combined to make deferred compensation a critical part of running your business.

This booklet covers the basics of deferred compensation plans from a business owner's perspective. As benefits escalate in cost, a clear understanding of your options is vital.

In the following pages, we'll answer these key compensation-plan questions:

- Which plans provide the greatest tax benefits?
- Can some plans benefit the owner and key employees more than the average worker?
- How flexible is each plan?
- Which plans cost the least to set up and administer?

But remember: This booklet is not a substitute for personal, professional advice. The financial, legal and tax aspects of designing each particular plan vary.

Tip

For owners and employees alike, qualified deferred compensation plans offer one of the most tax-efficient ways to provide retirement benefits.

QUALIFIED VS. NONQUALIFIED PLANS

Deferred compensation plans fall into two major types — qualified and nonqualified. Both types delay payments to employees — allowing them to defer tax until they have an unrestricted right to the funds.

But, as the employer, your tax treatment differs greatly. You can currently deduct payments to a qualified plan, even though the funds are not taxable to the employee until a future date. You generally can't deduct payments to a nonqualified plan until they are taxed to the employee.

But nonqualified plans do have a major benefit. "Discrimination" rules — rules requiring that qualified plans benefit most employees on a generally equivalent basis — don't apply to nonqualified plans. As an owner, you can concentrate benefits on yourself and your key employees without making similar contributions for the bulk of your work force.

Which type of plan is best for your company? Think about this: When your 401(k) plan has reached its annual maximum amount, supplemental nonqualified plans are a great way to give extra benefits to highly compensated employees.

We will begin by looking at qualified plans — both the basics and specific defined contribution and defined benefit plan alternatives. Then, starting on page 21, we will discuss nonqualified plans followed by four nonqualified plan options.

SHOULD YOU CHOOSE A QUALIFIED PLAN?

Qualified plans offer many benefits but are subject to complex rules. Let's review the benefits of each plan type, the discrimination rules each faces, minimum and maximum contributions, and the employer's and employee's concerns when it's time to distribute the funds.

MAJOR BENEFITS

The main benefit of qualified plans — for both employers and employees — is favorable tax treatment:

- Employers receive a current deduction for contributions.
- Employers often can delay payment of current-year contributions until their tax returns' due dates or — in many cases — until their extended due dates.
- Employees are generally not taxed on the contributions and earnings until they receive the funds.
- Employees' distributions may qualify for beneficial tax treatment.

But a qualified plan does more than save your tax dollars. It can also:

- Make your company more competitive in hiring and retaining the best workers.
- Increase employees' incentive to boost productivity, especially if contributions are tied to profits.
- Protect plan assets from creditors.
- Provide secure retirement funds for your employees.

What do you give up for these advantages? You may give up some of the ability to provide disproportionate benefits to yourself or your key employees.

Tip

For plan participants — which can include owners — qualified plans are the only remaining tax shelters.

PLAY BY THE RULES

With a qualified plan, you have little ability to discriminate — that is, to offer benefits to one group over another. You must offer benefits to a wide range of employees — you can't simply sweeten the pot for your key players or highly compensated employees.

How do you identify your highly compensated and key employees for discrimination-test purposes? The rules are complex, but likely candidates include anyone who is:

- More than a 5% owner,
- A relative of an owner, or
- An employee earning more than $90,000 annually.

You can automatically exclude some employees from your plan and the discrimination calculations, such as:

- Union employees whose retirement benefits were the subject of good-faith bargaining,
- Employees under age 21,
- Employees with your company less than one year,
- Employees who work fewer than 1,000 hours per year, or
- Employees who are nonresident aliens with no U.S. income.

Independent contractors are not employees and you don't have to cover them. But if you misclassify employees as independent contractors, your plan could lose its qualified status.

You may have to treat workers you lease from an outside organization as employees for qualified plan purposes if:

- They perform duties usually performed by your employees,
- Are under your direct control, and
- You lease them for one year or more.

If you misclassify employees as independent contractors, your plan could lose its qualified status.

Most discrimination tests measure the relative number of highly and nonhighly compensated employees benefited by the plan or the level of benefit credited to key employees. One test — the "top-heavy plan" test — measures the relative amount of assets the plan holds for each of those groups. Your plan can become top-heavy without losing its qualified status. But you usually must make larger contributions for the average employee and use a faster vesting schedule.

If you or your co-owners have ownership interests in other companies, you must consider one other discrimination issue. You may have to include in your discrimination calculations employees of all companies in which the group has an ownership interest exceeding 50%. For example, you can't avoid the rules by placing all your key people in one company and your other employees in another.

As you can see, some discrimination is allowed — but not much. Still, if you're willing to benefit most employees, qualified plans are one of the best fringe benefits you can offer, because you can deduct contributions and both you and your employees can defer taxes.

MAXIMUM COMPENSATION FOR PLAN PURPOSES

When determining contributions, you can count only the first $205,000 in 2004 (adjusted for inflation, but in $5,000 increments) in compensation. So, let us assume your salary as owner is $300,000, and the plan contributes 10% on behalf of participants. You can contribute only $20,500 (10% of $205,000), even though 10% of your compensation would equal $30,000.

HOW TO MAXIMIZE (OR MINIMIZE) YOUR CONTRIBUTIONS

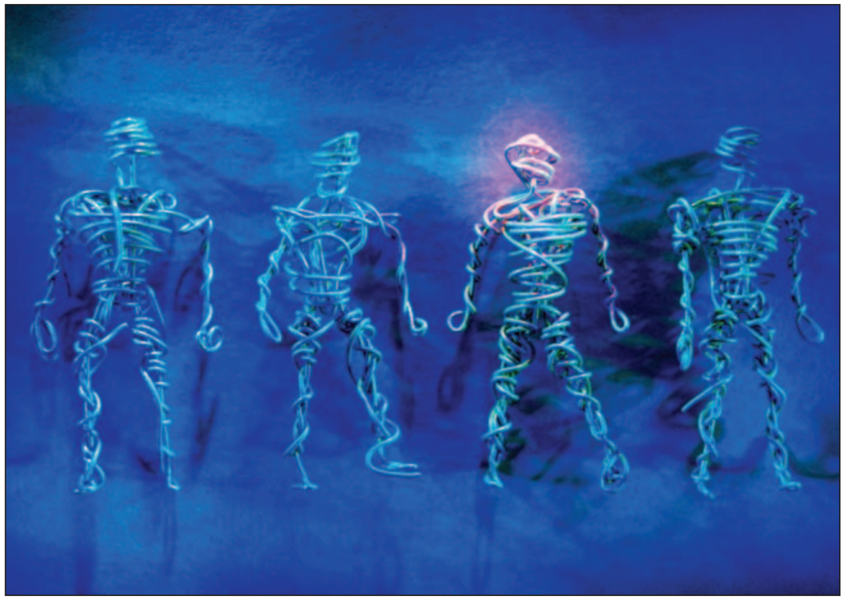
How beneficial your plan can be depends on how much you contribute to it. And how much you can — or must — contribute depends on the type of plan you choose.

Qualified plans are either defined contribution plans (such as profit sharing plans) or defined benefit plans (commonly known as pension plans).

Tip

Owners can receive in 2004 up to $41,000 in annual allocations in some defined contribution plans.

In a defined contribution plan, the plan defines the contribution the company will make on behalf of the employee. The contribution is usually expressed as a percentage of the employee's compensation. The maximum addition to an employee's account for one year is $41,000 in 2004 (indexed for inflation). The minimum contribution may be zero — or a fixed percentage of earnings — depending on the type of plan you adopt.



Tip

Defined contribution plans can be extremely flexible when it comes to contributions.

Defined benefit plans are more complicated. The plan defines the benefits the participants will receive. The company's contributions are determined actuarially based on the amounts needed to provide the promised benefit. That benefit can't exceed the lesser of $165,000 in 2004 (indexed for inflation) or 100% of the average amount of an employee's three highest consecutive years of compensation.

Defined benefit plans have one key advantage. Despite discrimination rules, these plans tend to provide greater benefits to owners and their highly compensated employees. Owners tend to be among the oldest — and certainly the best paid — employees. Because benefits are determined actuarially based on compensation and must be available by retirement age, contributions are usually much higher for owners who are closer to retirement age.

But this advantage has a cost. Your company must continue to contribute to defined benefit plans regardless of how your company performs. Also, your plan's investments affect your contributions. The plan must maintain a pool of assets large enough to pay promised benefits. If the plan's investments do well — thus adding to the pool — your contributions may be reduced. But if the investments fare poorly, you may have to increase your contributions.

Tip

Older owners and highly compensated employees usually benefit the most from defined benefit plans.

VESTING SCHEDULES

Your plan's vesting schedule determines when you and your employees have nonforfeitable rights to plan funds. You have some flexibility in setting your vesting schedule, but tax law determines the minimum requirements. For example, by the seventh year of employment, participants must be fully vested. But you can select a schedule that allows faster vesting than the required minimums. Matching contributions and top-heavy plans must be fully vested after six years.

Two things to remember about vesting: First, when employees leave your company, they are entitled to benefits only to the extent they are vested. Any unvested funds stay in the plan. Depending on your wishes, these funds can benefit your other employees or reduce your future contributions.

Second, you can choose from a variety of vesting schedules, and you can use this flexibility to your benefit. For instance, if you're in a line of business with high turnover and few employees stay for five years, consider a five-year cliff-vesting schedule. Employees who leave before completing five years of service would forfeit all benefits.

Conversely, you may feel that vesting gradually — starting in the first few years of service — could cut your turnover. Employees with gradually vesting benefits may feel they have more to lose if they leave.

Tip

If your company has high turnover, a five-year cliff-vesting schedule could reduce your contributions.

Weigh the pros and cons and use the vesting schedule that best suits your situation.

TAKING MONEY OUT OF A QUALIFIED PLAN

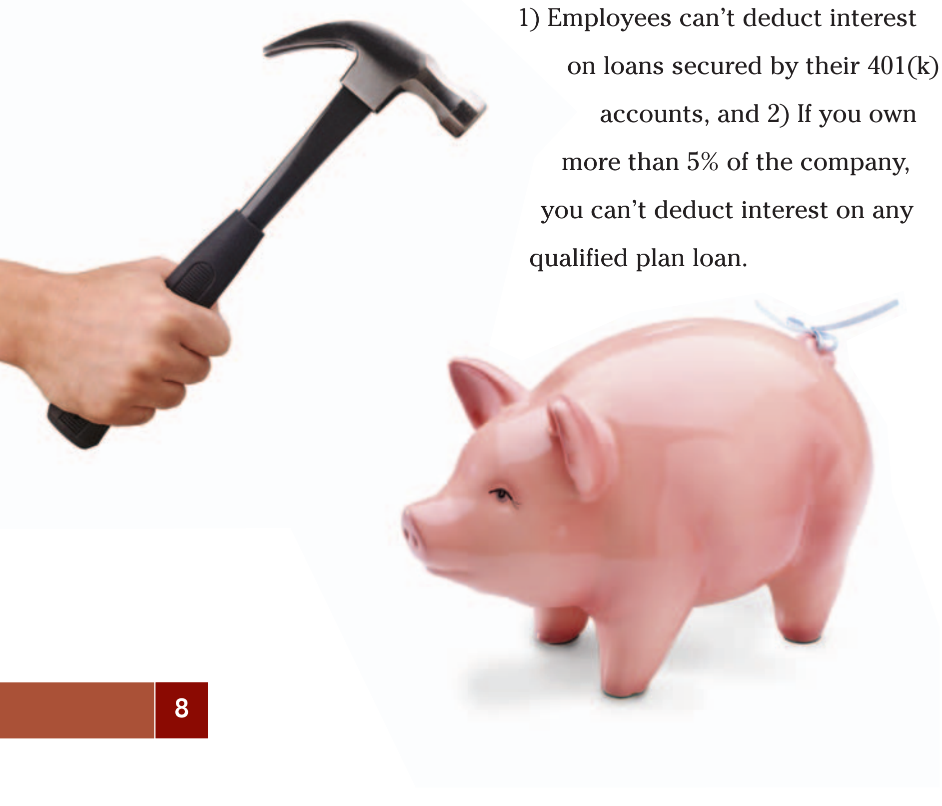
Once money is contributed to a plan, whether from employer or employee contributions, it can be distributed only under limited circumstances. Participants can either receive distributions or borrow funds from the plan.

Borrowing from the plan

The ability to borrow money from your plan is an important benefit for you and your employees. But significant restrictions on plan loans include:

- Generally, participants can borrow only the lesser of $50,000 or 50% of their vested balances.
- Loans must be equally available to nonhighly compensated and highly compensated employees.
- The plan must charge a commercially reasonable interest rate.
- Repayments must be made at least once a quarter and must be substantially equal.
- Except for some loans made to buy a principal residence, loans must be repaid within five years.
- A participant's spouse must approve loans exceeding $5,000.

Interest on plan loans is usually deductible according to the same rules governing other interest expense, with two exceptions: 1) Employees can't deduct interest on loans secured by their 401(k) accounts, and 2) If you own more than 5% of the company, you can't deduct interest on any qualified plan loan.



Receiving a distribution

Of course, a participant's other method of receiving funds from the plan is taking a distribution. A plan can allow distributions at one or more of these times:

- At voluntary or involuntary termination of employment.
- After age 59½, even if the participant is still employed.
- Upon the participant's permanent disability.
- Upon the participant's death.
- In cases of financial hardship [401(k) plans only].

Participants who directly roll over the distribution to a traditional IRA or another qualified plan will owe no current taxes.

You can choose any or all of these times to allow distributions from your plan. You should select the options that best suit your needs.

For instance, many employers delay distributions to discharged employees until they reach retirement age. This can increase administrative costs, but it also ensures you won't help finance employees who leave to form their own company or join competitors. It also ensures that the benefit is available when needed most — at retirement.

You also must decide what distribution options your plan will offer. Different methods have different cash-flow and tax ramifications for plan participants.

Here are some of the more popular options:

- A lump-sum distribution.
- A life annuity.
- A joint and survivor annuity.
- Various term annuities.

A 10% penalty tax is usually assessed on any funds withdrawn before age 59½.

No matter which options your plan offers or how you or your employees choose to take distributions, participants must begin to withdraw funds by the latter of April 1 following the date they reach 70½ or the date they terminate employment. Owners holding more than 5% of the business and traditional IRA holders must begin distributions on April 1 after they reach age 70½. But remember that a 10% penalty tax is usually assessed on any funds withdrawn before age 59½ (except under certain qualifying circumstances).

Now let's examine the various distribution options in greater detail.

Lump-sum distributions

A lump-sum distribution means withdrawing a participant's entire vested balance in the same calendar year. What the participant does with the money determines the tax treatment.

Participants who directly roll over the distribution to a traditional IRA or another qualified plan will owe no current taxes.

Spreading the wealth — Annuities

If participants prefer a regular income, they may take their distributions as an annuity. How much the annuity pays, for how long and to whom depends on the type of annuity the participant chooses.

Joint and 50% survivor annuity. This form of annuity ensures an income for the plan participant and spouse. With this option, they receive fixed monthly payments until the participant dies. The spouse then receives half that amount monthly until his or her death. If the spouse dies first, the participant continues to receive the full benefit. The original monthly payment is based on actuarial computations taking into account both the participant's and spouse's ages.

Married participants will need spousal consent to choose any option besides a joint and 50% survivor annuity from a pension plan. And if the spouse waives this right before the plan year in which the participant reaches age 35, the participant will need the spouse's consent again after that date. These rules serve to protect spouses.

Life annuity. Life annuities pay participants fixed monthly incomes (based on their life expectancies) for the rest of their lives. In a sense, this is a gamble. Participants win if they live longer than expected and lose if they die early.

Because of this element of chance, some participants choose life annuities with a guaranteed minimum term (such as 10 years). Minimum-term annuities guarantee an income for 10 years even if a participant dies before the term is up. The annuity pays those living beyond the term for the remainder of their lives.

20% WITHHOLDING TAX ON QUALIFIED PENSION PLAN DISTRIBUTIONS

The Unemployment Compensation Act of 1992 imposed a 20% withholding requirement on lump-sum pension distributions. Its goal was to increase tax reserves by accelerating tax collection on taxable retirement plan distributions.

The act places administrative burdens on employers with qualified retirement plans. For participants, the act means they must pay their tax much sooner if they don't roll over plan distributions directly into another qualified plan or a traditional IRA.

Under these rules, participants are encouraged to roll over their distributions into new plans to delay paying their tax. Participant loans in default are deemed distributions subject to federal income tax, but aren't subject to the 20% withholding tax. Distribution of a participant's accrued benefit that is partially offset by an outstanding loan may also avoid the 20% withholding tax under some circumstances.

Minimum-term annuities guarantee an income for 10 years even if a participant dies before the term is up.

To explain the effect, we can look at how Mr. X would be treated under these guidelines. Say he has an account balance of $10,000, of which $3,000 is an outstanding loan. He leaves his job and elects a direct rollover into another qualified plan. Because he opted for the direct rollover, no withholding was required on the net balance of $7,000 rolled over or the $3,000 loan offset. But if he hadn't chosen a direct rollover after offsetting his loan, the full $10,000 would've been subject to the 20% penalty. In this scenario, Mr. X would wind up with a check for $5,000, because the $2,000 withholding tax (20% of $10,000) would be withheld from the $7,000 payable to him.

If a distribution payment is considered an eligible rollover distribution, the withholding requirement will apply to it. Also, plan managers must give distribution recipients prompt written explanations of their options.

DEFINED CONTRIBUTION ALTERNATIVES

Now that we've covered the ground rules for qualified plans, let's look at some specific plan options for your company. As we examine each plan, we'll answer these questions:

- How flexible is the plan?
- How much will it cost to administer?
- What are the minimum and maximum contributions?
- What type of company should consider this plan?

Let's examine some of the most popular types of defined contribution plans.

PROFIT SHARING PLANS

Many companies find profit sharing plans attractive because they offer considerable flexibility and low administrative costs. Plan contributions can be discretionary. Based on each year's results, the company can decide how much — or how little — to contribute to the plan.

Thus, in a profit sharing plan, the minimum contribution is zero. The maximum contribution is 25% of compensation paid to eligible employees.

Tip

Profit sharing plans can allow you to make large contributions in good years and small contributions in bad years.

The simplest way to allocate the contribution is pro rata — each participant gets a contribution in proportion to salary. For example, a company could contribute 10% of each employee's earnings to the plan. A participant earning $50,000 would receive a $5,000 contribution.

PROFIT SHARING PLANS

- Extremely flexible.
- Low administrative costs.
- Contributions can be completely discretionary.
- Maximum contribution is 25% of total compensation of eligible employees.
- No minimum contribution.
- Best suited for companies that want maximum flexibility.

Using age and pay in profit sharing plans

If your key employees are older and you want to give them a larger share of the contribution than they would receive under a traditional profit sharing plan, consider an age-based allocation profit sharing plan. The basis for allocating contributions under this plan type is determined by calculating the present value at age 65 of an annuity for life equal to 1% of pay. The interest rate in making this calculation may be not less than 7.5% or more than 8.5%.

The chart below shows that a 60-year-old participant would receive a profit sharing contribution almost 18 times larger than a 25-year-old participant with the same pay would receive. The example is based on 8.5% interest and postretirement mortality table UP-84.

Profit sharing plans with age-based allocations are appropriate when you want to:

- Favor older key employees.
- Provide greater benefits for older employees who have fewer years to accumulate retirement benefits than younger employees have.
- Provide flexibility of discretionary contributions.

But no participant, regardless of salary, can receive a contribution exceeding $41,000.

Chart 1

Age weighted profit sharing plan

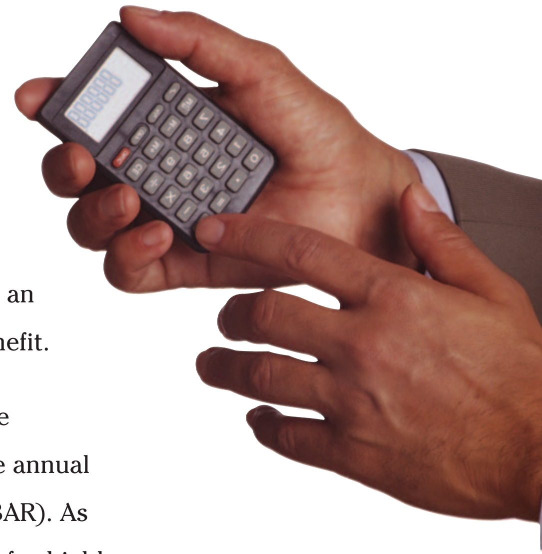
Age of participant	Salary	Present value of annuity at age 65 equal to 1% of salary
60	$10,000	$529
55	$10,000	$352
50	$10,000	$234
45	$10,000	$155
40	$10,000	$103
35	$10,000	$69
30	$10,000	$46
25	$10,000	$30

Comparability plans

IRS rules allow business owners to shift a substantial portion of their profit sharing contributions to key employees.

These profit sharing plans (known as comparability plans) can create annual contributions as high as $41,000 for an older, highly compensated group of employees with only 5% of pay required for contributions to the accounts of younger, nonhighly compensated employees. But the plans must still meet nondiscrimination requirements. The arithmetic is complex, but the benefit to business owners is major.

At heart, a comparability plan doesn't differ significantly from a traditional profit sharing plan. It simply divides plan participants into two or more classes and allows contributions to be determined separately for each class. Then the math begins.



Each participant's allocation is calculated in total, with interest, to retirement age. This amount is then divided by what's called "an annuity purchase rate," producing an equivalent monthly retirement benefit.

This number is then divided by the participant's salary to arrive at the annual equivalent benefit accrual rate (EBAR). As long as the EBARs are comparable for highly and nonhighly compensated employees, no discrimination exists. Chart 2 compares the

Chart 2

Comparison of types of profit sharing plans

Name	Age	Compensation	Straight	Integrated	Cross test
Management	55	$150,000	$20,484 38.7%	$22,652 42.8%	$41,000 77.6%
Sales	45	$55,000	$7,511 14.2%	$7,008 13.3%	$2,750 5.2%
Sales	38	$63,000	$8,603 16.3%	$8,027 15.2%	$3,150 6.0%
Secretary	30	$30,000	$4,097 7.9%	$3,823 7.2%	$1,500 2.8%
Staff 1	28	$26,000	$3,551 6.7%	$3,313 6.3%	$1,300 2.5%
Staff 2	25	$24,000	$3,278 6.2%	$3,058 5.8%	$1,200 2.3%
Staff 3	23	$21,000	$2,868 5.4%	$2,676 5.1%	$1,050 2.0%
Staff 4	21	$18,000	$2,458 4.6%	$2,294 4.3%	$900 1.6%
Total:		**$387,000**	**$52,850**	**$52,850**	**$52,850**

As you can see from these totals, through the comparability plan, the manager receives 77.6% of the contribution. Through a regular plan, the manager receives only 38.7% of the contribution.

different types of profit sharing plans. As you can see, with the comparability plan, the manager received a contribution equal to 27% of compensation, but nonmanagement employees received a contribution of 5% of their compensation. The IRS series of tests to determine EBAR's comparability is complex, but often well worth the effort.

Investigate this type of plan if you're an owner or principal wanting to maximize contributions for highly compensated employees, minimize contributions for other employees and reasonably limit contributions.

Tip

Owners can make disproportionate contributions to key people by taking Social Security into account.

Social Security considerations

Here's a way to make the plan better for the owner. Although all qualified plans must make allocations on a generally equivalent basis to all participants, some disparity is allowed to make up for the relatively less favorable treatment highly compensated employees receive under Social Security. Employees earning $205,000 in 2004 receive no more Social Security benefits than employees earning at the Social Security wage base ($87,900 in 2004).

In a traditional profit sharing plan or money-purchase plan (other than an age-based profit sharing plan) that takes Social Security into account, a company can contribute proportionately larger shares to owners and other highly compensated employees. This treatment partially offsets the negative treatment afforded highly compensated employees by Social Security.

This disproportionate treatment is an option for many qualified plans. The effect varies depending on participants' incomes.

MONEY-PURCHASE PLANS

Money-purchase plans are similar to profit sharing plans. Money-purchase plans have low administrative costs, but they're not as flexible as profit sharing plans. In a money-purchase plan, the company must contribute a set amount annually to the plan based on a fixed percentage of eligible compensation.

The set contribution can be as low as you want or as high as 25% of compensation. Whatever contribution you decide on, remember this: You must make the contribution each year, no matter how your company does.

MONEY-PURCHASE PLANS

- Are less flexible than profit sharing plans.
- Have low administrative costs.
- Require yearly set contributions.
- Limit maximum contributions to 25% of eligible employees' compensation.

TARGET-BENEFIT PLANS

Target-benefit plans are money-purchase pension plans that are a cross between defined benefit and defined contribution plans. Annual contributions are determined using a defined benefit formula, but contribution limits are identical to those of defined contribution plans. After a contribution is made, it is distributed to each person's separate account. The earnings grow tax-free until distributed, when the participant receives the vested balance. But this has a price: higher administrative costs owing to actuarial requirements.

401(k) PLANS

Section 401(k) of the Internal Revenue Code is probably the only part of the entire code most people know by number. And with good reason: Never before have employees had such flexibility coupled with a tax-advantaged way to save for retirement. Since their introduction, 401(k) plans have become the most popular qualified retirement plan.

A 401(k) plan allows employees to defer some of their compensation until retirement. The plan sponsor deposits these deferred amounts into the plan where they grow tax-deferred until distribution. The funds belong to the employees, so they are always 100% vested in their account balances.

Participation is voluntary. During the calendar year, an employee can contribute the lesser of:

1. $13,000 in 2004 and $16,000 including catch-up contributions if over age 50 (indexed for inflation), or
2. A percentage of compensation specified in the plan.

Each employee decides how much to put in within the limits. An employee can elect to contribute nothing.

One limitation: The plan sponsor performs mathematical tests to ensure the difference isn't too great between the average contributions of highly and nonhighly compensated employees. Failing these tests could limit the contributions of highly compensated participants. But your plan can skip the testing if it makes a safe-harbor matching contribution.

Employees have an extra benefit with a 401(k) plan — they can receive hardship withdrawals.

Funds in qualified plans are normally available at a participant's death, disability or separation from service. But a participant with a financial need and no other recourse can withdraw money to:

- Pay deductible medical expenses.
- Buy a principal residence.
- Prevent eviction from or foreclosure on a principal residence.
- Pay tuition for postsecondary education for the participant or dependents.

The participant has to pay income tax on hardship withdrawals when received and also may be subject to the 10% early-distribution penalty unless the money is used for deductible medical expenses.

For an employer, a 401(k) plan also offers some flexibility. Employers don't have to contribute to participants' accounts, but have the option of making matching contributions.

You can make matching contributions either by using a set formula (for instance, 50% of employee contributions up to 6% of compensation) or you can make a discretionary contribution each year. The first option is a way to increase employee participation — after all, how often do employees have a chance to give themselves a raise? The second option gives you the same flexibility as a profit sharing plan — and coupling the contribution to the company's performance could increase productivity.

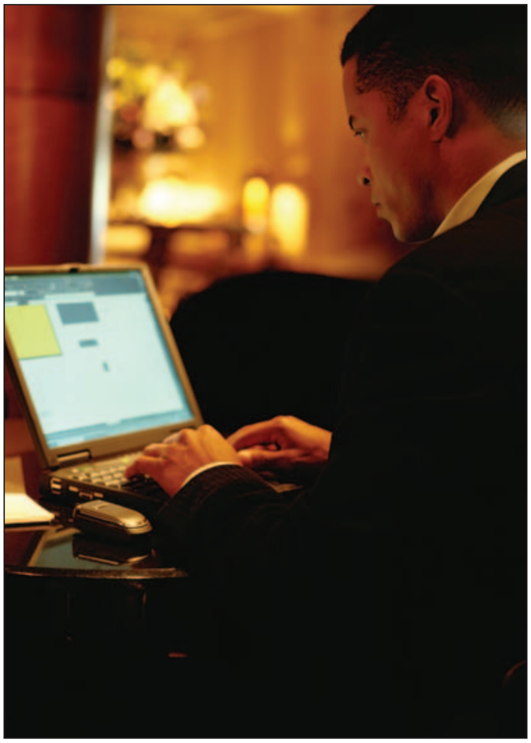
Matching contributions to highly compensated employees are subject to the same discrimination tests applied to employee contributions. Even if your company already has a qualified plan, adding a 401(k) element can allow you and your employees to boost their retirement savings. Many participants in other qualified plans are unable to deduct IRA contributions. With a 401(k), they have a tax-advantaged retirement savings option.

A 401(k) plan has several other advantages over a traditional IRA:

- Higher annual contribution limits.
- Participants can borrow from their accounts.
- The employer may match contributions.

401(k) PLANS

- Have maximum flexibility.
- Have relatively high administrative costs.
- Don't require contributions.
- Have a maximum allowable employee contribution of $13,000 in 2004 [$16,000 including catch-up contributions if over age 50 (indexed for inflation)]. Employers can make matching contributions.
- Don't require minimum contributions.



SAVINGS INCENTIVE MATCH PLANS FOR EMPLOYEES (SIMPLEs)

Beginning in 1997, SIMPLEs became available for employers with fewer than 100 employees. SIMPLEs escape the nondiscrimination tests and the top-heavy requirements imposed on other defined contribution plans. These plans also have simplified filing requirements. They can be used as part of a 401(k) plan or an IRA program.

Employers must match 100% of employee contributions up to 3% of pay or contribute 2% for each employee. Sometimes the 3% match may be reduced to 1%. Employee contributions may not exceed $8,000, or $9,000 including catch-up contributions for participants over age 50, and all contributions are 100% vested.

POUR-OVER PLANS

Currently, highly compensated employees can contribute to their 401(k) plans only an amount that is tied to the amount contributed by rank-and-file employees. [See the 401(k) section.] The drawback is that if rank-and-file employees contribute too little, highly compensated employees may not be able to defer as much as they would like. If highly compensated employees contribute too much, the plan may fail discrimination testing and have to return part of the employees' contributions to them as taxable income.

So blending 401(k) and nonqualified plans is a good option for highly compensated employees who want to maximize their deferrals. This is how it works: Highly compensated employees can defer a specified amount of income into a nonqualified retirement plan. After the actual contribution percentage and the actual deferral percentage tests are completed, the employees must transfer within a specified time (usually one or two months) the proper percentage into the 401(k) plan. Any amount left in the nonqualified plan will continue to accumulate.

Highly compensated employees can defer a specified amount of income into a nonqualified retirement plan.

EMPLOYEE STOCK OWNERSHIP PLANS (ESOPs)

An ESOP is a special type of profit sharing plan. Instead of investing plan funds in stocks or bonds, for example, the plan must invest primarily in the sponsoring company's stock.

With a traditional ESOP, your company can save tax dollars without a cash outlay. Suppose you contribute stock valued at $100,000 to your ESOP. Assuming a 34% tax bracket, your company saves $34,000 in taxes. If you'd contributed $100,000 in cash to a regular profit sharing plan, you'd get the same $34,000 savings, but your company's cash position would decrease by $66,000 ($100,000 minus $34,000).

A second ESOP type — a leveraged ESOP — can be the perfect vehicle for providing a market for buying stock from existing shareholders.

A leveraged ESOP can offer employers three special benefits:

1. The chance to defer recognition of capital gains on the sale of company stock to the ESOP.
2. A tax-deductible buyout of your holdings or other shareholders.
3. A deduction for dividends paid to the ESOP.

ESOPs allow your company to buy out other shareholders on a tax-deductible basis.

Shareholders can postpone capital gains tax by selling shares to the ESOP if the ESOP will own at least 30% of the company's stock after the transaction. Here's how: Suppose your ESOP buys 30% of your company's stock. If you reinvest the proceeds from the sale in securities of one or more eligible U.S. corporations, you can defer gain until you sell the replacement securities. But you must buy the replacement securities between three months before and 12 months after your sale of stock to the ESOP.

ESOPs also allow your company to buy out other shareholders on a tax-deductible basis. By making tax-deductible contributions to the ESOP, which buys the other shareholders' stock, the buyout becomes tax deductible.

Financing also can be less expensive. For example, the ESOP may borrow funds to buy company stock. And dividends your company pays to the ESOP also may be deductible.

Many business owners considering an ESOP voice the same concern: Who votes the ESOP shares? The ESOP's trustee votes the stock — and the company picks the trustee. Thus, you retain control except for corporate events requiring more than a majority vote (such as a merger, acquisition or liquidation). Participants must vote directly on these.

Before business owners adopt an ESOP, they must address other issues. For example, if the stock is not publicly traded, the participant or his or her beneficiaries must have the right to offer the stock for sale back to the business. This is called "repurchase liability" and can be extremely burdensome if not properly planned for.

SEPs are easy to set up and inexpensive to administer.

Should you consider an ESOP? If you can accept a dilution of your stock ownership and having your employees as fellow shareholders, an ESOP could be right for you.

SIMPLIFIED EMPLOYEE PENSIONS (SEPs)

If cost is a big concern, a SEP may be your best choice. It's easy to set up and inexpensive to administer, and has no required employer contribution.

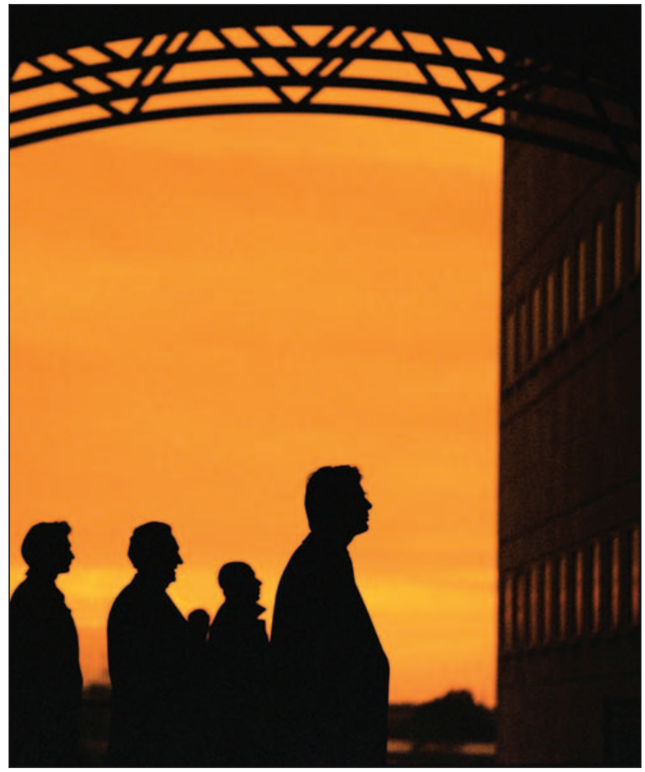
What price do you pay for this simplicity?

- Participants are always fully vested and may withdraw funds at any time.
- You must include anyone — other than some union members — who:
    1. Earns at least $450 in 2004 (indexed for inflation),
    2. Worked for you in any part of three of the last five years, and
    3. Is age 21 or older.
- Matching contributions are not allowed.

If cost and simplicity of operation are your main concerns, a SEP may be the plan for you.

THE DEFINED BENEFIT PLAN ALTERNATIVE

Defined benefit plans are your other qualified plan option. When you think of traditional pension plans — which provide set monthly payments to employees either for life or for a set term — you're usually thinking of a defined benefit plan.



A defined benefit plan could be your best bet if your goal is to benefit mainly older, highly compensated employees with substantially longer terms of service than the rest of your work force.

Defined benefit plans differ from defined contribution plans in many ways. Instead of maintaining separate accounts for every participant, a pool of assets is dedicated to providing stated benefits to all participants. As participants become eligible for distributions, payments are made from this fund.

DEFINED BENEFIT PLANS

Should your company consider a defined benefit pension plan? Ask yourself these questions:

- Is your company consistently profitable?
- Do you wish to make large contributions?
- Do you wish to primarily benefit older, higher-compensated employees?

The benefit is generally defined as an average of annual preretirement compensation — often based on either the participant's last five years with the company or the highest consecutive five years of compensation.

The maximum annual benefit as of a participant's Social Security retirement age can't exceed the lesser of:

- $165,000 in 2004 (indexed for inflation), or
- 100% of the average of the three consecutive highest years' compensation.

At the other extreme, a de minimus rule allows you to provide up to a $10,000 annual retirement benefit to any employee, regardless of current age or compensation. Employing a spouse or other family member part time could be a valuable option.

A few words about flexibility: You have considerable latitude in setting up your plan. But once established, you can change little. You will be required to make a contribution sufficient to fund the projected benefits regardless of what kind of year you have.

Although administrative costs may be high and flexibility relatively low when compared with many defined contribution plans, this plan could be the option for you if your goal is to provide a higher level of benefits and more tax leverage for your older or higher-paid employees than they could have received under a defined contribution plan.

SHOULD YOU CHOOSE A NONQUALIFIED PLAN?

Although one or more qualified plans may meet your needs, many companies find they still want to provide additional benefits to some key employees — including the owner. That requires a nonqualified plan. In most cases, you'll receive no tax deduction for contributions to a nonqualified plan until payments are made to your employees. Still, the benefits of nonqualified plans can be considerable.

Under a nonqualified plan, you don't have to meet the nondiscrimination requirements imposed on qualified plans. You can offer a nonqualified plan to just those employees you wish to benefit. You can even tailor individual plans to suit the needs of your organization's key players. And you can structure such plans to meet your exact goals. For instance, to encourage employees to stay with the company, you can impose longer vesting periods than allowed under qualified plans.

4 NONQUALIFIED PLAN OPTIONS

As competition for top people heats up, more and more companies are looking at nonqualified plans for their key personnel. Here is a description of four of the most offered nonqualified alternatives.

Wage deferral or deferred compensation plans

The simplest nonqualified plan — a wage deferral or deferred compensation plan — postpones employees' receipt of some of their regular and/or bonus income until a future year. This allows employees to postpone paying taxes and possibly shift income from a high-tax to a low-tax year.

Such a plan should be in writing and be established before wages are earned. Also, be sure to state the nontax business reasons for the agreement or the IRS may challenge the plan's legitimacy. Remember, to pass IRS muster, the employee can't have access to the funds until the ultimate date of receipt.

Excess benefit or supplemental retirement plans

These plans provide benefits in excess of those provided under an employer's qualified plan. For instance, qualified defined contribution plans are capped at $41,000. Under an excess benefit plan, key people could receive benefits exceeding that cap by as much as you wish.

Phantom stock plans

A phantom stock plan awards an employee "units." These units are usually tied in value to the company's stock, but carry no ownership or voting rights in the company. This way, you tie an employee's eventual compensation to the company's performance without actually giving out stock.

For example, you award $10,000 of phantom stock at a time when your company's stock is valued at $1,000 per share. The employee doesn't own any actual stock but owns the equivalent of 10 shares. If your stock triples in value over the next 10 years, your employee's phantom holdings are worth $30,000.

At a future date, the company compensates the employee for the phantom stock at a price per share equivalent to your company's stock value. By awarding units based on such criteria as years of service, profitability, or sales goals or other performance measures, you can use the plan to help reach specific corporate objectives. Everybody wins. You haven't given away any actual stock, but your key people can still benefit from future increases in your stock's value.

Tip

With an excess benefit plan, key people can receive benefits in excess of those available under qualified plans.

You can even tailor individual plans to suit the needs of the key players in your organization.

Restricted property plans

Under these plans, the company gives property — such as stock or life insurance — to employees as part of compensation. But their right to transfer the property is

You can even tailor individual plans to suit the needs of the key players in your organization.

restricted or they run a substantial risk that they may have to forfeit it.

For example, let's say the chief engineer for your startup company is a vital player. You give him 10% of the company's stock — which is currently worth little — and tie the right to the stock to length of service. If he leaves your employ during the first year, he forfeits all the stock. An employee's rights to the stock vest at 20% per year, reaching full rights after five years.

A restricted property plan is attractive for both employers and employees. Employees don't have to pay taxes on the property until the restrictions expire, even though they may eventually have complete freedom to do as they wish with it. Even if the property doubles in value before the restrictions lapse, no tax is due when they initially get the property.

The employer benefits because employees covered by the plan have strong motivations to perform — and stay with the company — until the restrictions expire.

One further note: Employees have the option of paying tax on the property in the year received, based on the property's value at that date. If employees are sure to receive the property and sure that it will increase in value, they could save considerable taxes later by paying early — but only if they're certain that both these conditions will be met.

NOW WHAT?

Now that you have a better handle on your deferred compensation plan alternatives, we'd like to help you find the best solution for your situation. Every company has unique benefits needs — and limited resources with which to meet them. We have the experience and the knowledge to work with you to find the best plan — or plans — for you.

CHOOSE THE BEST DEFERRED COMPENSATION PLAN FOR YOU AND YOUR BUSINESS...

Smart planning can help save you, your business and your employees thousands of dollars in taxes while building funds for a secure and enjoyable retirement.

Plus, a carefully chosen plan can enable you to provide more retirement benefits for yourself and key employees without making similar contributions for the bulk of your work force. This can save your business thousands more while making it more competitive in hiring and retaining top talent.

Our advisors have helped hundreds of businesses develop and implement deferred compensation plans that have enabled them to achieve their goals. We would welcome the opportunity to help you, too, make the right choice.

Fax or mail back this form, or call us today to learn more about developing a successful deferred compensation plan.

❑ **Yes!** I would like to structure the best possible deferred compensation plan for me and my business. Please call me at (______________________________) or e-mail ____________________________ to arrange a time to talk about the topics I've checked below:

❑ Qualified vs. nonqualified plans
❑ Defined benefit plans
❑ Defined contribution plans
❑ Profit sharing plans
❑ Money purchase plans
❑ Target benefit plans
❑ 401(k) plans
❑ SIMPLEs
❑ Pour-over plans
❑ ESOPs
❑ SEPs
❑ Wage deferral plans
❑ Excess benefit plans
❑ Phantom stock plans
❑ Restricted property plans
❑ Discrimination tests
❑ Vesting schedules
❑ Loans from qualified plans
❑ Lump sum vs. annual distributions
❑ Taxes on distributions

❑ My greatest deferred compensation concern/need is:

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____

____

____

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