What Are the Advantages of Kai-Zen and Tri-Zen over Traditional Deferred Compensation?

Introduction

In the past, traditional deferred compensations plans were frequently funded by Corporate Owned Life Insurance (COLI) products. The benefit to the corporation was that they could enjoy the tax advantages of life insurance tax deferred cash value growth and, potentially, any premature deaths that would increase their return. Over the years, the competition in this space has become so acute that the costs have been shrunk down, and as a result, clients can enjoy high early cash values. These high cash values help with the accounting of deferred compensation because they can offset most, or in some cases all, of the balance sheet liability associated with offering the deferred compensation plan. If you look at a low load COLI product, its cost drag will typically be in the 0.5% range (all cost), so for a 7% return profile the client will net an IRR of approximately 6.5%.

While this all looks good on paper, the problem with traditional compensation plans is that they fundamentally miss the mark when it comes to providing companies with a competitive advantage.

Failing to Meet the Needs of Key Employees

According to available data, only a third of what is needed to maintain lifestyle for high income earners in retirement is being saved by employees. However, this is not due to poor planning. Instead, it is because the amount of money needed to get to that maintenance level is simply too much. Statistically, most people don't save meaningfully for retirement (or even become a key employee) until their mid-forties. To compensate for this, financial planners suggest that high income earners save 35% of their salary to maintain lifestyle if they start in their mid-forties.

At the end of the day, the issue with deferred compensation is that companies do not have enough money to fund the levels necessary to meet the lofty financial targets of their top employees. From the employee's perspective, the value of supplemental retirement plans comes from their ability to provide the additional amount employees need to maintain their lifestyle in retirement. When companies fail to provide these extra funds, deferred compensation plans lose much of their appeal. And, this is before regulatory reporting and administration requirement come to play.

Although companies are funding what they can, deferred compensation is a pure expense that will always be limited by how much cash flow the company can divert to fund the plan. If two employers fund the same amount, they spend vast sums of money to look the same as their competitors, and still the plan does not meet the needs of the employee. To make matters worse, many of the COLI plans we see today are degraded by the policies being underfunded, and expenses to the employer do not stay at 0.5%. As the underfunding approaches target premium or the equivalent, expenses approach 4-6% and the underfunded plan performs even worse, increasing the cost to employers. In conclusion, from a strategic perspective these deferred compensation plans are not creating an advantage. They simply make a company look the same as their competitors.

Reinventing Traditional Deferred Compensation Plans

The workforce is forecast to shrink by 16 million over the next 10 years as baby boomers retire and finding talent will become increasingly harder. Most COLI plans are group Variable Universal Life (VUL) policies which have full market volatility exposure, so the plan's returns are destroyed by a market correction, which is likely to happen every 7-10 years. To really put the nail in the coffin, when an employee takes the money out of the deferred compensation plan, they pay 40-50% tax on the money! Clearly, a substantial portion of money never makes it to the employee.

Common sense suggests that if employers had 40-50% of waste in a department, they would immediately assign a team to fix it. However, because deferred compensation and bonuses are the status quo, no one questions the way they are operated. Benefit providers and consultants are comfortable recommending deferred compensation, and most perceive this as the minimal risk option for their clients. To them, any other solution or would be a risk due to its lack of familiarity.

The Creation of Kai-Zen and Tri-Zen

Kai-Zen and Tri-Zen were invented by NIW first and foremost because we were both employer and employee, which gave us an advantage when designing a plan from both perspectives. Conventional plans did not solve our employees' retirement issues, yet paying large sums for a program such as deferred compensation that ultimately did not achieve its objective seemed wasteful.

Kai-Zen and Tri-Zen changed the way things were done by becoming one of first supplemental retirement benefit plans to bring additional money to the table and minimize tax exposure through its structure.

Here are the key differences Kai-Zen and Tri-Zen have from traditional deferred compensation plans:

a) The programs are structured to allow lenders to add the extra money to minimize the funding gap by adding 3X more cash over and above what the employer or employee chooses to put into the plan. The net result is +60-100% more retirement income for the employee
b) The loans are structured so the plan is the ONLY and SOLE security for the loan – neither employer or employee are in any way connected to, or obligated by the bank loan.
c) By putting the money into a smallest maximum overfunded IUL policy, the following is achieved:
    a. Money is taken out tax free as policy loans (as with all insurance policy loans)
    b. Downside protection from market corrections (as with all IUL products)
    c. Asset protected and bankruptcy remote (as with all insurance in most states)
    d. Cost over time are in line with a correctly funded COLI plan (plan design of NIW to minimize costs)

Now let's look at the math. If the IUL policy, like the COLI policy, grows at 7% and the costs end up averaging 0.5%, the net IRR on the client's money is around 6.5%. But with Kai-Zen or Tri-Zen, the client gets that return on the money they invested, and an additional return associated with the net plan return (policy return minus loan costs) on the extra money the lender adds. The extra money from the lender adds +2-3% incremental additional return on your cash. In this example, the IRR is 8.5%, which is

even better considering that there won't be any tax due on this amount. Additionally, this extra return is sustainable because the risk profile of an IUL is less than a security or VUL.

More importantly, there is also more cash in the plan working for you. An 8% return on $1 million is better than an 8% return on $100,000; by the same logic, the extra cash put into Kai-Zen or Tri-Zen increases the critical mass of cash working for the key employee's benefit.

To reduce risk even more, NIW stress tests the Kai-Zen and Tri-Zen designs to survive a Great Depression or 1980's interest rate type environment. Ironically, the revenue from the Kai-Zen Great Depression scenario quite often is higher than the revenue from a standard deferred compensation COLI plan in a normal scenario.

What is the difference between Kai-Zen and Tri-Zen?

Kai-Zen is an after tax 162 Bonus plan enhanced; the company bonuses the employee, the employee pays the tax, and the company takes the deductions and incurs the expense. The bank financing creates, on average, an additional +60% return which essentially recovers the money lost to the employee via tax (approximately 40% income tax loss).

With Tri-Zen, the bank lending and trust-based set up is like Kai-Zen but instead of giving the money to employees as a bonus, the money is a split dollar loan (not applicable to employees affected by Sarbanes Oxley). The advantage of doing this is that the split dollar loan makes the contribution pre-tax to the employee. This results in employees having almost double the client payment into their plan, which the bank then leverages up again using the same approach as Kai-Zen. Ultimately, this provides the employee with on average +100% more retirement income. The life insurance in the plan repays the employer so the employee does not have to. Since the employer payment is a loan, it is after-tax to the employer so it does not give a deduction to the employer, but rather eliminates the expense entirely thereby improving EBITDA. The split dollar loan is a term loan repaid at death plus interest (AFR long term rate), so from a cash flow perspective it is little different from Kai-Zen (except it saves FICA costs), but from a balance sheet perspective it is drastically more favorable to the employer. It is a true win/win scenario for both sides.

Benefits of the Life Insurance Policy

With both Kai-Zen and Tri-Zen, the IUL products used have some additional benefits to the employee, the most obvious of which is a permanent death benefit.

There are also important living benefit protections that can used while the employee is living in the event of:

Critical illness
Chronic illness
Terminal illness

Statistically, many employees will need these living benefits at some point. The benefit of Kai-Zen and Tri-Zen over the alternatives is the program kicks in if they lose their ability to earn which is critically important and not covered by most deferred compensation and or COLI plans.

Conclusion

In conclusion, Kai-Zen and Tri-Zen take the money employers are already paying and supercharges it for the benefit of both parties, ultimately resulting in a benefit plan that has substantial competitive advantages in the recruiting and retaining key employees.