Learn to Speak Fluent Nonqualified Deferred Compensation: A Guide to Understanding the Language Spoken in the World of Nonqualified Plans

By William L. MacDonald

William MacDonald explains the fundamentals of nonqualified deferred compensation plans and why they appear more complicated than is necessary. Every competitive company must consider how to implement such a plan to attract, retain, and reward their executive talent.

Many executives have accumulated millions of dollars in nonqualified deferred compensation plans. These plans provide important tools enabling executives to accumulate savings for their retirement. However, when the subject of nonqualified plans comes up in conversation or in top-level company meetings, company leaders can find themselves longing for a more sophisticated understanding of the fundamentals of nonqualified plans. In truth, these plans are truly not difficult to understand. At their core, they are simply a way for the highly compensated to save money on a tax-deferred basis.

It is true, however, that these plans come with a language all their own, and because of this, many financial and human resource executives often find them somewhat difficult to understand, at least at first.

Some of the major questions executives might have include:

- How can I get an overview of the subject?
- Why do consultants and other advisors recommend certain features in the plan?
- What is the real cost of implementing a plan?
- Why do most consultants recommend that we fund the plan with life insurance?
- How complex is plan administration?

This article will help you think about and discuss these and other issues that affect the design, funding, and administration of nonqualified plans. This overview requires no special knowledge of nonqualified plans. Instead, nonqualified plans are clearly explained in plain English.

Background on Nonqualified Plan

Executives are at a disadvantage when it comes to saving for retirement. The rules imposed by the Employee Retirement Income Security Act of 1974 (ERISA) limit the amounts that highly compensated executives can contribute annually to qualified plans such as the 401(k). For example, the "highly compensated" are restricted to a contribution into the company's 401(k)

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of not more than $15,500 ($20,500 if you are over 50) in 2007.

ERISA was enacted to protect the rank and file from potential abuses by senior management, and in that regard, it has been a success. The enactment of ERISA placed restrictions on the senior management group. Of course, these individuals are highly compensated because of their relative value to the business enterprise. Companies must find ways to attract and retain these highly valued employees if they are to succeed in their growth objectives and create positive returns for their shareholders.

To address the inequity created by ERISA, and to provide a valuable executive benefit, companies began to offer savings plans considered "nonqualified," meaning that they are exempt from the "qualified plan" limits imposed by ERISA (e.g., $15,500 limit in 401 (k) plans).

Nonqualified deferred compensation plans are one of the methods available to achieve the goal of attracting, retaining and rewarding a company's top talent. These plans are offered by 85 percent of the Fortune 1000 because no other executive benefit costs the company so little while providing plan participants so much.

The word "nonqualified" is confusing. Why would an executive want something that isn't qualified? Nonqualified means the company is not subject to onerous requirements of qualified plans impacted by ERISA. A plan can be designed for a select group which is not subject to ERISA requirements.

Who is Eligible to Participate in Nonqualified Plans?

Nonqualified plans can be offered only to those the company deemed eligible. ERISA says the plan must be for a "select group of highly compensated and/or management employees." As a rule of thumb, these are employees who earn in excess of $100,000 annually, although the Department of Labor guidelines do not define this issue specifically. To be safe, companies should only provide this benefit for those employees earning over $100,000 annually and only for up to 10 percent of the total employee population (e.g., 1,000 employees allows 100 employees to participate in the plan).

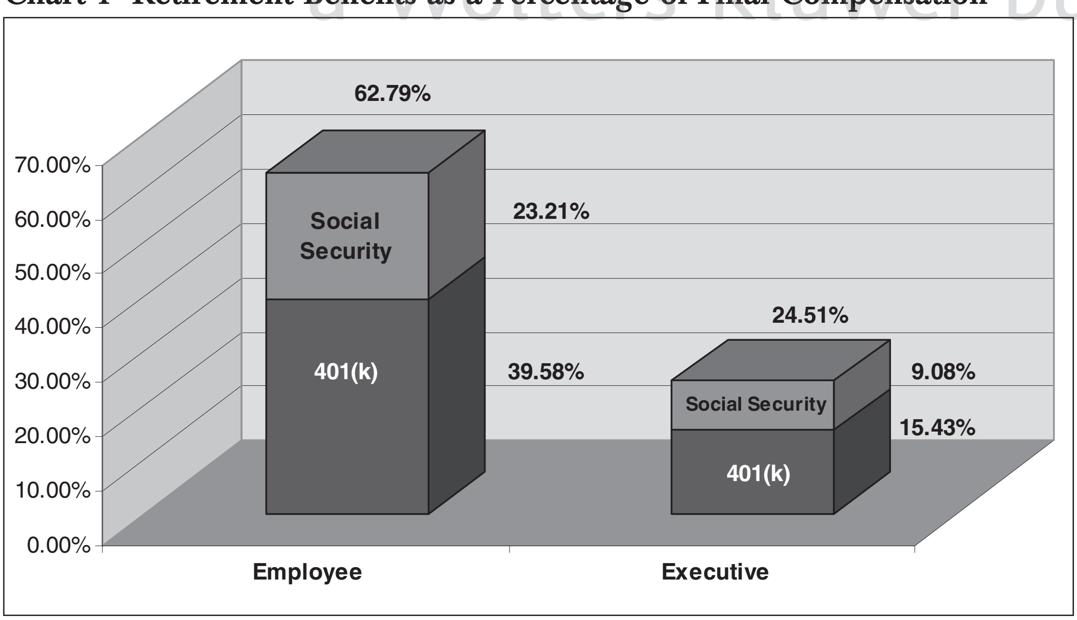
Nonqualified Plans Fill Retirement Gap

Retirement plans deemed to be "qualified" under ERISA include the ubiquitous 401(k) plan among others. The limits governing how much a person may contribute to a 401(k) plan make it only marginally valuable to highly compensated executives who could never accumulate retirement savings as a significant percentage of their annual compensation solely through their 401(k).

To address this inequity, as mentioned above, and to provide a valuable executive compensation benefit, companies began to offer savings plans considered "nonqualified," which refers to their exemption from ERISA requirements for qualified plans.

Take an executive at age 50 and assume he earns $250,000 per year with a 4 percent annual wage increase. Then assume that he defers 15 percent of his income with a 50 percent company match. Because of the 401(k) limit he can only accumulate 15.43 percent of his final income, as compared to an employee who

Chart 1 Retirement Benefits as a Percentage of Final Compensation



earns $50,000 per year with the same increases who will accumulate 39.58 percent of their final income and receive significantly higher Social Security benefits (see Chart I).

Objectives for Nonqualified Plan

It is important to establish the plan objectives up front. A nonqualified plan can help a company ***attract, retain, reward, and motivate*** key employees. But while the plan can do all of these things, you should prioritize your objectives in order to get the maximum benefit from the plan. This will allow you to select design features to help you meet your company objectives for the plan (Chart II).

> As opposed to "qualified" retirement savings plans, nonqualified plans must be "unfunded". This means that the money deferred by the participant goes into the company's general account and cannot be set aside to guarantee the plan's future obligations.

Chart 2 Attract, Retain, Reward, Motivate

All nonqualified deferred compensation plans can help a company attract, retain, reward, and motivate key employees.
However, the plans can be structured to emphasize one of these areas over another.

Attract	Retain	Reward	Motivate
• Deferral of signing bonus • High deferral limits • Flexibility	• Company contribution with vesting schedule • Retirement incentive	• High deferral limits • Flexibility	• Performance-based company match on contributions • Company stock

Nonqualified Plan Design

Because these are nonqualified plans, the company becomes the architect in designing the plan to meet the company's objectives. As long as you only provide this benefit to a "select group of highly compensated and/or management personnel" companies can do pretty much anything. A typical design could offer:

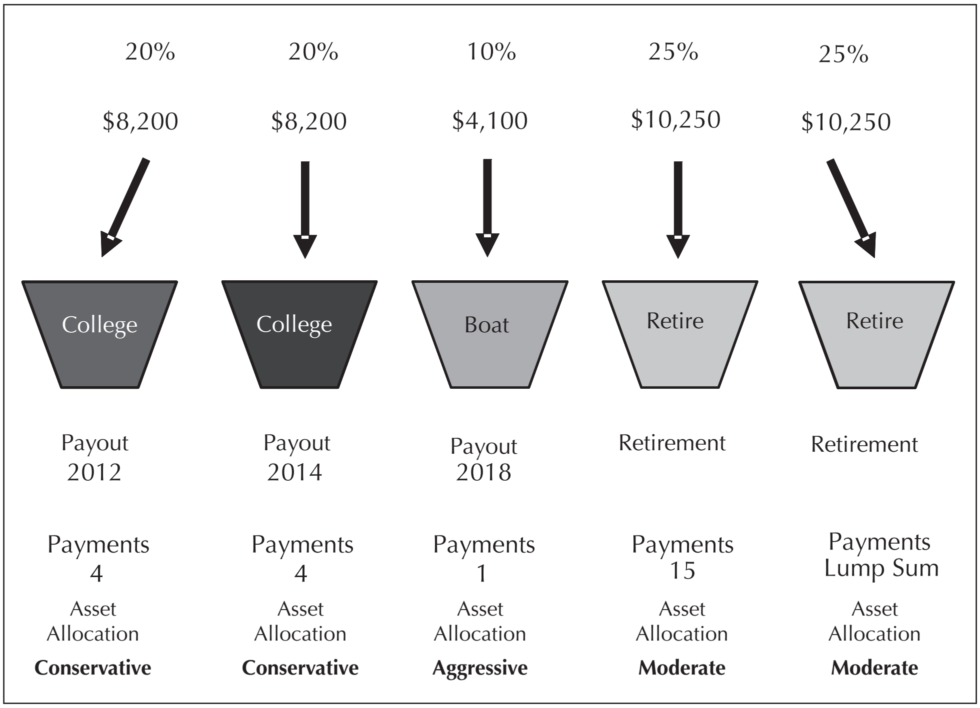
- The ability to defer up to 80 percent of salary and 100 percent of bonus compensation. The reason for 80 percent is that you need to withhold dollars to be able to cover FICA, medical insurance, and other withholdings.
- The ability to have different payout schedules for each year's worth of deferrals (see Chart III).
- Immediate 100 percent vesting on employee's deferrals.
- The ability for participants to withdraw monies while still employed without penalties (see Chart III).
- The ability to choose from a wide range of benchmark investments from growth to fixed income funds such as the 401(k). Company stock can be used as well.
- Latitude for the company to select who participates.

One of the major advantages in today's nonqualified plan is the flexibility it offers the participant. A typical design would allow annual deferral elections of salary and/or bonus compensation that could help meet future life style needs. The following chart illustrates how an executive can elect to defer compensation to meet a number of life time events.

This executive has two children who will start college in 2012 and 2014, so he has allocated 20 percent to each child's college account which would pay out benefits over a four-year period. After the children are out of college, and the executive starts to plan for retirement, this executive decides to save in order to purchase a boat, so he allocates 10 percent of this year's contribution to his "boat account." Here he could pick a different asset allocation than he used for his children's college funds. And finally, in planning for retirement, he has set up "two buckets," one to pay a portion of his accumulation in a lump sum, simply to take some money off the table since he is an unsecured creditor of the company (more about this later), and another to pay out over a 15-year period. Next year, he can add to these buckets, or establish new ones.

Another feature normally found in a deferred compensation design is the ability to re-defer these elections. Under the law (409A), an executive can re-defer as long as he makes the change one-year in

Chart 3



advance of the scheduled distribution and re-defers for at least 5 years. For example, if the executive decides to change the receipt of his Boat account from 2018 to a later date, he can do so as long as the re-deferral election is made by December 2016, and the new distribution date is no earlier than 2023. He could then re-defer again following the same rules.

Why Nonqualified Plans Are So Popular

With a nonqualified deferred compensation plan, you can:

- Defer far more pre-tax compensation than is possible with a 401(k)
- Significantly reduce current income tax liability
- Utilize tax-advantaged investment options
- Enjoy higher equivalent rates of return than from after-tax earnings
- Meet short-term and long-term financial goals
- Enjoy penalty-free scheduled distributions while employed for short-term goals
- Receive lump sum or installment distributions upon termination or retirement
- Choose from a diverse choice of investment options
- Elect payout timing and/or method by deferral year

Tax deferred savings with no government limit make nonqualified plans much more attractive than personal savings on an after-tax basis.

One of the major advantages of deferred compensation is the power of tax deferred compounding. The following chart illustrates the advantage of compounding money on a tax deferred basis versus investing after-tax. The after-tax cash in 15 years ($384,040) is $102,753 more than a personal investment ($281,287) outside of the plan.

One of the advantages mentioned earlier is that most plan designs allow participants to draw from their account balances over a period of time, thus allowing tax-deferred growth on the unpaid balance. If the participant selects installment distributions, the benefit of deferring is even greater.

The following chart illustrates paying out an account balance of $640,040 over 5, 10, or 15 years assuming 9 percent growth.

Figure 1 Pre-Tax Investment

	After-Tax Savings (Not Tax Deferred)	Pre-Tax Savings (Tax Deferred)
Annual Savings	$20,000	$20,000
Taxes on Savings	40%	N/A
Estimated Taxes	$8,000	$0
Net Invested	$12,000	$20,000

Investment Returns are Tax-Deferred Too

	After-Tax Savings (Not Tax Deferred)	Pre-Tax Savings (Tax Deferred)
Amount Invested	$12,000	$20,000
Investment Return	9%	9%
Annual Earnings	$1,080	$1,800
Tax on Investment	40%	N/A
Net Account Earnings	$648	$1,800

Chart 4

For after-tax investing to achieve a return equivalent to pre-tax investing, the after-tax investment would have to earn a higher return.

Informal Funding

The amounts deferred are recorded as a liability on the company's balance sheet. These amounts will grow over time, and can be a significant liability to the company. In order to offset this liability, companies often choose to "informally" fund their deferred compensation plans. As opposed to "qualified" retirement savings plans, nonqualified plans must be "unfunded." This means that the money deferred by the participant goes into the company's general account and cannot be set aside to guarantee the plan's future obligations. Should a company sponsoring such a plan become insolvent, the amount deferred is considered part of the company's assets and is therefore subject to the claims of creditors.

Formal funding, as is required with qualified plans such as the company's 401(k), occurs when the company sets the money or investment outside the reach of its general creditors. The company, in other words, can't touch the monies earmarked for payout under the plan. Should the company become insolvent, creditors cannot make claims against monies in formally funded programs.

Nonqualified plans, on the other hand, are informally funded when a company sponsoring such a plan decides to take some or all of the money it receives through deferrals from the plan participants and invest it to help ensure that when the time comes to pay out funds, those funds will be there. Companies are also interested in hedging their liabilities with an asset. The company may invest in virtually anything to accomplish these goals, but the most prevalent vehicles used are mutual funds or variable universal

Chart 5

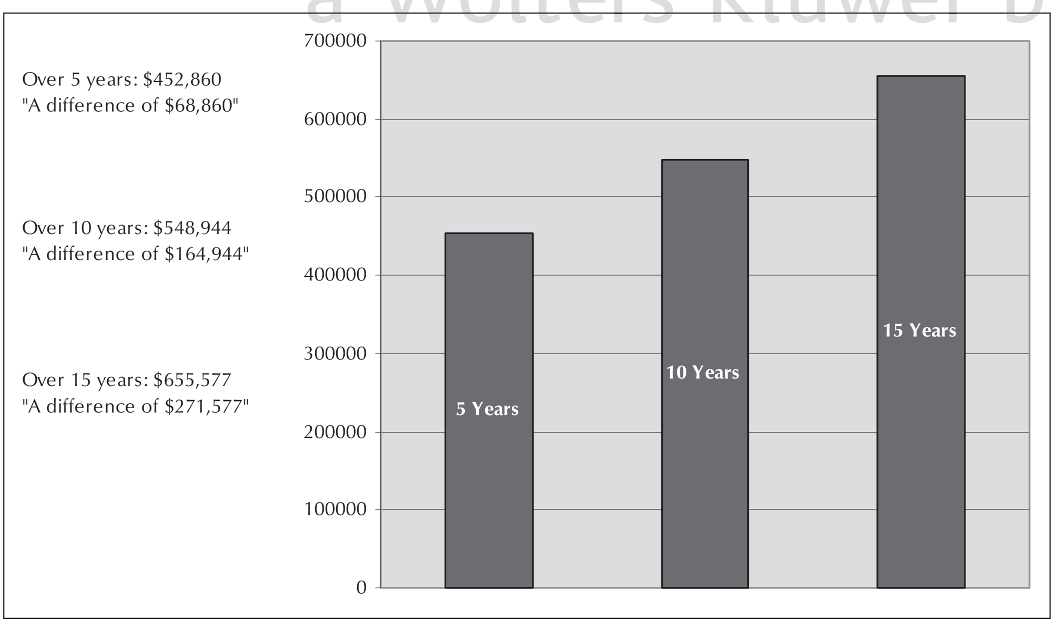


Figure 2

If your tax-deferred rate of return is...

8.00%
10.00%
12.00%

You'd need this rate without tax deferral

10.00%
13.33%
16.67%
20.00%

life insurance contracts owned by the company, termed COLI (Corporate Owned Life Insurance).

COLI products are popular because of the tax advantages they provide to the corporation. Any investment gains, dividends, or interest earned within a COLI insurance contract held until maturity are non-taxable to the corporation. On the other hand, if the company seeking to informally fund its nonqualified deferred compensation plan were to choose mutual funds, most gains would be taxable.

The analysis a company does at this stage is to compare the cost of insurance to the taxes paid on

Chart 6

	Tax (Non-COLI)					Cost (COLI)	
	(1)	(2)	(3)	(4)	(5)	(6)	(7)
		Current Taxation					
Year	Deferred Tax Expense	Tax on Interest and Dividends	Tax on Long-Term Capital Gain Dividends	Annual Income Tax	Total Tax Liability	Insurance (Cost)/ Benefit	Incremental Benefit
				=(2) + (3)	=(1) + (2)		
1	(33,306)	30,143	21,501	(51,644)	(84,950)	(19,981)	64,969
2	(40,945)	62,001	72,278	(134,279)	(175,224)	(61,388)	113,836
3	(42,855)	95,793	131,509	(227,302)	(270,157)	(117,312)	152,845
4	(44,984)	131,350	193,559	(324,909)	(369,893)	(165,467)	204,426
5	(47,273)	168,711	258,715	(427,426)	(474,699)	(236,481)	238,218
6	(49,677)	207,972	327,186	(535,158)	(584,835)	(317,855)	266,980
7	(52,203)	249,229	399,138	(648,367)	(700,570)	(375,302)	325,268
8	(19,901)	261,145	452,543	(713,688)	(733,589)	(357,457)	376,132
9	(14,938)	273,477	478,817	(752,294)	(767,232)	(224,731)	542,501
10	(15,480)	285,790	500,360	(786,150)	(801,630)	(242,403)	559,227
Total	(361,562)	1,765,611	2,835,606	(4,601,217)	(4,962,779)	(2,118,377)	2,844,402

Assumptions

Sample Census - 208 Participants eligible
Projected Deferrals - $2,854,526
Participation Rate - 50%
Deferral Period - 7 Years
Investment Rate - 8%
Retirement Age - The later of age 65 or 7 years of participation
Retirement Payout Duration - 10 Years
Mortality Age - 80
Corporate Tax Rate - 40%
    70% Corporate Dividend Exclusion
    Securities classified as Trading under FAS-115
Investment Rate - 8%
Trust Deposits - Equal to Projected Employee Deferrals
Withdrawals - Equal to Current Taxes and Retirement Benefits

the mutual fund investment. If the plan allows the participant to defer their income into mutual funds similar to the 401(k) plan, then the company records the amount deferred, plus the pre-tax earnings from the mutual fund (Chart VI). To offset that liability, the company would invest the deferrals into COLI insurance contracts with a similar mutual fund investment. The table below shows the impact of recording the COLI asset on the company's books.

Use a Rabbi to Protect your Assets

In most cases, companies who informally fund their plan also place their investments in an irrevocable trust referred to as a Rabbi Trust. This protects participants by preventing the company from using those assets for any other reason than to pay benefits in the nonqualified plan. In this way, assets are protected against events like change of control of the company, change of heart of future management, or changes in the financial condition of the company short of bankruptcy.

The Rabbi Trust had its origin in a determination by the IRS that an irrevocable trust established for a rabbi by the rabbi's congregation was not subject to current income taxation of the assets therein because the assets remained subject to the claims of the congregation's general creditors. Many tax practitioners looked at this private letter ruling and thought it to be a great device to protect executive's nonqualified assets in the event of a change in control of the company, a change in the company's policy with regard to paying benefits, or a change in the company's financial condition short of bankruptcy. In 1992, the IRS issued guidelines for the so called "Rabbi Trust", therefore being the most common devise used today.

Risks of Offering a Nonqualified Deferred Compensation Plan

The first risk of a nonqualified plan is the risk to the participant if the company becomes insolvent or files for bankruptcy. As discussed earlier, this risk is why companies can go above and beyond the limits imposed on 401(k) plans. If this risk is of major concern, stop here and consider an after-tax alternative such as the Insured Security Option Plan (ISOP®) that will provide participants with full bankruptcy protection. The Rabbi Trust will cover most of the other risks the executive may be concerned with, but not bankruptcy or insolvency risk.

For the company, the key thing to remember when considering a plan is its financial impact. Tracking the assets and liabilities is important. Remember, the plan's liability is created through the deferrals from participants along with the interest earned, and the asset is the amount the company is retaining from compensation deferred and the investment income thereon. When those two figures don't track, there is a mis-match.

When liabilities exceed assets, the company is left to make up the difference. Many executives do not realize that there is a cost to the company when employees defer current pay. When an employee receives current compensation, the company incurs a net expense equal to the after-tax cost of paying the compensation. For example, it would actually cost a company in a 40 percent tax bracket only $60,000 to pay $100,000 in current compensation because the company would get to deduct the payment, thus saving $40,000 in taxes. By offering the employee the opportunity to defer $100,000, the company would have a current reduction in cost of only the $60,000 the after-tax cost of current compensation. However, because the company would credit the employee's deferred compensation account with the full $100,000 deferral, the company will incur an additional current cost, further increased when it credits the deferred compensation account with a pre-tax return.

Let's look at this a little deeper. Under the deferred compensation plan, the company has given that executive a number of investment choices. Let's assume the executive chooses an equity mutual fund, and it returns 8 percent: at the end of the year the company's liability would now be $108,000.

The company had a choice on the asset side in deciding how to invest the employee's deferrals to hedge the company's liability. Assuming the company wants to informally fund the plan, there were two choices:

1. The company chose to invest $100,000 in the same mutual fund the participant chose. The fund's return would mirror the employee's selection, earning 8 percent on the invested asset. But, because the gains earned in such an investment are taxable, the company's effective return would be less than 8 percent after tax.
2. The company could chose to invest $100,000 in a Corporate Owned Life Insurance (COLI) contract. Because the investment gains, interest, and/or dividends earned within an insurance contract held until maturity are tax-free, and assuming the company earned an 8 percent annual return within the contract, notwithstanding

the cost of insurance, the assets would track the plan's liabilities. Additionally, because the cost of insurance in a well-designed COLI product is generally less than the avoided tax, COLI is widely used by tax-paying entities.

Although COLI has an advantage over mutual funds for most tax-paying entities, there are a number of things to keep in mind. The policies must be held until the death of the insured to realize the tax-free return. Therefore, a key financing issue with COLI is finding the liquidity to pay benefits. Although the policy cash value can be accessed through policy loans or cash withdrawals to pay benefits, this can be an inefficient source of funds.

In short, when using COLI to hedge deferred compensation liabilities, companies should consider the trade-off between tax efficiency and liquidity. COLI also works best when the plan has continuing growth in liabilities, as new deferrals can be used to fund future benefit cash flows.

Plan Administration

Most companies outsource plan administration. The administration of a nonqualified deferred compensation plan requires significant expertise and intricate systems. The expertise must be broad in subject, deep in understanding, and wide enough to meet the needs of all participants. The administration of a deferred compensation plan, although not subject to ERISA's rules governing qualified plans, is subject to some reporting and filing requirements. Participants must be enrolled annually, and proper communication of plan balances and the status of each executive's account is an ongoing requirement. Plan accounting and financial reports need to be provided to the corporate sponsor. Oftentimes web sites are used to allow participants to enroll, make certain elections, and check balances 24/7.

The following is a partial listing of administrative services related to nonqualified deferred compensation plans with which companies should be familiar:

- Record keeping and the production of periodic benefit statements.
- Coordination of all informal funding requirements, such as deposits via COLI premium payments, invoices, auditing, reconciliation and reporting, and monitoring of informal funding adequacy.
- Disclosure of plan liabilities and related assets for financial reporting.
- Online enrollment and enrollment support services.
- Preparation of plan communication materials.
- Daily valuation and Internet access to participant account balances.
- Ability to track assets to liabilities on a daily basis.
- Proxy disclosure and SEC 16b reporting, as necessary.
- Toll-free service center to assist participants with questions regarding the plan.
- Development of a customized administration manual.
- Preparation of an "Annual Report Card" summary.
- Ultra-secure and independently audited systems.

Conclusion

Nonqualified plans will continue to play an important role in the wealth accumulation area for a company's senior executives. Although implementing a nonqualified plan seems complex, it really doesn't have to be. True, there are more moving parts than in the company's 401(k) plan. But, once the issues are fully understood, a nonqualified plan need not be any more complex than a qualified plan.