The Wealth Counselor
A monthly newsletter for wealth planning professionals

The Continuing Significance of Non-Qualified Deferred Compensation

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If you work with business owners and their key employees - or you would like to - you need to be conversant about Non-Qualified Deferred Compensation (NQDC) plans. NQDC is often a significant component of key employees' compensation because qualified plans are inadequate to meet the retirement needs of those with above average compensation. Also, many employers use NQDC as a tool to enhance retention of their key employees. NQDC plan design and funding is highly flexible so it is useful in many different situations. For all these reasons, it is important that all wealth planning professionals have a basic understanding of NQDC and its application. This issue of *The Wealth Counselor* explores NQDC plans that do not require current funding by employers.

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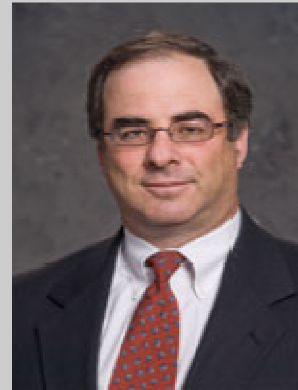

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Who Has NQDC Plans?
According to a recent study of Fortune 1000 companies,

- 85% sponsor NQDC plans;
- 71% finance plan liabilities, with 5% considering doing so;
- 91% credit mutual funds and/or company stock;
- 68% credit earnings daily; and
- 97% use a third party administrator.

But NQDC plans are not just for enormous companies. There are approximately 64,000 U.S. companies that have NQDC plans in place for their key employees. As the number of employees increases, so does the likelihood of a NQDC plan: from 13% of companies with less than 100 employees to 84% of companies with 50,000 or more employees.

What Are NQDC Plans?
As their name implies, NQDC plans are not ERISA-qualified plans. Because of that, they are not subject to most of the strict ERISA requirements for qualified plans. NQDC plans can be custom tailored to help the employee beneficiary achieve a wide variety of financial objectives with different timing. Some examples are providing a retirement income stream, money to buy a second home, funding for children's or grandchildren's education, and income tax planning.

Unlike ERISA plans, which require the plan sponsor to transfer ownership of assets to a trustee, an NQDC plan creates a contractual obligation between the employer and the employee. There is no "pot of money" to pay the benefit. Instead, paying the promised benefit is a contractual obligation of the employer. If the employer fails, the NQDC plan participants are among its unsecured creditors.

Planning Tip: For income tax purposes, participants do not recognize the income when it is deferred under an NQDC plan. Income is recognized only when the employee makes withdrawals from the NQDC plan.

An example: Ms. Key Employee has a base income of $150,000 and an annual bonus of $50,000. Ms. Key Employee elects to defer 10% of her base pay and 50% of her bonus, for a total of $40,000 per year. She has three objectives: (1) funding her two children's higher education; (2) buying a vacation home; and (3) saving for retirement.

Ms. Key Employee can break up and allocate the deferrals as she pleases, and she can dictate how long each allocation should last. Thus, if her children are approaching college years, she can allocate 70% of her base pay deferral ($10,500) for the older child, but only for 4 years, and 30% of her base pay deferral ($4,500) for the younger child for four years, then increasing to 100% ($15,000) for an additional two years. She can also allocate to pay out 30% of her bonus deferral ($7,500) for the vacation home, but only beginning in year 2. She could then allocate the balance of her bonus deferral towards retirement.

Most plans have a November-December enrollment for "regular" deferrals and performance-based compensation (PBC). Enrollment for "regular" deferrals may not be changed after the beginning of the plan year for which they are applicable. However, the law and many plans allow changes to PBC deferral up to mid year. Each deferral election must specify the percentage to be deferred, whether the percentage will apply to salary or PBC, when withdrawals from the deferred compensation will begin, and the timing of the withdrawals thereafter. An election for an NQDC plan year is "irrevocable" once the enrollment window for that plan year closes.

Subsequent changes to an NQDC plan withdrawal election are permitted but must be made at least 12 months prior to the scheduled withdrawal and result in the withdrawal's being delayed at least five years.

Planning Tip: NQDC plan deferrals but can be suspended in certain cases of hardship.

Planning Tip: Deferral agreements may be creative. For example, an employee can defer 10% of salary and a percentage of bonus that depends on the size of that bonus ("ladder" bonus), for example:

- If bonus is less than x then defer 0%
- If bonus is between x and y then defer 25%
- If bonus is between y and z then defer 50%

"Separation from service" is the triggering event for retirement distributions to begin. However, many plans do not distinguish between the employee retiring and the employee quitting (e.g., to go work for a competitor).

Planning Tip: Consider requirements for a minimum attained age, length of service or both to create a distinction, such that the employee's distribution elected is valid only if the employee meets the requirements. If the employee does not meet the requirements, the plan can provide for a lump sum distribution.

Funding the NQDC Plan Liability
There are three basic ways the employer may handle its liability to the participants under an NQDC plan: (1) do nothing; (2) purchase taxable investments (e.g., mutual funds); and (3) purchase tax-deferred corporate-owned life insurance (COLI) on the participants. The employer may also combine approaches, as for example by using both COLI and making taxable investments to hedge the company's exposure.

There is no "best" approach. Which approach is "best" for a particular employer depends on the company's:

- Income tax bracket;
- Cost of money;
- Earnings assumption;
- Realized vs. unrealized distributions;
- Cash flow; and
- Other factors.

There are advantages and disadvantages to each funding method.

The Do Nothing Plan
The advantages of not financing the NQDC plan include (1) simplicity; (2) if the company's ROE is greater than the promised benefit, the spread benefits the company; and (3) it does not tie up cash needed to grow the company. The disadvantages are (1) it

depends on future liquidity (increased risk to participant); (2) the company is liable for benefit regardless of earnings; and (3) "legacy vs. liability"- leaving future management the responsibility for generating the cash flow to pay the benefit liability when due.

Taxable Investments
The advantages of making taxable investments (typically mutual funds) to provide assets that can be sold to pay NQDC benefits are (1) many investment options; (2) direct crediting of earnings; and (3) it is easy to understand. The disadvantages are: (1) the earnings on the investments are "taxable" to the company; (2) it requires the highest cash flow to support the income tax on the earnings; and (3) transaction accounting and recordkeeping may be difficult.

Corporate-Owned Life Insurance (COLI)
The advantages to buying COLI to provide funds to pay NQDC benefits are (1) earnings accumulate "tax deferred;" (2) distributions made by policy loan are tax-free (subject to contract limitations/charges); and (3) life insurance death proceeds are tax free to the company as beneficiary. The disadvantages are: (1) the cost of life insurance; (2) the underwriting process; and (3) the need to educate the client and potentially other advisors.

According to a recent Fortune 1000 survey of NQDC plans,

- 61% use COLI, either primarily or in combination with the other means for funding;
- 45% use primarily taxable investments;
- 23% use primarily employer stock; and
- 15% use primarily other funding mechanisms.

Planning Tip: Through the use of a "rabbi" trust, the assets purchased to hedge the employer's liability to the NQDC plan participant can be protected from all risks except that of the employer's bankruptcy.

Planning Tip: Technical Bulletin 85-4 provides the generally accepted accounting principles (GAAP) for corporate-owned life insurance. In general, this accounting treatment, over the life of a plan, can result in a more favorable accounting treatment for the company when compared to the accounting used for the other NQDC financing methods.

Administering the NQDC Plan
Administering an NQDC plan can be as simple or complex as the employer chooses. The simplest NQDC plans simply credit a fixed annual interest rate to plan deferrals. At the other end of the spectrum, NQDC plans with third party administrators may offer participants control over his or her deferral accounts through internet access, hypothetical investments in selected mutual funds, daily crediting, and combined reporting with the

participant's other accounts with that administrator.

Planning Tip: With an NQDC plan in which the employer's liability is funded with taxable investments, the administrator can match the plan's actual investments with the hypothetical investments made by the plan participants to minimize the company's exposure.

Conclusion

Non-qualified deferred compensation creates significant planning opportunities for company owners and key employees, including increased retention of key employees. By working together during the design, implementation and administration of NQDC plans, the planning team can ensure that the selected NQDC plans meet the planning goals of both the employer and its key employees, which often include its owners.

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