

Funding Nonqualified Plans after the Pension Protection Act of 2006

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On August 17, 2006, the President signed the Pension Protection Act of 2006 (PPA) into law. The PPA makes sweeping changes that affect the operation of both qualified and nonqualified retirement plans. This report will answer two pertinent questions raised in the wake of the Act:

1. What impact will the PPA have on the design and funding of nonqualified plans?
2. What should companies be doing today in response?

THE PPA AND FUNDING OF NONQUALIFIED PLANS

What does it mean to “fund” a nonqualified plan?

The PPA has created certain restrictions on the funding of nonqualified plans. Before we address the nature and scope of those restrictions, though, it makes sense to review the issues behind what it actually means to “fund” a nonqualified plan.

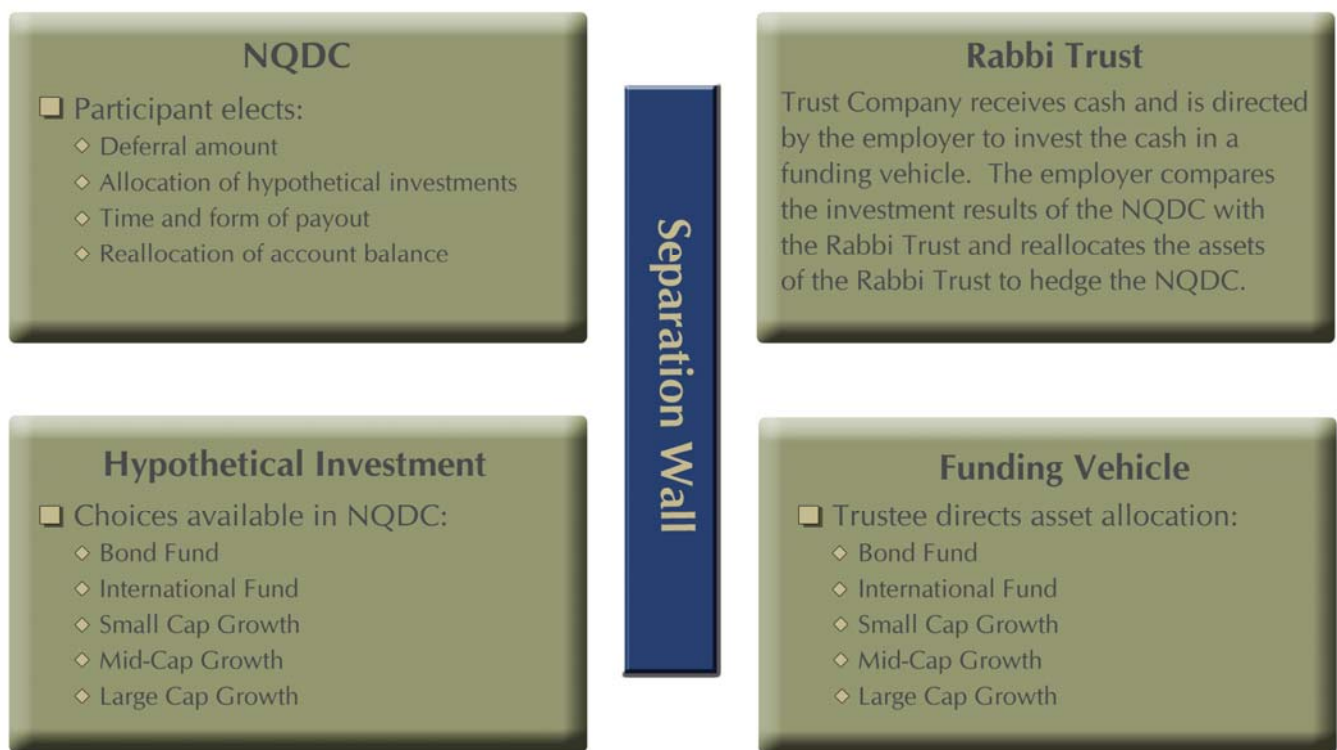
To begin, we must understand that a nonqualified benefit is only a “promise to pay” some future benefit and, thus, all nonqualified plans are technically “unfunded”. “Unfunded” means that money deferred by a participant or a future benefit provided by the company is held in the company’s general account and cannot be segregated to guarantee the plan’s future obligations. Should a company sponsoring such a plan become insolvent, the deferred amounts are considered a part of the company’s assets and, therefore, subject to the claims of the company’s creditors.

This “unfunded” feature is what gives a nonqualified plan its pre-tax and tax-deferred status. Since the dollars are subject to the company’s creditors and a “substantial risk of forfeiture” exists, the participating employee is not currently taxed. Nonqualified benefits are subject to the potential of loss, therefore only those employees who are designated as “top hat” (i.e., highly-compensated) may participate. The Department of Labor (DOL) believes only those who are classified as “top-hat” employees have access to pertinent information and are involved in the decision-making of the company to understand the risks associated with an “unfunded promise to pay”.

Informal Funding:

Thus, unlike qualified plans (i.e., 401(k)), nonqualified plans are not required to be “funded”. Most companies, though, will “set aside” dollars that provide liquidity for future nonqualified benefit obligations. This setting aside of dollars to meet nonqualified obligations is known as “informal funding”. Generally, the dollars used to informally fund the plan are set aside in a Rabbi Trust, which prevents the use of the assets for any purposes except the payment of benefits under the plan. Whether held in trust or not, informally funded assets remain general assets of the company and remain subject to the claims of creditors.

The chart below helps visualize the dynamics of a deferred compensation plan that is informally funded. In this scenario, the employee’s “account” is represented on the left-hand side of the illustration, labeled “liability”. The amounts represented to the employee in the form of a deferred compensation plan balance is a promise to pay, or liability of the company. The employee often has the ability to direct the “investment” of his/her account within a menu of mutual funds, but this investment is a book account only and does not represent the actual corporate asset. On the right-hand side of the illustration we see the corporate asset – the dollars set aside (usually in a Rabbi Trust) to informally fund the plan. The company will want the asset to track the liability as closely as possible and will generally manage the asset on an aggregate basis to track changes in the liability. Maintaining a “separation wall” between the asset and liability is important to ensure the employee has no direct control over the corporate asset. Any access to the corporate asset by the employee raises the possibility of the employee being deemed to have “constructive receipt”, thus triggering immediate taxation of the benefits.



Note: The above illustration presents some of the investments that are available in nonqualified plan. Nothing included herein should be construed as a recommendation of any particular type of investment. Investors should consult with their professional advisors to determine what is appropriate for their unique situation.

Why should a nonqualified plan be informally funded?

Essentially four reasons exist for a company that might informally fund a nonqualified plan:

1. **To hedge a volatile, variable liability.** For example, if the nonqualified liability is tracking the returns in an equity-based mutual fund(s), a year of good returns might increase the net liability by 10 – 15%, or more. If the total plan liabilities are \$10 million, a 15% increase in the liability would translate to a \$1.5 million hit to earnings for the year.

2. **To improve the long-term financial impact of nonqualified plan liabilities.** Nonqualified plans create an additional tax and benefit expense to the sponsoring company. Some funding strategies can reduce, or even eliminate, the long-term expense of the plan.
3. **To provide liquidity for benefit payments.** Participants in a nonqualified plan will generally assign greater value to a plan for which the company has set dollars aside to assure liquidity for benefit payments.
4. **To provide benefit security.** A funded Rabbi Trust is generally used to create a higher level of benefit security. A well-structured Rabbi Trust will protect participants in the event of:
 - Change of control,
 - Change of heart, or
 - Change in financial condition short of bankruptcy.

Example: Unfunded vs. Funded Financial Performance

The chart below demonstrates the impact of three approaches to nonqualified plan funding: unfunded, funded with non-tax managed investments, and funded with tax-managed investments (COLI).

ASSUMPTIONS

Existing NQ Plan Balance	\$10,000,000
Annual contributions (7 years)	\$1,000,000/year
Corporate Tax Rate	40%
Blended Investment Rate	8%
NPV Discount Rate	5%
Retirement Age	65
Mortality	Age 80

	Unfunded	Non Tax-Managed	Tax-Managed (COLI)
NPV of Cash Flow	(\$17,504,357)	(\$9,224,876)	\$7,725,397
Internal Rate of Return	N/A	4.94%	7.14%

The PPA and New Restrictions on Nonqualified Plan Funding

The Pension Protection Act of 2006 has placed new restrictions on the funding (or, “informal funding”) of nonqualified plans. The intent of these new rules is to prevent a company from allocating dollars to the benefit of senior executives when the retirement benefits of the rank-and-file employees are not adequately funded. Specifically, the PPA restricts set-asides for nonqualified obligations during the following periods:

- While defined benefit pension plans are significantly “at risk”. Ultimately, a plan will be defined as “at risk” if it is less than 80% funded. The funding levels will be phased in over 4 years as follows:
 - ◆ 2008 – 65%
 - ◆ 2009 – 70%

- ◆ 2010 – 75%
- ◆ 2011 – 80%
- The period during which the defined benefit sponsor is subject to bankruptcy proceedings.
- The 12-month period beginning six months prior to termination of a defined benefit plan if the plan is terminated with insufficient assets.

Consequences for a violation: The amount set aside for the executive's benefit is taxed as ordinary income and subject to the 20% penalty and interest under Section 409A. Any employer gross-up for the tax is treated as a non-compliant deferral under 409A (subject to the 20% penalty and interest). Any employer gross-up for the tax is non-deductible to the company. Section 409A prohibits payment from the nonqualified plan to pay the tax.

Although effective with the Act, most advisors believe the new rules restricting set-asides should have limited impact on plan sponsors in the short run. The PPA suggests that only public companies are subject to the set-aside restrictions, as the references to covered employees tie into the 16(a) and 162(m) rules. In addition, the funding rules under which plans are deemed "at risk" do not take effect until 2008. Prior to 2008 the rule applies only if an under-funded defined benefit plan is terminated or the employer is in bankruptcy proceeding.

Are there any "work-arounds" to the new restrictions?

Multiple Trusts: Despite the restrictions, many companies will want to fund at least a portion of their deferred compensation liabilities. This will be especially important in a plan that represents the voluntary deferrals of the participants. Since the restrictions apply only to executive officers of public companies, the company could consider segregating trust funding into two trusts:

- One trust provides funding for the executive officer team only.
- Another trust provides funding for the remainder of participants in the nonqualified plan(s).
- In a restricted period, only the non-executive trust would be funded.

After-tax funding – the ISOP[®]: An approach many companies are considering is to turn deferred, non-deductible liabilities into immediate benefits that are currently deductible to the company. (For more information on the ISOP[®], see William MacDonald's article, *Funding Your Supplemental Executive Retirement Plan (SERP) with Tax Deductible Contributions*, October 2006).

COLI PROVISIONS OF THE PPA

Since the 1970's companies have frequently utilized COLI to informally fund their nonqualified benefit plans because of the tax advantages that corporate-owned life insurance (COLI) provides. In the last several years Congress has scrutinized the prevalent practices in the use of COLI, and has sought to limit perceived abuses. What has resulted is a set of rules that puts future utilization of COLI in line with existing "best practices".

Before examining the new rules, it is good to review the purpose of COLI in the informal funding of nonqualified plans.

Why Fund with COLI?

The first step is to determine whether or not to informally fund the plan (discussed earlier). Then, the decision of whether to fund with COLI or with another non-tax managed investment is dependent on at least three factors:

1. Nonqualified plan liquidity needs. If the need for cash to pay benefits is relatively short-term in nature, COLI is probably not an appropriate choice.
2. Corporate tax rate. If the company is currently paying taxes at or near the maximum corporate rate, COLI can provide an effective means of managing the tax expense.
3. Underwriting considerations. Because COLI provides a death benefit, the insurer will require medical underwriting before issuing a policy. If the group to be insured is large enough (i.e., 25 or more participants), Guaranteed Issue is generally available.

Nationally, of funded nonqualified plans, approximately 70% are funded with COLI.*

**Clark Consulting – Executive Benefits – A Survey of Current Trends, 2005 results.*

“COLI Best Practices Provisions”

The PPA adopts the provisions of the “COLI Best Practices Act”, which was previously sponsored within Congress as stand-alone legislation. The Act codifies the prevailing best practices of the industry in the appropriate use of COLI. The PPA overtly permits the use of “employer-owned life insurance” as a financial hedge for nonqualified plan obligations. The Act states “death benefits will be taxable to the corporation unless...”

- Death benefits are paid to the heirs of the insured employee (i.e., in payment for stock in satisfaction of a buy-sell agreement),
- Insured employee was employed during the 12 month period preceding death, **or**
- Insured employee is/was one of the following at any time before death:
 - ◆ Director,
 - ◆ Highly-compensated employee (using the qualified plan rules), or
 - ◆ One of the top 35% of employees, ranked by compensation.

It is the last exception that gives comfort to companies wishing to fund nonqualified plan liabilities with COLI, as it allows the company to own and keep insurance on the lives of the very employees who would be participants in the plans for which the COLI funding is purchased.

Along with the coverage rules, the employer must satisfy a written notice and consent requirement. The notice must disclose to the insured employee:

- The company’s intent to purchase life insurance on the employee’s life.
- The maximum face amount to be purchased.
- The company will be the beneficiary of the policy.
- The policy may be held beyond the employee’s termination of employment.

The employee must consent to the purchase of the policy and the continuation of the insurance after his/her termination of employment. The insured employee must be a US citizen or resident. The

PPA also requires annual IRS reporting. As of the end of the year, the following information is required:

- The number of total employees.
- The number of employees insured under employer-owned insurance contracts.
- The total amount of insurance in force under such contracts.
- The name, address, taxpayer identification number of the employer, and business in which it is engaged.
- A statement that a valid consent was obtained.

The notice, consent and reporting rules apply to policies issued after the effective date of the PPA (August 17, 2006). The new rules do not apply to new policies created as a result of a tax-free exchange of pre- 8/17/2006 policies under Section 1035, unless a “material change” has been made to the policy. However, such exchanges often result in a material change and, thus, obtaining a new consent would be prudent practice.

GOING FORWARD – COLI BEST PRACTICES

In recent years, many companies have been hesitant to take on new COLI funding due to the attention being given to the strategy by Congress. The PPA should remove the “chill” that has recently restricted COLI funding. With the continued development of COLI products, many companies have discovered ever-improved financial results and better asset/liability tracking results. The improvements in modern, institutionally-priced COLI products have given companies great flexibility and tremendous P&L results.

Following are the improvements that one company realized through the restructure of existing COLI funding. In this case, after careful analysis it was determined that of the company’s existing COLI funding (approximately \$40 million), additional efficiencies could be realized through the restructuring of a portion of the total (approximately \$27 million). The net result was a 10-year P&L improvement of about \$6 million, life of plan NPV of cash flow improvement of about \$6.5 million, and an internal rate of return improvement of about 50 bps.

ASSUMPTIONS

Existing COLI Assets	\$40,699,259
Restructured COLI Assets	\$26,982,535
Corporate Tax Rate	40%
Assumed Investment Return	7%
NPV Discount Rate	6%
Mortality	Age 82

	Current Funding	Restructured Funding
10-Year P&L	\$20,860,833	\$26,431,854
NPV of Cash Flow	\$38,975,075	\$45,546,381
Internal Rate of Return	6.04%	6.54%

SUMMARY

Along with the many changes the Pension Protection Act of 2006 has brought to the operation of qualified plans, significant changes to the funding of nonqualified plans have also been introduced. Companies will now be forced to adequately fund their defined benefit pension plans before funding their nonqualified plans. In addition, traditional best practices in the use of corporate-owned life insurance (COLI) have now been codified by statute. By their actions, Congress has made permanent the appropriate and best use of COLI as a legitimate funding approach for companies sponsoring nonqualified plans.

Investors should discuss their own unique situation with their tax and financial professionals. RCG does not give legal or tax advice and the opinions presented in these materials should not be construed as such. All examples are hypothetical and not intended to represent any specific investment.

Investors should consider the investment objectives, risks and charges and expenses of the contract and underlying investment options, risks carefully before investing, The prospectus contains this and other information about the investment company and must precede or accompany this material. Please be sure to read it carefully.

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