

Understanding Nonqualified Deferred Compensation (NQDC)

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About This Report



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Section I.

RCCG

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NQDC Design

NQDC Design



ERISA

- ❑ In 1974, the Employee Retirement Income Security Act, known as ERISA was passed into law.
- ❑ The act was intended to regulate the activities of employers as related to their handling of retirement pension and savings plans.
- ❑ ERISA was enacted to protect the rank and file from the potential abuses by senior management, and in that regard it has been a success.

NQDC Design



401(k) Plans

- ❑ Retirement plans deemed to be “qualified” under ERISA include the ubiquitous 401(k) plan, among others.
- ❑ 401(k) plans limit the amount highly compensated employees can contribute to their plans (\$14,000 in 2005)*.

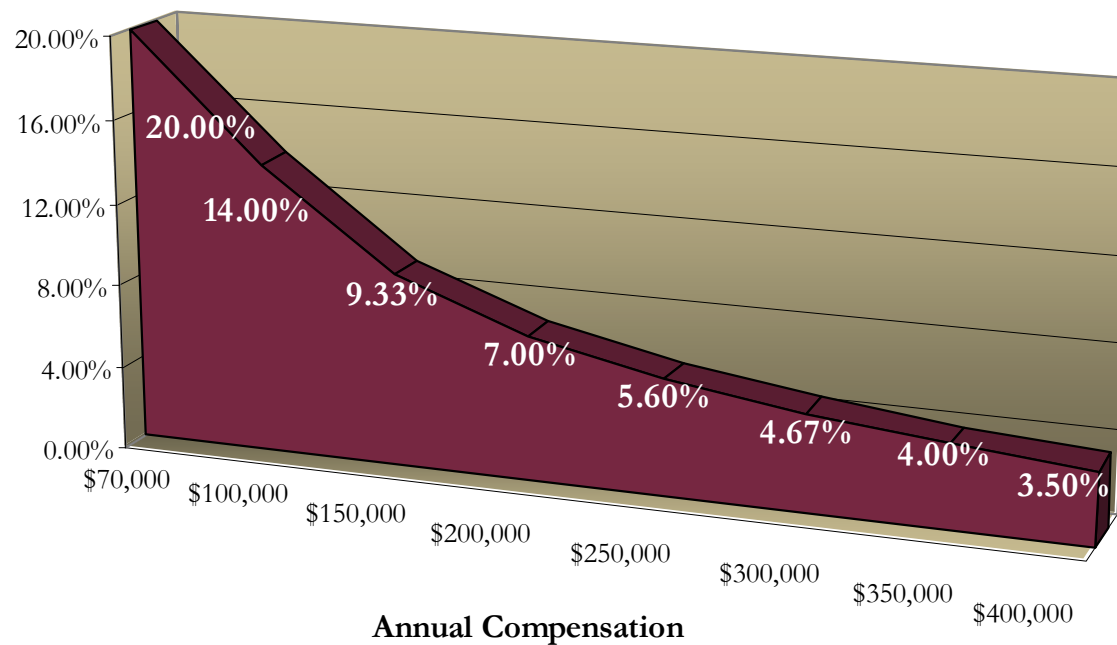
* IRC Section 402(g): 2005 plan year salary deferral limit is \$14,000 for participants under age 50.

NQDC Plan Design



Reverse Discrimination – 401(k) Retirement Savings Plan Maximum Pre-Tax Deferral as a Percentage of Compensation

- The maximum allowable contribution is \$14,000*.



* IRC Section 402(g): 2005 plan year salary deferral limit is \$14,000 for participants under age 50.

NQDC Design



How to Address the Problem Created by ERISA Companies

- ❑ Provide executives a “nonqualified” savings plan⁽¹⁾,
- ❑ Give participant the ability to defer over IRS limits (\$14,000 in 2005)⁽²⁾, and
- ❑ Provide a plan that is not subject to filing, funding or fiduciary responsibilities under Title I of ERISA.

⁽¹⁾ Does not satisfy IRC Section 401(a)

⁽²⁾ IRC 402(g)

NQDC Design



NQDC Plan

- ❑ The participant is not taxed on the amounts deferred until he or she receives the money.

- ❑ The company sponsoring such a plan cannot take the corresponding compensation expense deduction, but rather books a deferred tax credit equal to the amounts deferred until the money is paid to the participant, at which time the deduction is taken.

- ❑ The company also records the deferral as a liability on its balance sheet.

NQDC Design



Asset/Liability Separation

NQDC

- Participant elects:**
 - ❖ Deferral amount
 - ❖ Allocation of hypothetical investments
 - ❖ Time and form of payout
 - ❖ Reallocation of account balance

Hypothetical Investment

- Choices available in NQDC:**
 - ❖ Bond Fund
 - ❖ International Fund
 - ❖ Small Cap Growth
 - ❖ Mid-Cap Growth
 - ❖ Large Cap Growth

Separation Wall

Rabbi Trust

Trust Company receives cash and is directed by the employer to invest the cash in a funding vehicle. The employer compares the investment results of the NQDC with the Rabbi Trust and reallocates the assets of the Rabbi Trust to hedge the NQDC.

Funding Vehicle

- Trustee directs asset allocation:**
 - ❖ Bond Fund
 - ❖ International Fund
 - ❖ Small Cap Growth
 - ❖ Mid-Cap Growth
 - ❖ Large Cap Growth



“Distribution Options”

- ❑ **One of the attractions of deferred compensation plans is the “distribution options.”**
 - ◆ Each amount deferred can have its own payout schedule.
 - ◆ Participant can take short-term distribution (i.e. as early as 3 years from the year of deferral election).
 - ◆ Re-deferral features are common, allowing participants more flexibility*.
 - ◆ Retirement benefits can be paid in a lump sum or over 5, 10, 15 or 20 years (with tax-deferred on unpaid balance).

- ❑ **When participant receives a distribution from the plan, the taxes become due and the company takes the expense deduction for the amounts deferred.**

- ❑ **These plans are generally low cost and structured to attract, retain and/or motivate those eligible to participate.**

* IRC Section 409A.

NQDC Design



Who is Eligible to Participate in Nonqualified Plans?

- ❑ Plan must be for a “select group of management and highly compensated employees.”
- ❑ As a rule of thumb, these are employees who earn in excess of \$100,000 annually.
- ❑ As opposed to “qualified” retirement savings plans, nonqualified plans must be “unfunded.”

* ERISA §§201(2), 301(a)(3), 401(a)(1).



Section II.



NQDC Funding

NQDC Funding



“Unfunded”

- ❑ **“Unfunded” means money deferred by 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 amounts deferred are considered part of the company’s assets and therefore subject to the “claims of creditors” (in 401(k), this is not the case).**

NQDC Funding



“Unfunded” *(continued)*

- ❑ This “unfunded” feature is what gives the NQDC plan its tax-deferred status.
- ❑ The “general creditor risk” is why only those who are “highly compensated” may participate.
- ❑ The Department of Labor (DOL) believes that those who are “highly compensated” are capable of understanding the risk.

NQDC Funding



Informal Funding

- ❑ **Formal funding is required with qualified plans – money is set aside in investments outside company’s general creditors (i.e. 401(k)).**

- ❑ **“Informal Funding” is where the company invest deferrals to help match the assets to its liability.**

- ❑ **Informal funded assets are general assets of the company (even if held in a Rabbi Trust)*.**

*IRS Letter Ruling 8113107.

NQDC Funding



Informal Funding *(continued)*

- ❑ Company can invest in any asset, but most common choices are mutual funds or Corporate Owned Life Insurance (COLI).
- ❑ COLI products are popular because of the tax advantages they provide to the corporation.
- ❑ Any investment gains, dividends or interest earned within COLI insurance contracts held until maturity are tax-free to the company whereas mutual funds are taxable.

This hypothetical illustration shows how the performance of underlying accounts could potentially affect a policy's cash values and death benefits. It may not be used to predict or project investment results. Fees and charges vary between different policies; must refer to the policy prospectus for complete information on fees, charges or expenses. Mutual funds and Variable COLI are available by prospectus only.

NQDC Funding



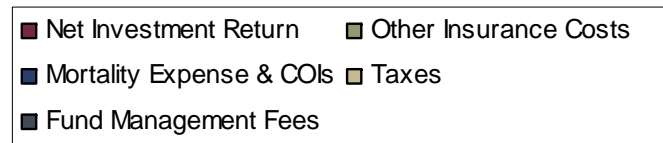
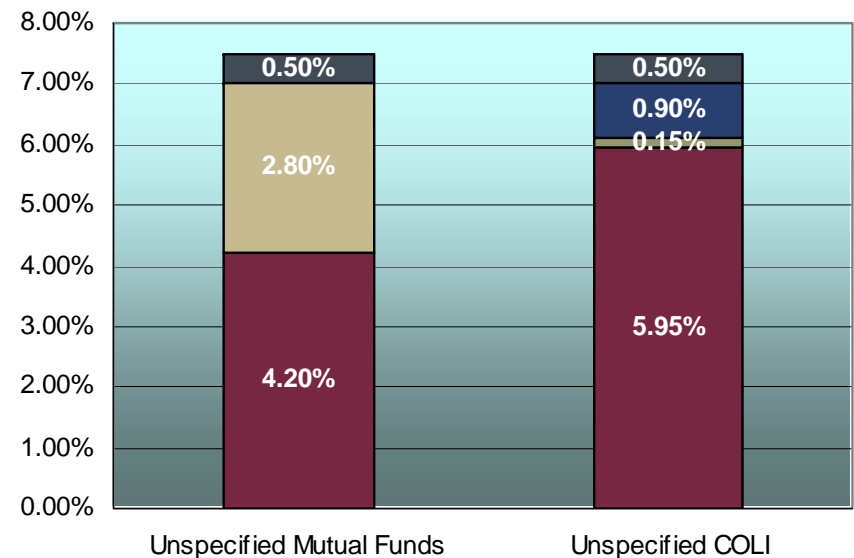
Informal Funding (continued)

- A simple analysis of mutual funds to COLI is to evaluate the cost of the insurance charges to the cost of taxes the corporation will pay on the fund performance.

7% Net Return Cost Breakdown

	40% Tax Rate	
	Unspecified Mutual Funds	Unspecified COLI
Net Investment Return	4.20%	5.95%
Other Insurance Costs	0.00%	0.15%
Mortality Expense & COIs	0.00%	0.90%
Taxes	2.80%	0.00%
Fund Management Fees	0.50%	0.50%

7.0% Net Return and 40% Tax Rate

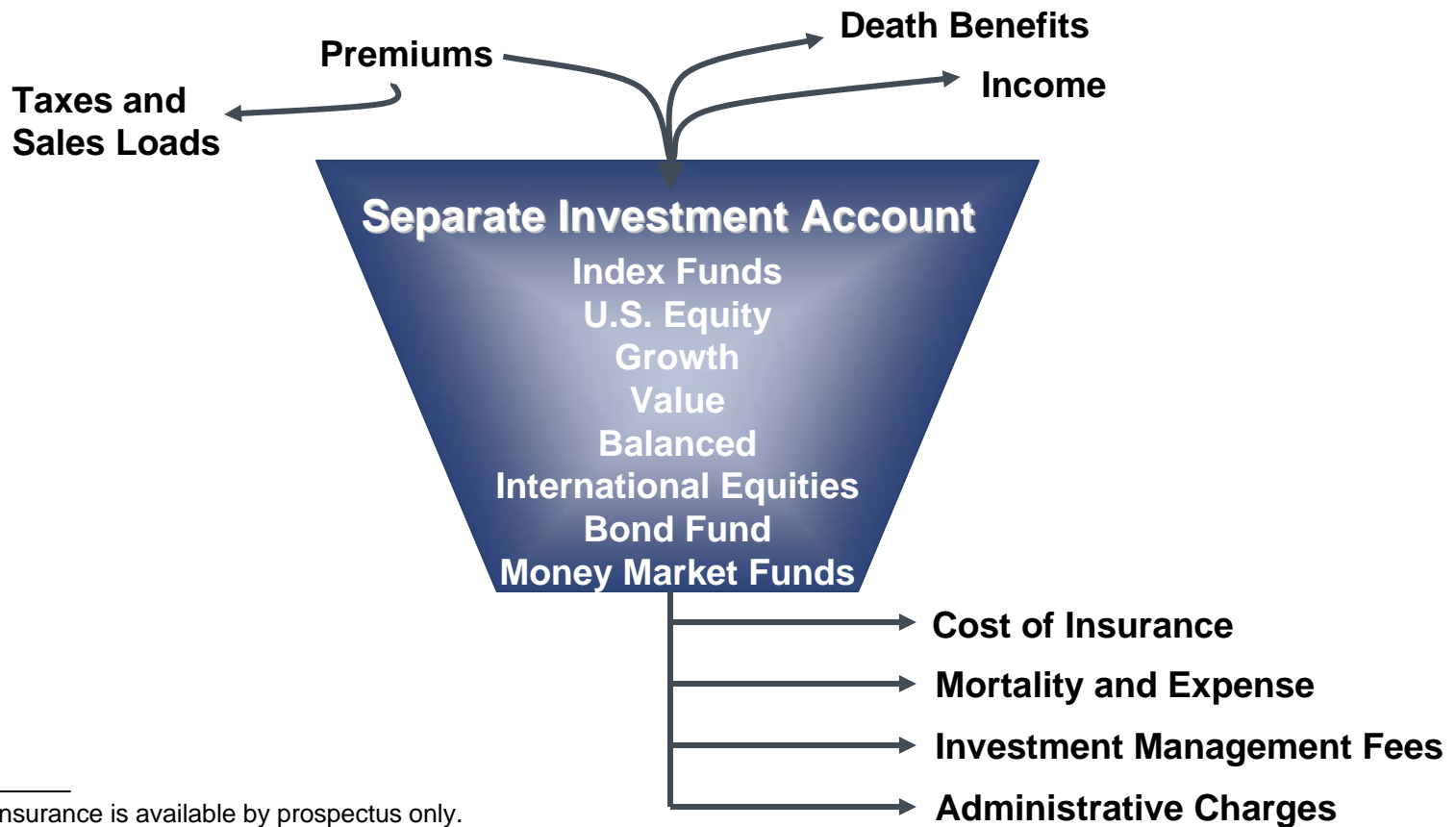


NQDC Funding



Informal Funding *(continued)*

Example of Variable Universal Life Insurance



Variable life insurance is available by prospectus only.

NQDC Funding



Informal Funding *(continued)*

- ❑ Most companies informally funding also place their investments in an “irrevocable trust” referred to as a Rabbi Trust*.
- ❑ Rabbi Trust protects participants by preventing the company from breaking its promise, except for bankruptcy.
- ❑ Rabbi Trust is simply another step a company can take to protect its promise to pay participants the money deferred.

*The Rabbi Trust got its name from an actual Rabbi who received a private letter ruling for his trust from the IRS. IRS Letter Ruling 8113107.



Section III.



NQDC Security: The Plan and Its Promise

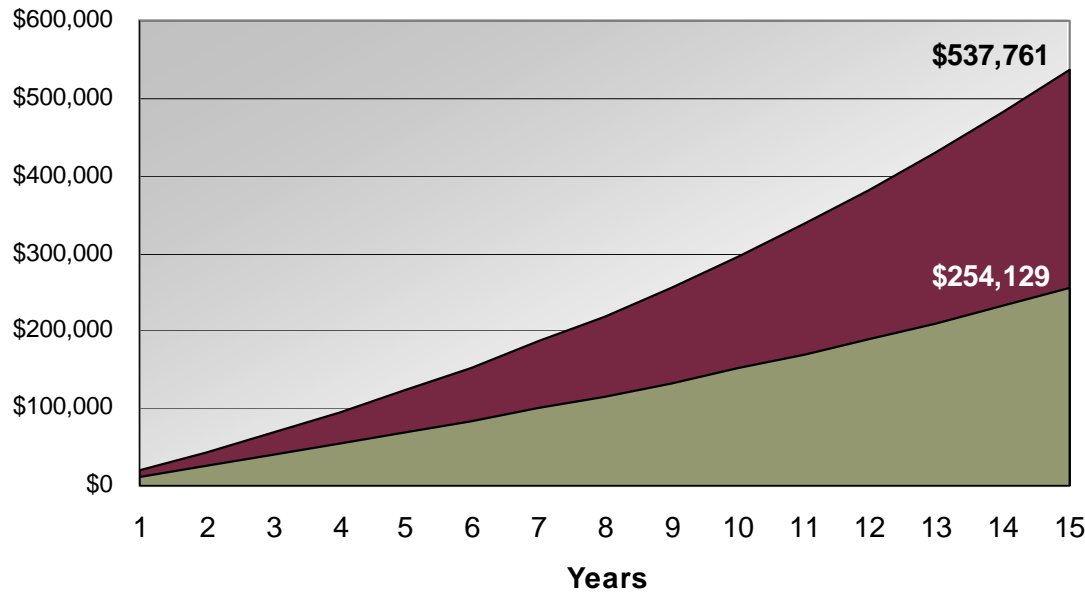
NQDC Security: The Plan and Its Promise



What Makes NQDC so Attractive?

- ❑ **Deferrals and investment gains grow on a tax-deferred basis.**

Growth (Invested to Earn 7% Annually)



Assumptions

- \$20,000 deferral for 15 years
- 7% Interest
- 40% Tax-Bracket

■ Pre-Tax Accumulation ■ Taxable Savings

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NQDC Security: The Plan and Its Promise



The Promise Behind the Plan

- ❑ **What creates this tax-advantaged situation is the promise behind the plan.**
- ❑ **When the executive “defers,” the company makes a promise to pay in the future.**
- ❑ **That promise is “unsecured” and subject to the companies “general creditors.”**
- ❑ **The “promise” part is what makes it all work.**
 - ◆ The company is not permitted to set the money aside, unreachable by the company’s creditors.
 - ◆ The only thing the executive receives for his or her deferral is the “promise to pay” by the company.

NQDC Security: The Plan and Its Promise



The Promise Behind the Plan *(continued)*

- ❑ **There are two other caveats that must be understood in order to maintain the tax advantage status of deferred compensation plans:**
 - ◆ **Constructive receipt** – must follow rules under IRS Section 409A to determine when you can defer and receive payouts.
 - ◆ **Economic benefit** – while money is deferred you can not receive any incidental (“economic”) benefit



Section IV.



**What You Need to Know to
Design Your Own Plan**

What You Need to Know to Design Your Own Plan



Objectives

- ❑ **The key to the design process going smoothly and resulting in success is to begin by determining and ranking, in order of relative importance, the company's objectives related to offering the plan in the first place.**

- ❑ **Nonqualified plans with their unrivaled flexibility can be designed to satisfy a myriad of objectives, but at their core they are put in place to:**
 - ◆ Retain key employees,
 - ◆ Recruit key employees,
 - ◆ Motivate key employees, and
 - ◆ Reward key employees.

- ❑ **Even though nonqualified plans satisfy all four, you need to rank them to maximize plan design.**

What You Need to Know to Design Your Own Plan



Attract, Retain, and Reward

- ❑ All nonqualified plans aid in the areas of attracting, retaining, and rewarding key employees. However, the plan can be structured to emphasize one of these areas over another.

Attract

Plan is designed with few, if any, vesting requirements and offers no penalty for voluntary termination of employment. Plan can be structured to defer signing bonus (with tight vesting schedule).

Retain

Plan design offers provisions that result in the creation of “golden handcuffs” or at least “five in the seat” vesting schedules, preferential treatment of payouts and company contributions can be treated differently to provide disincentive to leave company.

Reward

Plan is designed to reward executives in a tax-advantaged environment. Company contributions are discretionary, so they may be made one year and not the next. Vesting requirements may or may not be imposed. Plan also offers lots of flexibility and a number of investment options.

What You Need to Know to Design Your Own Plan



Case Studies

Objective	Design Feature
Retain Key Employee	<ul style="list-style-type: none"> ▪ Tight vesting on company match or contribution ▪ Loss of benefit if joining competitor ▪ Bonus interest contribution if he/she stays until retirement
Recruit Key Employee	<ul style="list-style-type: none"> ▪ High level of deferrals (90% salary, 100% bonus and defer signing bonus with some “teeth” on the vesting) ▪ Defer signing bonus ▪ Short-term distribution and flexibility ▪ Company contribution with vesting to achieve objectives
Motivate Key Employee	Match based on company performance
Reward Key Employee	<ul style="list-style-type: none"> ▪ Lots of flexibility ▪ High deferral limits ▪ Many investment options

What You Need to Know to Design Your Own Plan



- Nonqualified plans allow companies to discriminate, but in this case discriminate is meant in a positive way.**
- Each participant could be subject to different restrictions or lack thereof.**
- You could have different classes of employees based on any factor (i.e. title, years of service, age, etc.)**



Section V.



Summary

Summary



- ❑ **Nonqualified plans allow companies to be selective.**
- ❑ **Plan can help companies attract, retain, and reward key employees.**
- ❑ **Through proper funding, the plan can be cost neutral to shareholders.**



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