NOLAN FINANCIAL

Nolan Financial Report

Vol. 9 | No. 1

Planning Outside The Box With Nonqualified Executive Benefit Plans

The Multi-Faceted Advantages of Nonqualified Plans Over Traditional Plans

Introduction

In the last edition of the Nolan Financial Report (Vol. 8 | No. 4), we evaluated the strategic design aspects of Nonqualified Executive Benefit plans on a standalone basis. Under this analytical paradigm, employers utilizing Nonqualified Plans have many design opportunities to strategically align the interests of their key executives with those of the employer. Now, as we commence with the start of a new year, it is an opportune time to consider some of the broader and highly unique considerations of Nonqualified Plans that deserve due attention. In light of recent upheavals in the economy that have led to many socio-economic challenges, Nonqualified Plans have gained even greater relevance and importance for employers competing to attract, retain and reward talented executives.

In this edition of Nolan Financial Report (NFR), we will take a broad and comprehensive look at the many unique features of Nonqualified Plans to re-emphasize their importance for the next economic cycle. We will look at the many features of Nonqualified Plans that other traditional plans cannot offer with the same level of effectiveness that Nonqualified Plans do. Although the advantages of Nonqualified Plans that we will consider may be highly diverse, the diversity also highlights the one common advantage of all Nonqualified Plans—flexibility. Contrasted with the rigid features of Qualified plans and other traditional plans, a Nonqualified Plan could almost be considered a blank canvas that an employer may paint suited to its needs.

Nonqualified Plans

Most readers will be aware of the distinction between Qualified Plans and Nonqualified Plans. In broad terms, Qualified Plans are tax-advantaged retirement plans that offer limited benefits in dollar terms and are subject to more stringent conditions. In contrast, Nonqualified Plans offer almost unlimited flexibility and are not restricted in dollar terms, but with these plans employers do not get the tax-preferential treatment accorded to Qualified Plans. These distinctions impact only the employer. From a participant's perspective, both types of plans deliver similar benefits, although the retirement benefit available from a Nonqualified Plan may be much higher than what is allowable under Qualified Plans.

Advantages of Nonqualified Plans

In this section we will look at the unique aspects of Nonqualified Plans. It is important to point out that there are certain common characteristics applicable to *all* Nonqualified Plans. However, it should be noted that this discussion is general in nature and there will be other specifics applicable under various Nonqualified Plan designs. Nonetheless, a broad overview of unique Nonqualified Plan advantages is helpful to understand the relevance and potency of these plans. The flexibility of design affords employers the opportunity to include provisions that may not lend themselves well to other types of Qualified or traditional plans.

- **Selective Discrimination:** Nonqualified Plans may be offered on a selective basis to key groups of executives without any risk of discrimination. This is a highly flexible feature of all Nonqualified Plans. Unlike Qualified Plans that must not discriminate in terms of eligibility, Nonqualified Plans allow employers to customize the eligibility provisions to limited groups of executives or even specific individuals. Employers may thus restrict the Nonqualified Plan only to key groups of executives who are critical to the success of the company.

- **Flexibility of Plan Design:** Each Nonqualified Plan is unique. An employer has complete control over the design of a Nonqualified Plan by carefully crafting the provisions and conditions that fit with its needs. Nonqualified Plans may be designed as Defined Contribution plans, Defined Benefit Plans, or simply Elective Deferral plans. The employer may include a host of provisions including vesting, employer match, discretionary contributions, choice of investments, distribution options, in-service distributions, a combination of employer contributions and employee contributions, deferrals of base and bonus compensation, and many other provisions. Unlike Qualified Plans, Nonqualified Plans truly allow employers to design their own unique plans. It should be noted that there are certain regulations that must be adhered to, such as IRC Section 409A and IRC 457(f) among others, which prescribe the overall rules and requirements applicable to Nonqualified Plans.

- **Choice of Funding Vehicles:** If a Nonqualified Plan is implemented, the Employer has complete flexibility to utilize any funding vehicle that results in the best financial impact for the company. Employers may also make use of a combination of funding vehicles. Employers may thus utilize Corporate-Owned Life Insurance (COLI), Mutual Funds, Company Stock, or a combination of these. Employers may also choose to not fund the benefits and keep the plan 'unfunded'. To convey a positive message regarding benefit security, employers tend to informally-fund Nonqualified Plans ensuring that adequate funds will be available to pay out future benefits. Nonetheless, employers are not obligated to maintain funding and if the financial condition of the employer deteriorates, plan assets of the Nonqualified Plan may be liquidated to meet corporate needs.

- **Less Stringent Formalities:** Nonqualified Plans enjoy a higher degree of freedom not subject to the stringent requirements of ERISA. Qualified Plans have to comply with strict rules for discrimination testing, mandatory distribution ages, required minimum distributions, penalty for distributions before age 59½, etc. Due to less onerous administrative requirements, Nonqualified Plans are simpler to implement and administer. State-of-the-Art Nonqualified Administration Systems simplify the administration even further. Except for initial enrollment, Nonqualified Plans may be fully managed electronically on an ongoing basis.

- **Potentially Higher Retirement Benefits:** For senior executives earning higher levels of compensation, the retirement benefits available from Qualified Plans are fairly limited as a percentage of their overall compensation. This phenomenon is known as "reverse discrimination". Nonqualified Plans help to level the playing field, giving employers the opportunity to address the retirement benefit shortfalls facing senior executives. In addition to elective executive contributions that most Nonqualified Plans allow, employers have wide latitude in their ability to make employer contributions to enhance, supplement or restore lost benefits for senior executives. Employers may include conditional provisions to ensure that executives receive benefits commensurate with their contributions to the employer.

- **Unlimited Deferral of Compensation:** Towards the end of 2010, taxpayers breathed a collective sigh of relief thanks to the extension of the Bush-era tax cuts for another two years. However, burgeoning budget deficits and fiscal imbalances leave little doubt that higher taxes may be postponed but not avoided. States all over the U.S. are facing budget crises and they also have only one reliable source of revenue—taxes. To ameliorate the impact of taxation, executives do have the opportunity to defer their compensation into Qualified 401(k) Plans, but the deferral limit of $16,500 for 2011 is woefully inadequate for highly compensated executives. However, Nonqualified Plans may be designed to allow executives to defer 100%

of their base and bonus compensation in theoretical terms. In other words, there is ***no limit*** on the amounts an executive may defer within a Nonqualified Deferral Plan. However, due to practical considerations employers allow deferral amounts to substantially higher percentages than allowed under Qualified Plans but generally the amounts are not unlimited. An additional benefit is that executives have the flexibility and control to annually determine the amounts of compensation they want to defer.

- **Clawbacks:** Employers routinely provide incentive compensation to key executives to drive performance and to motivate or reward their executives. However, in many instances, a subsequent change in circumstances may rightfully necessitate the employer recouping its contributions, which is called a 'clawback'. For instance, an employer may have made generous incentive compensation awards to key executives only to be later embroiled in a situation involving restatement of company finances, unethical behavior by an executive or even a violation of certain non-forfeiture provisions. Most large employers now have some type of formal clawback policy in place, although clawback protections for publicly held companies are fairly limited and cumbersome to enforce. Employers thus have to resort to acrimonious and expensive recovery actions to enforce their claims. However, with a properly designed Nonqualified Deferral Plan, a clawback provision may be incorporated in the plan design that would allow an employer to recoup only those contributions that the executives may not merit. Essentially, by incorporating vesting provisions and adjustment provisions, the benefit payable to an executive may be subject to restatement in the event of certain triggering events that may require a clawback. However, assuming that during the vesting period no clawback adjustment is needed, the benefit would become vested and payable to the executive, along with some appreciation over the vesting period. In lieu of annual cash awards and complicated clawback recovery actions, Nonqualified Deferral Plans offer simpler and cleaner clawback solutions.

- **Performance-Driven Benefits:** In an era of the "new normal" of a muted economic recovery, compensation and benefits practices have come under greater scrutiny and become more prone to risking shareholder ire. In lieu of benefits that may be perceived as entitlements, Nonqualified Plans may be utilized to provide attractive performance-oriented benefits and rewards for key executives, payable only upon the attainment of certain conditions. As an example, a Nonqualified Performance Unit Plan may be designed that would only make annual employer contributions into an executive's retirement account if certain company-level and individually assigned targets were met. The design of a Nonqualified Performance Unit Plan allows for the accumulation of true performance-driven benefits that may be subject to multiple criteria. Such plans are more 'shareholder-friendly' and less prone to invoking shareholder ire.

- **Alternative to Stock-Based Compensation:** With the memory of the recent recession still fresh in everyone's minds, alternative compensation strategies, such as the grant of stock options, have lost favor, further compounded by the relatively recent accounting regulations that require the expensing of stock options. Executives who lost a lot of money linked to underwater stock options have become sensitive to the need for greater diversification. With a Nonqualified Plan, employers may provide retirement benefits that may not become entirely worthless by offering a wider array of investment options to plan participants. Employers may still link a portion of the benefits to company stock, however, for diversification, other investment choices may be offered as well.

- **Viability for Privately-Held Companies:** Publicly traded companies certainly have an attractive asset in their company stock, which may be offered to executives via stock options or other stock-based compensation plans. However, many companies in the U.S. are privately held or closely held, which makes it impractical to offer stock-based benefits to non-shareholder executives. Key executives who are in charge of running the companies do not have the same incentive as the company shareholders do. A Nonqualified Phantom Stock Plan allows non-shareholder executives to enjoy the same performance-driven benefits that are linked to the success of the companies. Executives may thus participate in the growth of their companies even though they may not be shareholders of the company.

- **Executive Retention in a Recovery Period:** Executive migration is a trend seen in the upper echelons of management especially during a period of economic recovery. As companies emerge from a recessionary period, key executives are more prone to seeking newer opportunities with other companies. In this regard, standardized benefits packages offer little by way of retaining key executives. In contrast, Nonqualified Plans may be designed that strategically address this issue by placing vesting and forfeiture provisions on substantial nonqualified retirement benefits. Key executives would thus have to receive substantially compelling offers from competing firms that would persuade them to forfeit sizeable nonqualified benefits. Similarly, in the event of a change in control, incorporating retention bonuses to remain with the company may effectively retain key executives.

- **Benefits to Executives:** In addition to the many advantages of Nonqualified Plans for employers, executives who are participants in Nonqualified Plans also enjoy many benefits. The first and foremost is the ability to defer taxes on substantially higher levels of compensation. This is an area of increasing concern as noted earlier. The second important benefit is that unlike Qualified Plans, which allow for payments of benefits upon retirement, Nonqualified Plans allow for *in-service* distributions as well. By having the flexibility to choose specific distribution dates, plan participants are able to time distributions according to their personal needs. From a benefit security standpoint, since Nonqualified Plan participants are general creditors exposed to the employer's insolvency, Nonqualified Plan distributions may be staggered to short distribution dates and re-deferred for a minimum of another five years, if the executives have no cause for concern. Nonqualified Plans also allow executives to derive retirement benefits commensurate to their contributions as the employer has discretion to award benefits that need not be uniform.

Summary

Nonqualified Plans are one of the most effective tools available to employers to recruit, retain and reward key executives. The many advantages of Nonqualified Plans highlight the flexibility of these plans, which is their strongest suit. Employers and executives, who may not have been familiar with Nonqualified Plans, will now recognize why these plans are gaining in popularity and usage. Over the next decade, Nonqualified Plans stand to become one of the important components of an executive benefits package—if not *the* most important.

If you have any questions or concerns about how your company may be impacted or would like additional information, please contact:

Michael E. Nolan
President and CEO
Nolan Financial
Phone: 866-810-6442
Email - nolanm@nolanfinancial.com

William A. Craig
V.P. Business Development
Nolan Financial
Phone: 866-810-6442
Email - craigw@nolanfinancial.com

avoiding penalties under the Internal Revenue code. Individuals should seek advice based on their own particular circumstances from an independent tax advisor.