

Nolan Financial Report

Making Nonqualified Plan Distributions Stretch Distribution Options - What's the Big Deal?

Introduction

Windfall - **wind·fall** *noun* \ˈwin(d)-fəl -- The *Merriam-Webster Dictionary* defines *windfall* as an unexpected, unearned, or sudden gain or advantage. In other words, it is a sudden happening that brings good fortune (as a sudden opportunity to receive money). Some would say that a distribution from a nonqualified deferred compensation plan ("NQDC") or a supplemental executive retirement plan (SERP) would be a "windfall", especially if the benefits are substantial. For many executives who are used to a certain cash flow on a weekly or monthly basis, the sudden influx of a large distribution of money can be rather disconcerting. Many are ill-prepared to manage this sudden windfall and will oftentimes make the absolute wrong decision on how to handle their new largess. This would usually be a topic of discussion more fitting to a lottery win or an unexpected inheritance. Given the unlikelihood of either of those happening, we will not make these latter two events a part of this article. However, the amount of some executive's deferred compensation plan account or their SERP can still be fairly substantial hence worthy of a closer look.

Most nonqualified executive benefit plans can help to accumulate and grow account balances over the typical career of an executive to a very significant sum. This is not entirely unexpected as we know that the ultimate objective for employers is to develop a strong plan for retaining key executives who are deemed critical to their ongoing success and future growth. One of the most cost effective means in this regard is the utilization of nonqualified plans.

Unlike with qualified plans, distribution options under nonqualified plans are determined by the sponsoring company subject to the requirements of Section 409A. A given employer may design and plan to limit choices on how and when participants receive distributions. We have found that these limited distribution options are often driven by the employer either not fully understanding the distribution options available, or not having a third-party record keeper with the proper administration system that can administer flexible distribution options. As a result, distributions may be limited to lump sums or fairly short durations, such as 5-years.

While employee contributions to most plans are typically 100% vested immediately, vesting schedules are often imposed for employer contributions—earning some nonqualified plans the nickname of "the golden handcuffs". Vesting periods are usually stretched out long enough to encourage the executive to remain with the company sponsoring the plan. It is this golden handcuff coupled with the executive's own pre-tax deferrals that help to accumulate the significant account balances discussed above.

As we know, nonqualified plans must satisfy the requirements of Section 409A of the Internal Revenue Code, which was added to the Code in 2005, and which substantially changed the regulations pertaining to nonqualified plans. Section 409A sets forth a variety of requirements applicable to nonqualified plans, including rules on distribution

options and deferral elections. Failure to comply with the requirements of Section 409A may result in the early taxation on nonqualified plan benefits as well as a 20% penalty tax and additional interest payable to the IRS.

Unlike qualified plans, nonqualified plans do not permit a rollover of plan assets into an IRA or another nonqualified plan when changing jobs. Instead, an executive must begin receiving payouts—and pay taxes on them—in accordance with the plan's terms.

Comparative Considerations

There are certain significant differences between qualified plans such as the 401(k) or a traditional defined benefit pension plan as compared to a nonqualified plan. These are important distinctions to remember as one considers the overall design of a nonqualified plan, especially in the context of the distribution options to be offered in a plan.

1. Nonqualified retirement plans are primarily offered to executives and other highly compensated employees whose participation and benefits from qualified plans may be significantly restricted. Typically the dollar amounts involved are higher, resulting in higher distribution payouts.
2. Nonqualified plans differ significantly from company to company, and from individual to individual within the same company. As a result, certain executives may receive higher payouts than others.
3. Unlike with qualified plans, there are no legal contribution limits for nonqualified plans. This may result in situations leading to the accumulation of significant account balances, especially with employer contributions or matches.
4. Typically, nonqualified plans are funded in one of three different ways: "Pay-as-you-go," mutual funds (and other publicly traded investments), and corporate-owned life insurance. Design of the funding program may also dictate the distribution options offered in a nonqualified plan.
5. Nonqualified plans do not permit the roll over plan assets into an IRA or another nonqualified plan when changing jobs. Instead, one must begin receiving payouts—and pay taxes on them—in accordance with the plan's terms. As mentioned earlier, this entails receipt of plan distributions, which may be disbursed over a relatively short timeframe.

In the last 18 to 24 months, corporate America has not focused on executive benefit issues as the U.S. has struggled to extract itself from the severe recession that began in 2007. Like many of our readers, we sense a mounting concern on the issue of executive retention that is being expressed in various media from professional journals to experts on television. As CEOs and Boards are urged to focus on the important issue of executive retention, it is important to consider the many unique attributes of nonqualified plans—such as the distribution options discussed in this article.

Issues with Revising Distribution Options

Most nonqualified plans have restrictions limiting the ability of participants to change their distribution elections. Typically, a full year must elapse between completing a change of distribution request and the payout. This prevents application of any incidence of *constructive receipt* (see *Martin v. Commissioner*, 96 T.C., No. 39, 1991). Some plans allow any change among the various available distribution options. Others may prohibit revisions to accelerated distributions—for example, a participant may be permitted to elect to receive his or her balance as a lump sum, and later change the distribution option to 10 annual installments. However, the participant would not be allowed to accelerate distributions from a 10 year payout to a lump sum. Some plans do not permit any changes. These companies say that allowing participants to make such revisions increases administrative burdens (although such changes can be handled easily with a proper nonqualified administration system).

Executives participating in deferred compensation plans typically have a variety of payout options to choose from—although the number of options was reduced with the passage of the *American Jobs Creation Act of 2004*. Distribution of plan funds is allowed in the following specific ways under the *American Jobs Creation Act*—separation of service; disability; a specific date under the plan that is defined in the plan documentation; a change in company ownership or control of the corporation, and an unforeseen emergency (as defined in the statutes); or death. If an executive enrolled in this type of plan dies or is fired from the company prior to retirement, he or she (or their family) receives a lump-sum payout of their benefits.

In our experience, we at Nolan Financial come across many nonqualified plans that are designed with inflexible or limited distribution options. The reason is generally the inability of the service provider to administer such complex plans on their incompatible administration systems. Additionally, at times funding considerations also play a role in limiting distribution options to shorter durations so as to reduce the administrative burdens of the service provider.

Nonqualified Plans — Distribution Considerations

Although good management and leadership are integral to executive retention, the nonqualified compensation and benefits package offered to executives certainly plays an important role in these efforts. Restrictive features of qualified retirement plans have added greatly to the appeal of nonqualified plans. The qualified plans offered by most employers are now generally limited to defined contribution type of plans, such as 401(k) plans and profit sharing plans. This shift to defined contribution plans requires the executive to take a more active role in managing and funding his or her retirement via nonqualified plans. In this context, it is imperative to design distribution options of nonqualified plans with care and due diligence for optimal distribution of benefits.

The introduction of the *American Jobs Creation Act of 2004* and the *Pension Protection Act of 2006* has shifted greater attention on the development and design of nonqualified plans. We believe that a NQDC plan, especially with an employer match, offers companies the most flexible opportunities in executive retention planning. As a result of recent legislative updates, NQDC plans have a very solid future in the executive benefits arena and, we believe, are a necessary component to help in the retention of high caliber executive talent. Other types of nonqualified plans may be utilized as well for executive retention, such as SERPs. Paramount in these design considerations is the understanding of the distribution options that can be designed into a nonqualified plan and why they are significant. Routinely, greater emphasis is placed on the design of vesting provisions, whereas, distribution options are incorporated without significant deliberations.

To us at Nolan Financial, a nonqualified plan is not just a retirement plan but rather a financial planning vehicle that the executive should be able to use to help achieve important financial goals. In this regard, there is a very important aspect relating to distributions that is often overlooked in the design of distribution options. Specifically, it is a little known fact that at retirement if the participant relocates to a no income tax state, if the distributions are delivered in substantially equal periodic payments and taken over a minimum of 10 years, it will result in the applicability of the state tax of the state of residency at retirement. (See H.R. 394, now P.L. 104-95). Recently, we were queried by a planner in the mid-west who had a client who was about to retire with a \$12MM balance in his Deferred Compensation Account. The only distribution option offered in his deferred compensation plan was a lump sum. This executive was retiring to a no income tax state. His employer listened to our recommendation and ended up saving this executive over \$960,000 in state taxes that he would have owed if he had been taxed in the state where his income had been earned.

a. Executive Retention

Nonqualified plans offer the flexibility to accommodate diverse retention needs of employers. A typical nonqualified plan has three components:

- An agreement between the corporation and the executive,
- A high quality funding vehicle utilized by the employer, and
- A nonqualified administration system that can properly administer intricate plan designs.

These three components allow management to design and build a supplemental benefits plan that precisely meets the needs of both parties for retention purposes. As an example, the Board may contractually agree with a talented executive the terms of a nonqualified plan that provides a supplemental benefit of \$50,000 a year for five years commencing in five years, subject to forfeiture of undistributed benefits, payable only if the executive stays with the employer for five years. Clearly the short duration of the distributions is less effective for retention purposes. A better approach would be to spread the distributions over ten years to make the risk of forfeiture more effective. Such an arrangement may also be renewed every five years.

b. Plan Design

Nonqualified plans are typically custom-designed to attract, retain, and reward key executives. These agreements are specifically tailored to meet the needs of the corporation and executive. Nonqualified plans do carry a higher risk for the participants in their capacity as general creditors, but they can be protected from the company's "change of heart" or "change in control" with some protective measures. However, participants cannot be protected from the employer's bankruptcy. For this reason, these plans are generally limited to the top 10% of the employee population of a company. It is expected that at this level in an organization, participating executives are much more aware of the financial soundness of their company and thus can enter into these types of plans with a greater sense of comfort and knowledge of their company's position.

Plan design is the most critical component and requires the greatest amount of upfront 'investment' of time and effort. Since nonqualified plans are highly customizable, the employer has the responsibility to design distributions options that balance the security needs of executives and the retention goals of the employer. Once the plan is designed properly, it will drive the funding and administration and, most importantly, create the retention device that was sought by the employer in the first place. Due to the complex nature of these plans, they require the assistance and guidance of highly specialized executive benefits consulting firms in order to be designed properly.

c. Funding Flexibility for Distribution Options

Nolan Financial's Nonqualified Administration System is designed to handle a myriad of different informal funding methods. These methods include unfunded plans as well as those funded with mutual funds, COLI or a combination of COLI and mutual funds. In order to leverage the full distribution capabilities of nonqualified plans, the funding and administration of these plans must be on par with the plan design objectives.

Nonqualified Plans that are individually-funded (especially with COLI) may be somewhat limited in their distribution options. In other words, the benefits of one executive are funded by a single life insurance policy. However, more sophisticated funding and administration methods entail aggregate-funding, whereby the funding and benefit distributions of groups of executives are aggregated as a pool. The aggregate-funding approach provides the employer the ability to structure distributions in any manner, without being limited by the funding vehicle.

In the event that the executive fails to meet the terms and conditions of the NQDC or SERP agreement, or under other circumstances, the corporation has the complete freedom to access plan assets, whether the funding vehicle is COLI or mutual funds. As a result, distribution options may be structured in any manner without restricting the rights of the employer to the plan assets.

d. Administration Considerations

Nonqualified plans require no IRS approval, no top-heavy discrimination testing and no tax filings and can be utilized with any or all eligible and participating executives without violating the non-discrimination provisions of ERISA. These plans may be changed or restructured as the needs of the parties may change, simply by mutual consent of the parties. In addition, they have no limitations on contributions, no age restrictions, and no penalties for early withdrawal. While there are some restrictions under IRC Section 409A, such as the changing of in-service distribution dates, with proper guidance, plan administrators can easily work around these restrictions.

While the flexibility of nonqualified plans is a huge advantage over qualified plans, if the service provider administering these plans is incapable of handling a myriad of distribution options, the nonqualified plan advantages may be easily lost. Ideally a nonqualified plan administrator should be capable of handling almost any permutation or combination of distribution options. If plan sponsors encounter situations where their service providers are able to offer only very limited distribution options for their nonqualified plans, the plan sponsors should seek other service providers.

e. Participant Taxation

As an executive enjoys no economic benefit until benefits are actually received, or no longer subject to forfeiture, the executive is not taxed during the accumulation period. However, by properly structuring distributions, an executive may be able to minimize the tax impact. As mentioned earlier, if an executive retires to a no-tax state and receives a minimum of ten annual distributions, the tax jurisdiction of the residing state should apply. Similarly, to minimize the risk of forfeiture, an executive may initially specify an in-service lump sum distribution in, for example, five years; however, the executive may subsequently change the distributions to fifteen annual installments commencing from retirement. This may also help to effectively lower the tax rate at retirement.

The ability to elect and change distribution options for taxation purposes is an important consideration for nonqualified plan designs. The underlying funding program and the administration system should support such flexibility in changing distribution options, as opposed to limiting them to inflexible choices.

Summary

A well-designed and properly-implemented nonqualified plan is truly the "Right Instrument" to meet a company's executive "attraction and retention" needs, as enunciated in this article. A customized nonqualified plan with flexible distribution options can help to effectively distinguish a company from its competitors and help to create an effective retention vehicle.

We expect that the attraction and retention of key management personnel will always be among the top five concerns of CEOs, especially as companies retool themselves for improving economic conditions. We also know that there are many nonqualified plan solutions available to address the financial security and retirement concerns of top executives. Distribution options are an important component and they must be designed carefully to improve the effectiveness and impact of nonqualified plans.

Nolan Financial has successfully designed and implemented nonqualified plans for all types of organizations, including for-profit and non-profit. We can help your organization do the same. If you have any questions or interest in regards to designing, funding or administering a nonqualified plan, please contact:

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