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5 Essential Components of a Nonqualified Deferred Compensation Plan

Today, 83% of Fortune 1000 companies have nonqualified plans in place and many executives are beginning to consider them a standard benefit.[1] An employer's ability to recruit and retain premier employees may be dependent on offering one of these plans.

Implementing a Nonqualified Deferred Compensation Plan takes careful planning and must start with a solid foundation. Ultimately, the plan must support the goals and objectives of the employer while meeting the needs of its participants.

Through years of experience, Nolan Financial has developed a blueprint that includes five essential components of a Nonqualified Deferred Compensation Plan:

1. Plan Design
2. Plan Funding
3. Plan Administration
4. Plan Investment Alternatives
5. Plan Communications and Participant Education

Plan Design

One of the most common issues we encounter with new or prospective clients is an underutilized plan. This is typically characterized by:

- A low participation rate
- A lack of participating Named Executive Officers
- Plan language that is perceived as confusing or appears to not offer financial planning opportunities

When we discover this type of low participation, it is often due to poor Plan Design. A well-designed plan should help participants become "retirement ready" and should be viewed as an important financial planning tool. A well-designed plan should also help an employer recruit, retain and reward executives while remaining §409A compliant.

Since a well-designed plan is an integral piece of the blueprint, Nolan Financial has developed a Plan Development Checklist. The Checklist is a tool that we use with all of our clients and prospective clients. It addresses the various components and features that are available within a deferred compensation plan such as: eligibility, definition of eligible compensation, participant deferrals, employer contributions or matches, vesting, distribution options, investment selections and plan sponsor financing, among others.

From our experience, plan design improvements can have the greatest single impact on plan participation and financial planning readiness. As a testament to the importance of a well-designed plan, we have seen clients increase their participation rate by more than 50% just by making plan design improvements.

Plan Funding

Although nonqualified plans cannot be legally funded and secured like a qualified plan such as a 401(k), assets can be "informally" set aside, to fund nonqualified benefits as long as the assets remain subject to claims of the company's general creditors.

When examining funding options for a nonqualified benefit plan, there are three primary choices. Employers can leave the plan unfunded, purchase equities/mutual funds, or purchase tax-deferred Corporate Owned Life Insurance (COLI).

If the employer chooses not to informally fund the plan, then the only accounting entries required is what is necessary to satisfy the plan's liabilities. However, if the employer has decided to informally fund the deferred compensation liabilities with either Corporate Owned Life Insurance (COLI) or mutual funds, there is separate accounting treatment for the asset that is held to fund the liability. This informal funding helps to mitigate the P&L expense (accounting) incurred by the plan's liability.

If the company uses mutual funds, any realized gains from the mutual funds (assuming they are classified as "available for sale" securities) become taxable to the employer each year since the funds are an asset of the company. The realized gains are treated as income to the company to help offset the liability expense; unrealized gains do not flow through as income to the P&L statement. The employer could also elect a fair value reporting option under FAS159, which allows them to report the full increase in value of the mutual funds, both realized and unrealized earnings. However, they would also need to report a deferred tax expense for the future taxes that will be due on the unrealized gains.

Determining which funding alternative is the best solution will depend on a variety of elements, so a careful analysis of cost versus benefit should be performed.

Performing this type of an economic benefit analysis can help employers determine the optimal method of financing future benefits and minimizing plan costs. Ultimately, going through this process can enhance company earnings and create the necessary balance between asset funding and benefit security.

As part of Nolan Financial's Nonqualified Benefit Solution Process, we perform a comparison of the features and benefits of each available funding option. Since Nolan Financial is independent, it has the luxury of being able to provide its clients a wide range of options with increased cost efficiency. Nolan Financial works closely with our clients to understand their unique needs and then develops a solution to help meet their benefit program goals.

Plan Administration

Nonqualified Deferred Compensation Plans can be complex. Plan sponsors and participants can often benefit from utilizing specialized administration platforms created specifically for nonqualified plans.

Many qualified plan administrators offer to administer nonqualified plans on their qualified plan system, but limitations of these systems can restrict the use of some unique features of nonqualified plans. Unfortunately, some qualified plan administrators may not even discuss certain nonqualified plan features since system constraints would not permit their use.

We encourage all employers to do a proper due diligence review of their current or prospective plan administrator. Benchmark their services and fees against other plan administrators every 3-5 years to be certain the administrator offers the latest technology and competitive fees. Employers should verify that all of the desired plan features could be administered on the administrator's plan system before deciding to use their services.

An employer should choose a nonqualified administrator or record-keeper based on experience, expertise and administrative capability. The administrator should also provide best-in-class service and offer the latest technology. It is very important that the recordkeeping system incorporates high-level checks and balances to assure plan administration integrity and accuracy.

Plan Investment Alternatives

In today's regulatory environment, it is common to see an employer's qualified plans (such as 401(k) or pension plan) driven by a written investment policy. The investment policy committee guides fund selection and subsequent performance while keeping the plan in compliance with ERISA regulations.

Nonqualified Deferred Compensation Plans do not have fiduciary liability as do qualified plans. However, it is still very important for the employer to insist upon proper investment option and monitoring criteria. These plans should have their own investment criteria and investment committee that can monitor the fund performance. A sound approach for managing the investments of a nonqualified plan should be similar to managing the investments of a qualified plan.

There should be an investment committee whose responsibilities include:

- Developing an investment policy statement
- Creating a proper mix of investment options
- Establishing asset allocation program
- Quarterly monitoring of the performance of these investment options from both a quantitative and qualitative perspective

It is important to note, since there is no fiduciary liability to the plan sponsor with nonqualified plans, employers can be more creative and consider more sophisticated investment options that may contain more of an element of risk. It may be more beneficial to the plan participants to have these sophisticated investment options since they themselves may be more sophisticated investors and have a better understanding of how these investment alternatives can more successfully impact their personal financial planning needs.

Plan Communications and Participant Education

When offering a nonqualified benefit plan, the most unfortunate scenario we have encountered is an employer who has a well-designed plan with an employer match and the proper funding, but whose plan sponsors have chosen not to properly communicate the benefits of this plan to its eligible participants. An employer's commitment to communication should go well beyond the development and delivery of the plan outline and brochure. A breakdown or lack of communication can have detrimental effects on a plan.

Participant education can fall into three general categories. Plan administrators or record-keepers must give each category their time and attention. These categories include: plan level education, investment level education and retirement / financial planning level education.

- **Plan Design Education** - is focused on the approved plan design and helping the participant understand the various components and key features such as vesting, distribution options, tax consequences and risk. The employer usually delivers these important components when the plan is first rolled out to the participants.

- **Plan Investment Education** - is designed to help the participant make the right investment choices that are in line with their personal risk tolerances. The participant needs to understand the importance of diversification and ongoing monitoring of their investment decisions. An employer's RIA or a non-affiliated personal RIA who is educated about the employer's choices typically delivers this.

- **Retirement / Financial Planning** - is perhaps one of the most overlooked, but most critical components of a well-designed Nonqualified Deferred Compensation Plan. Assets that a participant can accumulate in his or her nonqualified plan can far surpass the assets that can accumulate in the 401(k) or qualified pension plan.

Taking this type of approach to communication and education can better promote the “benefit of the benefit.” Proper communication and education can help support the goals and objectives of the employer while meeting the needs of its participants.

Final Thoughts

Nonqualified Deferred Compensation Plans are becoming more popular and we will see more demand as the US population continues to age. In the coming years, it is believed that higher personal income taxes will continue to be a reality. Higher tax rates and limitations on qualified plans create the perfect opportunity for employers to help highly compensated executives mitigate their personal tax liability and save for retirement. These plans provide a flexible financial planning tool to help executives reach their personal financial goals.

Nolan Financial has designed and implemented nonqualified plans for more than 24 years. Our specialized services cater to the needs of executives, physicians and directors of highly successful public, private and tax-exempt organizations. If you have any questions or interest in regards to designing, funding or administering a nonqualified plan, please contact:

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1. Executive Benefits: A Survey of Current Trends, 2012

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