

The Next Generation of Funding Alternatives for Nonqualified Plans

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Executive compensation and benefits involve inherent complexities that are further complicated by an increasingly invasive regulatory establishment. In a competitive and challenging environment, the urgent need of employers to attract, retain and reward talented executives is met via flexible *nonqualified* executive benefit plans. As *nonqualified* plans are not formally funded due to ERISA concerns, informal funding strategies vary significantly, with a tendency to treat the funding and administration pieces in a discrete manner due to various limitations. The funding and administration of *nonqualified* plans are thus executed with an incongruous *potpourri* of funding vehicles, administration systems and funding systems. This article proposes a *holistic* solution that would serve as a benchmark for the next generation of funding alternatives for *nonqualified* plans. In brief, a next generation funding alternative for *nonqualified* plans is one that maximizes economic benefits to plan sponsors and participants by utilizing a combination of funding vehicles for enhanced flexibility, relies on cost-efficient funding products, takes full advantage of arcane but flexible regulations, and utilizes specialized *nonqualified* administration systems fully integrated with funding systems.

An Introduction to the Next Generation of Funding Alternatives

The purpose of this article is to propose a benchmark solution for the *funding* of *nonqualified* plans at for-profit organizations. The unique value proposition of this article

is that the funding *and* administration components must both be treated as *integral pieces of the overall funding solution* and not as separate and distinct elements. The funding solutions proposed in this article pertain only to for-profit organizations and do not apply to non-profit organizations. The considerations involved in implementing and funding *nonqualified* plans at non-profit organizations are significantly different and beyond the scope of this article.

Nonqualified plans have grown widely in popularity and usage in recent years. However, due to their inherent nature of being *customized* plans, industry practices in the funding and administration of these plans remain highly incongruous. As an example, employers with existing *qualified* 401(k) deferred compensation plans tend to rely on their 401(k) plan administrators to also administer their *nonqualified* deferred compensation (NQDC) plans, mainly due to the convenience of having a one-stop vendor solution and modest cost synergies. However, *qualified* 401(k) plan administration systems are designed for rules and regulations that are vastly different from those applicable to NQDC plans. Some of the notable differences of *qualified* 401(k) plans are: scheduled in-service distributions are not available, distributions before age 59½ are permitted under limited circumstances, minimum distributions are mandated, distribution ages are prescribed, participants generally have only one deferral account and investment choices as well as distribution options are fairly limited.

Due to the inherently different design parameters of administration systems, *nonqualified* plans administered on *qualified* plan administration systems are forced to fit such a system, resulting in a loss of flexibility afforded to *nonqualified* plans. In the case of NQDC plans administered on *modified* 401(k) plan administration systems, the design

parameters of 401(k) plans are adopted as the template for NQDC plans as well. The end result is a compromised NQDC plan design. Thus, participants have to remain content with the same limited investment choices available in their 401(k) plan, fewer deferral accounts and limited distribution options. Furthermore, funding vehicles utilized for *qualified* plans are fairly limited—mainly mutual funds—hence the administration systems and processes are not set up for additional funding vehicles commonly utilized for *nonqualified* plans, such as corporate-owned or employer-owned life insurance (COLI). As a result of the limitations of the *qualified* plan administration systems used to administer *nonqualified* plan assets and plan liabilities, funding mismatches become a chronic issue requiring unplanned interventions to manually correct the imbalances.

In other cases—even if a *nonqualified* administration system is utilized—the system deployed to administer participant accounts (i.e., plan liabilities) may not necessarily be linked to the system used to manage the plan’s assets. The lack of an integrated funding and administration solution necessitates reliance on manual processes entailing greater administrative burdens, higher probability of errors, and funding discrepancies between plan assets and plan liabilities.

The next generation of funding alternatives contemplates a seamless integration of funding vehicles and administration systems that benefit both employers and participants. In contrast with funding strategies based on funding considerations alone, the next generation of funding alternatives encompass a multitude of elements that impact *nonqualified* plans, including—a combination of funding vehicles (investment securities and COLI), cost-efficient products (private placement vs. registered products), specialized administration systems (custom *nonqualified* administration systems vs.

qualified plan administration systems), full integration of funding and administration systems, leveraging technological capabilities to capitalize on the flexibility afforded to *nonqualified* plans, and ensuring full compliance with complex government regulations.

Deploying a next generation funding alternative results in the minimum expense for the employer while delivering enhanced supplemental benefits to the participants. Employers minimize plan expenses by utilizing institutional products with better pricing and features, avoiding funding imbalances by using sophisticated administration systems, and by primarily utilizing a funding vehicle such as COLI—private placement or registered, depending on plan size—for better tax, accounting and financial impact. Supplemental benefits to participants are enhanced as they may avail a better selection of investment options and control over the investment strategy of their *nonqualified* plan accounts. Participants also enjoy a very high degree of flexibility in the timing and number of distributions they may schedule in the *nonqualified* plan suited to their needs.

It is important to point out that this article includes a discussion of the *essential* elements relating to the *funding* and *administration* of a *nonqualified* plan—all of which are required at a minimum for any *nonqualified* plan. Certain non-essential aspects that may be unique to each employer are beyond the scope of this article, such as premium financing options, alternative minimum tax (AMT) and net operating loss (NOL) carryovers, among others. It should also be noted that COLI funding of a *nonqualified* plan might involve different designs, such as funding for death benefit recovery only with no policy distributions, or a mix of both. In this article it is assumed that COLI funding is undertaken with the combined objectives of taking policy distributions and receiving death benefits for cost-recovery. This funding approach lends itself better to *nonqualified*

plans—NQDCs in particular—and allows employers to plan for future benefit payment needs from the funding vehicle, as opposed to relying on corporate cash flows.

A Brief Overview of Nonqualified Plans

Executive benefit plans that may be offered on a discriminatory basis to a select group of management or highly compensated executives—referred to as “top hat” employees—are called *nonqualified* plans.¹ The most prevalent among *nonqualified* plans are Supplemental Executive Retirement Plans (SERPs) and Nonqualified Deferred Compensation Plans (NQDCs). SERPs are similar to pension plans and are funded entirely by employer contributions. NQDC plans are elective deferred compensation plans that are funded primarily with participant deferrals, but may also offer limited employer contributions. Nonqualified plans do not receive the tax preferential treatment available to *qualified* plans. In contrast, *nonqualified* plans are not subject to the limits prescribed by the IRS, which affords these plans greater flexibility. From a technical perspective, *nonqualified* plans must remain ‘*unfunded*’ to avoid the onerous requirements of Title I of ERISA.² As such, a disadvantage of *nonqualified* plans is that any ‘*informal funding*’ undertaken by an employer in a given year to meet future plan obligations does not reduce the employer’s reportable taxable income for that year. Furthermore, assets set aside by the employer to informally fund a *nonqualified* plan must always remain subject to the claims of the employer’s creditors, thereby allowing executives to avoid the implications of ‘constructive receipt’.³ Tax deductions to the employer are available in those future years when benefit payments are made to participants. In the context of this article, any reference to funding implies *informal funding* undertaken by the employer.

From a participant's perspective, a SERP or NQDC plan offers benefits comparable to those available from a *qualified* plan. This is important as *nonqualified* plans help to complement and supplement limited benefits available from *qualified* plans. With no compensation or benefit limits applicable, employers have wide latitude in designing *nonqualified* plans suited to their unique organizational needs.

Nonqualified plans help to offset the 'reverse discrimination' phenomenon due to government imposed *qualified* plan limits that impact highly compensated executives.⁴ For example, in the year 2010 the limitation on elective deferrals under IRC §402(g)(1) is \$16,500, which is applicable to 401(k) plans. As a result, a lower-earning employee with a \$60,000 annual salary can defer about 25% of his or her income into a 401(k) plan; whereas, a highly compensated executive earning \$300,000 can defer only 5.5% of his or her salary. The result of reverse discrimination is that senior executives derive lower retirement benefit income as a percentage of their final average compensation from *qualified* plans when compared to rank-and-file employees. Some examples of these regulatory restrictions applicable to *qualified* plans include:⁵

- Limits on 401(k) or other *qualified* plan contributions
- Limits on the compensation that can be taken into account for *qualified* plans
- Limits on employer contributions to defined contribution plans
- Annual 401(k) plan discrimination testing failures may further reduce contribution limits for highly compensated executives

Funding Selection Due Diligence Protocol

First, the days of being able to administer *nonqualified* plans with an Excel spreadsheet have long gone. The advent of new regulations mandates that employers

utilize a specialized *nonqualified* administration system capable of accurate and compliant administration.

Second, regulations such as IRC §409A—among others—prescribe rules applicable to *nonqualified* deferral plans. In addition, IRC §101(j) establishes the best practices for the use of COLI for informal funding. In designing a new executive benefits program, or redesigning an existing program, the plan sponsor and administrator need to understand how the plans are impacted by IRC §409A and other governing regulations.

Third, critical to a funding solution is a proper plan design. If the plan design does not reflect the goals of the organization, then the overall effect, desired behavior change and the funding alternative will not easily achieve the intended goals.

Last, but not least, the selection of financial or life insurance products requires a thorough and objective evaluation due to their complex structures and customizable characteristics. Institutional life insurance products are frequently upgraded, which may completely change their rankings in terms of cost-competitiveness and relative advantages.

Funding Vehicles

In general, ‘three’ funding vehicles are typically deployed for informally funding *nonqualified* plans. The first *funding* vehicle—keeping the plan ‘unfunded’—is in fact one where the employer chooses to not fund the plan’s obligations. With an ‘unfunded’ approach, the employer essentially makes the decision that the allocation of available capital to its own operations is the best funding alternative.

For purposes of this article, the following funding vehicles are discussed briefly, along with a summary of their advantages and disadvantages:

1. Unfunded (Pay As You Go – Corporate Cash Flow)
2. Investment Securities (Mutual Funds, Stocks, etc.)
- 3.a. Corporate-Owned Life Insurance (COLI) – Registered products
- 3.b. Corporate-Owned Life Insurance (COLI) – PPVUL products

1. Unfunded

Under this alternative, future benefits are paid out of corporate cash flow as they come due. The advantage of this approach is that the employer does not have to set aside funds, thereby using available cash in its own operations. For example, an employer may retain participant deferrals for use in business operations, instead of investing in funding vehicles like mutual funds or COLI.

However, disadvantages of the unfunded approach are fairly obvious, as the employer makes the assumption that its future financial position will allow benefit payments to be paid out from cash flow. The onus of mounting benefit obligations is essentially passed on to future management leaving less room to maneuver. This method also does not provide for any cost recovery. From a financial standpoint, the direct P&L expense attributable to the plan is also higher since there is no offsetting gain from plan assets; however, higher corporate earnings may indirectly mitigate the plan's expense. Participants view unfunded plans as offering lower benefit security, which is why executives consider unfunded plans less desirable and less motivating.

2. Investment Securities

With this funding alternative, the employer invests in investment securities, such as mutual funds, to pre-fund future executive benefit liabilities. Generally, the minimum funding threshold is *de minimis* with typical investment securities. The key advantage of

utilizing investment securities is that a very large selection of investment choices is available along with a high degree of flexibility *vis-à-vis* liquidity. As a result, overfunding is not an issue. In addition, the employer's effort to undertake some type of funding—in contrast with a completely *unfunded* plan—adds some level of security and assurance to plan participants—even more so if a *Rabbi Trust* is utilized.⁶ A *Rabbi Trust* is a grantor trust of the employer holding the *nonqualified* plan assets and it offers protection to the executives in the event of the employer's unwillingness to pay the benefits or a change of control.⁷ However, a Rabbi Trust does not offer protection against the employer's insolvency and its creditors.⁸

The most significant disadvantage of utilizing investment securities is that the employer has to bear the cost of taxes on investment earnings, which may substantially diminish the financial advantages when compared to other funding vehicles. Due to the ability to precisely match assets with liabilities, this funding vehicle precludes any element of cost recovery. From a P&L reporting standpoint, if investment securities are classified as “*available for sale*” (as they commonly are under FAS 115), unrealized gains will not flow through to the P&L statement until they are liquidated, subjecting the employer to the attendant tax impact.⁹ Thanks to a relatively recent Financial Accounting Standards Board (FASB) statement issued in February 2007, SFAS No. 159, employers now have an opportunity to elect “fair value” recognition of specific investment securities, without having to liquidate those investments.¹⁰ Although SFAS No. 159 increases the viability of utilizing investment securities for informally funding nonqualified plans, the tax disadvantages cannot be avoided resulting in a permanent disadvantage when compared to COLI funding.

3.a. Corporate-Owned Life Insurance (COLI) – Registered Products

Employer-owned or corporate-owned life insurance is commonly referred to as COLI. COLI funding is particularly attractive due to its unique tax and accounting advantages not available to other funding vehicles, such as investment securities.¹¹ If properly designed, COLI funding also provides an opportunity for cost recovery to a degree unavailable under *any* other financial product by far. For example, an employer may acquire a \$1 million policy on a 45-year old executive with \$48,000 in projected annual premiums to be paid over 7-years to fund the future benefit liability. If the executive dies prematurely in the third year, the employer will receive a tax-free death benefit of \$1 million. However, with any other funding vehicle, the most an employer could expect would be a return of principal ($\$48,000 \times 3 = \$144,000$) plus reasonable appreciation.

Although the financial merits of life insurance are beyond the scope of this article, it is worthwhile to point out that insurance companies are able to offer substantial death benefits to a small percentage of claimants in any given year by pooling premiums and spreading risk. Since the mortality experience of a small group of executives will always vary from those of large pools of insureds, even slight deviations in actual mortality experiences can weigh in favor of the employer. Employers normally plan for a *conservative* scenario assuming all executives live to projected mortality ages; thereby targeting specific cash value accumulation, which is manageable. As the timing of death benefits is always unpredictable, a conservative scenario allows employers to fund COLI policies, *at a minimum*, for partial cost recovery. The downside of funding for cost recovery is that employers have to fund policies with marginally higher premiums to

support a higher death benefit, and if overall policy returns fall short of expectations, additional premiums may be required.

As is the case with investment securities, an employer acquires COLI to pre-fund future executive benefit liabilities. Institutionally priced, registered COLI products have minimum funding thresholds starting around \$100,000 in annual premiums. Thus, employers with smaller plans may consider registered COLI products and employers with larger plans may consider PPVUL—discussed in the next section. It is important to point out that the tax and accounting rules are the same for *all* life insurance products.¹² Hence, the choice of a registered COLI product or PPVUL product impacts only the *product features*, such as expenses and loads, negotiable or non-negotiable pricing, custom or fixed menu of investment sub-accounts and minimum annual premium commitments.

Registered COLI products are equally viable and highly effective for smaller-sized plans, as these products are priced specifically for the institutional market place based on favorable mortality tables. In contrast, traditional—i.e., retail—life insurance products, available for individual purchases, are based on less favorable mortality tables of large pools evidenced by higher loads and expenses. The biggest difference between registered COLI products and traditional life insurance products is that COLI products normally *do not have surrender charges* applicable whereas traditional products do. In this article, the use of PPVUL products is suggested as the *preferred* approach for large cases as they may involve millions of dollars in lifetime premiums. By using PPVUL products the difference of a few basis points in pricing can result in substantial savings for the employer.

COLI policies may be funded on an aggregate basis (by pooling executives) to improve funding efficiency even though each underlying insurance contract is specifically linked to an individual. The aggregate funding approach allows for better management of cash flows—in synchronization with the *nonqualified* plan's accumulated liabilities—due to the advantages of efficient premium allocation, group underwriting concessions, dispersion of investment risk and negation of the impact of employee turnover.¹³

Although various types of COLI products are available (such as, whole life and universal life) that may be suited for different situations, this article emphasizes the use of *variable universal life* (VUL) insurance products. VUL products are variable products as they incorporate investment sub-accounts that are similar to mutual funds, thereby giving the employer (plan sponsor) greater control over the investment strategy. Furthermore, VUL products utilize separate accounts, which afford greater protection against the issuing insurance company's insolvency or financial distress.

In the years when benefits are payable, the employer initially takes cumulative withdrawals from the COLI policies up to cost basis (i.e., an amount equal to the premiums paid) and/or tax-free loans thereafter when the cost basis is exhausted. Aggregate distributions from the policies are generally taken for the *after-tax* amount of the benefits payable, due to the offsetting impact of the tax deduction available to the employer on the benefit payments. As described earlier, an important advantage is that by funding COLI with marginally higher premiums (i.e., premiums in excess of amounts needed to fund benefit obligations) employers can incorporate the element of cost recovery. The death benefit of each COLI policy provides cost recovery via a tax-free life

insurance death benefit payable to the employer. Under IRC §101(A) and §101(j), employers may insure their top 35% highest compensated executives for informally funding their benefit obligations. In addition, some *nonqualified* plans may be designed to allow for a split of the life insurance proceeds to benefit the survivors of the insured executives.¹⁴

As with any informally funded plan, the COLI funding vehicle provides an added semblance of security and assurance to the participants. A key financial advantage of COLI funding is that the cash values inside the policies appreciate on a fully tax-deferred basis. The cash value appreciation is not taxed unless the policies are surrendered. Furthermore, unlike investment securities that are classified as ‘*available for sale*’, the unrealized gains on policy cash values flow through to the P&L statement.¹⁵ Hence, while there is no tax impact on the cash value gains, there is a positive impact for financial reporting purposes. On a *net present value* (NPV) basis, the positive impact to the P&L statement may be 30-40% higher, on average, as compared to funding with investment securities. The P&L gain is attributable to the more advantageous tax and accounting treatment of COLI, as well as the receipt of tax-free death benefits over the life of the plan.

It is important to note that although the COLI policies are funded to manage the cash value component—which is more predictable—the death benefit component is always unpredictable and is *substantially* higher than the targeted plan liabilities. The unpredictable timing of policy death benefit proceeds may provide for considerably *higher* cost recovery, *if* deaths occur earlier than projected. If properly designed and funded, a COLI funding vehicle may yield the best financial results among various

funding vehicles due to the accounting, taxation and death benefit recovery advantages. Not surprisingly, approximately 61-68% of FORTUNE 1000 companies that informally fund their *nonqualified* retirement plans do so with COLI.¹⁶

In terms of disadvantages, when compared to thousands of available investment securities, a typical registered COLI product's investment sub-account choices are fairly limited to a fixed menu of offerings. The choices range from 50-100 variable investments along with some fixed accounts, all of which may be utilized without triggering any taxation despite frequent reallocation of cash values. To counter the disadvantage of limited investment sub-accounts, insurance companies undertake regular due diligence to ensure competitiveness of their investment offerings. Another disadvantage is that as true life insurance products, all COLI policies involve the cost of the insurance coverage, although the associated costs are lower for COLI products due to institutional pricing as compared to retail life insurance products.

3.b. COLI-Private Placement Variable Universal Life (PPVUL)

From a funding vehicle standpoint, a PPVUL COLI product has the same tax and accounting advantages available to it as any registered COLI product. However, the unique structuring of PPVUL products may offer several additional advantages for the employer (plan sponsor) if a PPVUL product can be utilized instead of a registered COLI product. If a plan involves higher amounts of funding commitments (which generally correspond to the size of the plan liabilities of the *nonqualified* plan), the employer may wish to consider a PPVUL product *in lieu of* a registered COLI product. In order to qualify for most PPVUL products, the minimum funding threshold is generally \$1 million in annual premiums.

A PPVUL product offers several advantages. A PPVUL product may have upwards of 250 investment sub-accounts, instead of the typical 50-100 for a registered COLI product. More investment choices for the plan's investment committee, or the designated Registered Investment Adviser (RIA), increase the probability of a better array of investment choices for the executives. In addition, a PPVUL product is filed differently from registered COLI products, which allows for more flexibility in terms of pricing. Negotiation may be possible depending on the size of the proposed funding commitments, allowing for custom pricing of the PPVUL product. In general, with a PPVUL product the cost of insurance charges, mortality and expense charges, and premium loads may be lower. Additionally, policy riders may be customizable and custom investment sub-account options may be allowed.

Navigating the Statutory Minefields

The next generation of funding alternatives must offer the flexibility of complying with complex rules and regulations that allow for the delivery of retirement benefits without triggering adverse consequences or compromising their usefulness. The efficacy of a funding alternative can be determined only with due regard to the rules and regulations that govern various aspects of *nonqualified* plans, some of which are briefly discussed here.

American Jobs Creation Act (AJCA) of 2004 – IRC §409A. With the passage of the AJCA, Congress created §409A of the IRC, which applies to “*nonqualified* deferred compensation”. This was in direct response to perceived abusive compensation practices at companies like Enron, WorldCom, etc. These rules apply to employees, directors and “other service providers” and are in addition to IRC §451 constructive

receipt rules. Under the *doctrine of constructive receipt*, income may be considered received by a taxpayer in a given year and be includable in gross income if it is made available for the taxpayer to draw upon at any time, unless it is subject to substantial limitations or restrictions.¹⁷

IRC §409A impacts four key aspects of all NQDC plans:

- 1) It restricts the timing of deferral elections, which must be generally made before the end the participant's taxable year preceding the service period with some exceptions;
- 2) It limits permissible payment events to separation of service, disability, death, a specified time or pursuant to a schedule, upon a change in control, and upon an unforeseeable emergency;
- 3) It restricts changes to the time and form of payments such that acceleration of payments is not allowed, any subsequent change to a payment date cannot be effective for at least 12 months, the changed payment date must be delayed for at least another 5 years, and any change must be made at least 12 months prior to the date of the payment subject to the change; and
- 4) It restricts certain funding vehicles that insulate NQDC plan assets from creditors and does not allow the use of offshore trusts if services giving right to the compensation earned were not performed in that foreign jurisdiction.

The impact of IRC §409A on administration system capabilities is tremendous and of utmost significance to plan participants. Of the several permissible payment events, the ability to specify a time or payment schedule affords participants the greatest control and flexibility. Since IRC §409A does not prohibit or limit in-service

distributions, a participant may elect to specify an *unlimited* number of in-service distributions. A participant may thus stagger distributions over multiple years to compensate for the solvency risk of the employer and to select distribution dates that coincide with personal financial needs. Furthermore, IRC §409A allows subsequent changes to be made to payment dates, which affords a participant the added flexibility to re-defer compensation if in the future the solvency risk of the employer is not a concern, or if the participant's financial needs change. The downside to the laddering approach is that if the participant wishes to delay a payment, it must be re-deferred for at least another five years and each re-deferral election must be planned in advance.

Pension Protection Act (PPA) of 2006 – IRC §101(j).¹⁸ Congress created IRC §101(j) to prescribe the acceptable uses of employer-owned life insurance (i.e., COLI) policies to fund employee benefits. These provisions were added in response to corporate abuses such as “*Janitor Insurance*” enriching employers at the expense of employees. Regardless of the broad, negative portrayal of COLI, it was widely utilized as an informal funding vehicle for *bona fide* executive benefit plans, specifically to address liabilities of the *nonqualified* plans only. However, the COLI Best Practices provisions of the PPA helped to affirm the uses of COLI for *nonqualified* plans, while retaining all of the tax and accounting advantages that have established COLI as a preferred funding vehicle.

IRC §101(j) requires that prior to the issuance of a COLI policy, the following requirements must be met:

- The employer must give written notice to the employee indicating that the employer intends to insure his or her life. This notice must specify the amount of

life insurance to be issued on the employee's life and that the employer will be the policy's beneficiary.

- The employee must respond with written consent to being insured and acknowledge that the insurance may continue after the employment relationship terminates.

A COLI policy that is subject to IRC §101(j) must also meet the requirements of IRC §6039I, which requires that the employer file a return detailing certain information about the number of contracts and the number of involved employees. The employer must maintain records as necessary to determine whether the requirements of §101(j) have been satisfied.

Under the reporting requirement of §101(j) the employer must file an annual information return with the IRS that includes the following information:

- Total number of employees at year-end
- Number of employees insured under COLI policies at year-end
- Total amount of corporate-owned life insurance in force at year-end
- Name, address and taxpayer ID number of the employer and type of business in which it is engaged
- Statement verifying that the employer has met valid notice and consent requirements for each insured employee, before the issuance of the insurance contract

IRC §817(h). In reference to the utilization of PPVUL products—suggested in this article for large sized cases (i.e., with annual premiums above \$1 million)—risks associated with IRC §817(h) pertaining to investment diversification and investor control

issues must be considered. If a PPVUL product is utilized, IRC §817(h) must be complied with—even more carefully if custom investment options are incorporated—to ensure tax-deferred appreciation is not lost. Per IRC §817(h), for a variable life insurance contract to qualify as life insurance for U.S. federal income tax purposes, investments in each sub-account must be “adequately diversified.” Each sub-account must hold *at least* five investments and limit the extent to which investments may be concentrated.

Furthermore, a PPVUL contract owner will be considered the owner of variable account assets for federal income tax purposes if the owner possesses “incidents of ownership” in the assets (e.g., ability to exercise control over the investment of those assets.) This may result in the PPVUL policy failing to qualify as life insurance and instead being reclassified as an investment contract; resulting in taxation to the contract holder on the annual increase in a policy's cash value. The IRS has issued a number of Private Letter Rulings (PLRs) and Revenue Rulings that affect how PPVUL products may be operated and marketed in order to ensure that the policies meet the statutory definition of a life insurance contract. These rulings further clarify and define the investor control and investment diversification regulations.¹⁹

The Need for a *Nonqualified* Administration System

With the advent of IRC §409A, many employers find that they can no longer administer *nonqualified* plans on their own or continue to use their 401(k) provider's *qualified* plan platform. Many employers were forced to freeze their pre-2005 deferred compensation plans and start over with a new IRC §409A plan design for new deferrals. In a complex regulatory environment, employers need to rely on a true *nonqualified* administration system that can specifically accommodate the restrictions of IRC §409A

including, if relevant, the administration of bifurcated plans from existing record-keepers to manage both pre- and post-§409A plans on a single platform. The need for a robust and highly flexible *nonqualified* administration system cannot be overemphasized. Due to the intricacies and restrictions of IRC §409A, a participant can derive maximum flexibility in the timing and receipt of *nonqualified* benefits only by staggering deferrals into multiple deferral accounts and selecting multiple distribution dates.

With a *nonqualified* plan, employers may offer participants a more diverse menu of investment choices, which may include potentially any investment security as long as it has readily available performance data. However, for practical reasons, employers usually offer a menu of choices that are the same as the investment choices available in the underlying funding vehicles (i.e., mutual funds or COLI). Once participants select the ‘deemed’ investment choices for their deferral accounts, administration systems track the hypothetical returns for all participant accounts. The employer’s benefit liability is based on the hypothetical account values of all participants. Although the employer is under no obligation to formally invest in the same investment choices elected by the participants, in order to prudently manage future benefit obligations, employers typically follow the investment allocations of participants by coordinating investment decisions of participants on the administration system with the investments of the employer in the underlying funding vehicles. As the assets in the funding vehicles are always subject to the claims of the employer’s creditors, participants are not deemed to be in constructive receipt of the underlying assets.

Given the prevalence of 401(k) plans and the convenience factor of having one plan administrator, *qualified* plan administration systems are widely utilized in

administering *nonqualified* plans even though they do not offer the same level of flexibility as custom *nonqualified* administration platforms do. Only a specialized *nonqualified* administration system offers the flexibility of allowing participants to select potentially any permutation or combination of accounts, investment choices and distribution elections to correspond with their future financial needs or to address their benefit security concerns. Furthermore, only a sophisticated *nonqualified* administration system can allow *multiple* accounts of each participant to be allocated among multiple deemed investment choices.²⁰

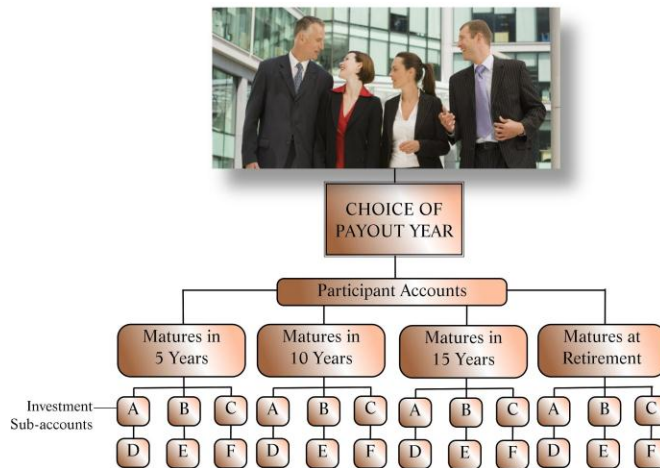


Chart A illustrates the flexibility of a *nonqualified* administration system whereby a participant may make deferral elections into multiple accounts, with each account having a different payout year. By having the ability to select different distribution dates and investment choices, a participant can better match the timing of *nonqualified* plan distributions to coincide with personal financial needs, such as paying for college tuition, making a down payment on a second home, drawing retirement income or other planned needs.

The Proposed Next Generation Funding Alternative

After taking into account various important aspects impacting *nonqualified* plans, we will now consider a model next generation funding alternative.

Funding Strategy Essentials. This article proposes a *combination* of investment securities (for short-term needs only) and PPVUL (for all long-term needs) for informally funding *most nonqualified* plans. If the relatively smaller size of a plan does not allow for the utilization of a PPVUL product, a registered COLI product may be utilized instead. In addition, *plan administration* must be simultaneously carried out through closely linked *nonqualified* administration systems and the insurance/financial product systems.

Short-term liquidity needs—arising due to short-term deferral elections or payouts—necessitate the need for some funding allocation towards investment securities. During the first five to seven years, funds needed to cover benefit expenditures may be utilized from the investment securities account. This is significant if executive retirements or in-service distributions are pending during this initial period. By utilizing investment securities to meet funding needs for initial years, the employer eliminates the state premium and Deferred Acquisition Cost (DAC) taxes that would be incurred with a PPVUL product. If the *nonqualified* plan does not require any distributions in the first five to seven years, then employers do not need to utilize investment securities. In cases where an employer may *already* have a *nonqualified* plan in place funded with investment securities, the recommended approach would be to transition the entire investment securities account—net of benefit payments payable during that initial period—into PPVUL policies over a period of five to seven years.

Under the provisions of IRC §7702—governing life insurance contracts—a life insurance policy must qualify under one of two available tests—the *Cash Value Accumulation Test* or the *Guideline Premium Test*—both of which are designed to limit premium contributions to amounts commensurate with the projected death benefit. In light of the provisions of IRC §7702, the funding of a life insurance policy is most efficient if undertaken over a period of five to seven years since it allows for the intended objective of maximizing premium contributions (builds cash values) and securing the lowest possible initial policy face amount (depletes cash values). Due to the provisions of IRC §7702, a life insurance policy must maintain an adequate proportion of death benefit in relation to cash values to avoid being considered a *Modified Endowment Contract* (MEC).²¹ Although a MEC is treated as a life insurance contract upon the death of the insured, distributions from MECs are taxed similar to annuities. Hence, any COLI funding undertaken with an intention to access cash values must ensure that the policies do not become MECs at any point in time, and this normally requires COLI policies be funded over an initial period of five to seven years for ideal results.

Most *long-term* funding needs should be funded with PPVUL policies. A registered COLI product may be utilized in lieu of a PPVUL product if the planned premium contributions do not qualify for a PPVUL product. Despite the insurance-related fees and expenses of PPVUL products, the overall tax and accounting advantages result in better financial impact when compared to investment securities. The element of death benefit cost recovery helps in lowering the expense of the *nonqualified* plan for the employer. The acceptable uses of PPVUL (i.e., COLI) to informally fund *nonqualified* plans provide employers with a highly effective funding vehicle that should be utilized in

every permissible scenario. It is important to restate that institutional COLI and PPVUL products can be surrendered, if necessary, without triggering any surrender charges. The ability to liquidate the PPVUL policies without surrender charges affords flexibility to the employer in the event of a future deterioration in its own financial condition necessitating access to PPVUL cash values.

Administration Strategy Essentials. An important component of the next generation funding alternative is the inclusion of a sophisticated *nonqualified* administration system. Thanks to a robust *nonqualified* plan administration system, participants can be given the opportunity to make daily investment reallocations to their various *nonqualified* plan accounts, as well as select various combinations of investments for each account. Control of this magnitude over investment elections does not run afoul of constructive receipt issues, due to the IRS's clearly stated position in regard to *nonqualified* plans.²² In essence, constructive receipt is not implied if a participant receives distributions only under plan provisions and the employer's obligation remains a mere promise to pay. Furthermore, as described earlier, a *nonqualified* plan cannot be formally funded with assets set aside in trust to pay plan benefits. Thus, all assets associated with a *nonqualified* plan must remain subject to the employer's creditors.

As would be expected, a higher frequency of daily investment reallocations by participants would result in a greater tax impact for the employer (due to the process of matching assets with liabilities) if investment securities were solely utilized. However, to the extent PPVUL funding is utilized, matching daily reallocations among the various investment sub-accounts would not result in any adverse tax impact for the employer.²³

Hence, an employer's adverse tax impact may be limited only to the initial years during which investment securities are utilized for short-term liquidity needs.²⁴

An important technological development in this area is that the next generation of *nonqualified* administration systems can now electronically reallocate investment sub-accounts of the insurance company administration systems or mutual fund platforms, on a nightly basis, to match the *daily* investment reallocations made by participants. Specialized *nonqualified* administration systems can work in tandem with highly sophisticated insurance policy administration systems of certain insurance companies and mutual fund platforms. This daily reallocation of values allows the employer to accurately match plan assets with plan liabilities, resulting in greater funding efficiency. As described earlier, constructive receipt issues do not arise as the employer is under no obligation to either fund the plan informally, or to match plan assets with the investment selections chosen by the participants. The employer has complete discretion over plan assets without regard to participant investment elections or accumulated liabilities.

Aggregate funding of plan liabilities allows for a combination funding approach (utilizing investment securities and PPVUL) and it does not add any additional complexity for employers due to the reliance on sophisticated *nonqualified* administration systems.

In summary, the following are the key highlights of a model next generation funding alternative proposed in this article:

- Utilizes *a combination of funding vehicles* to balance short-term and long-term liquidity needs and for added flexibility
- Undertakes an *aggregate-funding approach* to better manage cash flows

- Relies on *investment securities for short-term liquidity needs*
- Utilizes *PPVUL funding primarily for most long-term funding needs* – for large-sized plans PPVUL products offer better features and lower product expenses, both of which may be customizable
- *Leverages use of a specialized nonqualified administration system to offer maximum flexibility to participants* while remaining in full compliance with complex regulations
- *Matches plan assets with plan liabilities more closely* due to better synchronization among sophisticated administration systems of the plan administrator and the insurance/financial company
- *Maximizes economic and financial advantages to the employer* by deploying a comprehensive funding solution, in contrast with an incongruous funding strategy devised with a bias towards one funding vehicle and carried out with incompatible and deficient administration systems

Conclusion

Commonly utilized funding strategies for *nonqualified* plans do not rely on a seamless integration of two key elements—*funding* and *administration*. Each element is handled in a relatively discrete manner due to administration system and insurance/financial product system limitations, necessitating a reliance on manual processes. In contrast, the next generation of funding alternatives adopt a holistic approach by seamlessly integrating a flexible funding strategy with the specialized *nonqualified* administration system capabilities. Investment securities and PPVUL may be combined to address short-term and long-term funding needs, but with a greater

funding allocation toward PPVUL to maximize the accounting, tax and financial advantages. Employers with smaller plans may substitute a PPVUL product with a registered COLI product, which are also designed specifically for institutional applications.

The potency and flexibility afforded to *nonqualified* plans can be fully realized only by implementing a next generation funding alternative. By undertaking a due diligence protocol, employers now have the means and resources available to implement a next generation funding alternative for their *nonqualified* plans.

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- ¹ §201(2), §301(a)(3) and §401(a)(1) of the Employee Retirement Income Security Act of 1974 (ERISA).
- ² §4(b)(5), §201(2), §301(a)(3) and §401(a)(1) of Title I of ERISA.
- ³ Treas. Reg. § 1.451-2(a). Also see *Davis v. Commissioner*, T.C. Memo. 1978-12.
- ⁴ IRC Section 415 of the Internal Revenue Code provides for dollar limitations on benefits and contributions under qualified retirement plans.
- ⁵ As published by the Internal Revenue Service, IRC §402(g)(1); §401(a)(17) and §415.
- ⁶ In the early 1980s, the IRS ruled that that an irrevocable trust established by a congregation for a rabbi did not result in immediate federal income tax consequences for the rabbi as the trust's assets were subject to the claims of the congregation's general creditors. Since then such trusts are referred to as Rabbi Trusts. PLR 8113107 (Dec. 31, 1980).
- ⁷ In Revenue Procedure 92-64, 1992-2 C.B. 422, the IRS provided a model grantor trust that could be utilized in nonqualified executive compensation arrangements.
- ⁸ IRC §83(a).
- ⁹ FAS 115: *Accounting for Certain Investments in Debt and Equity Securities*.
- ¹⁰ FASB Statement of Financial Standards No. 159: *The Fair Value Option for Financial Assets and Financial Liabilities Including an Amendment of FASB Statement No. 115*.
- ¹¹ FASB Technical Bulletin 85-4: *Accounting for Purchases of Life Insurance*.
- ¹² *Ibid*.
- ¹³ Aggregate COLI Funding is more efficient than individually funded life insurance policies for the following reasons: 1) Efficient COLI Funding: Aggregate COLI funding relies on pooled life insurance contracts to informally fund benefits of the entire group. For example, an employer may spread annual premiums across multiple policies in varying amounts, which yield the highest cash value accumulation. 2) Less Stringent Underwriting: Aggregate COLI funding is normally utilized in conjunction with Guaranteed Issue underwriting (available for groups of 15 or more participants), which allows all participants to be insured with less stringent underwriting. 3) Dispersion of Investment Risk: As employers attempt to match plan assets with plan liabilities by mirroring the investment elections of participants within the policies, aggregately-funded COLI policies allow employers to spread the investment allocations/risk across all policies in a consistent manner. 4) No impact of turnover: Employee turnover does not impact an aggregately funded plan as policies on departed executives may be kept in force and utilized without requiring any substantial changes to the COLI funding program.
- ¹⁴ This is achieved via a policy endorsement (similar to an endorsement split dollar plan) with the executive having to pay taxes annually on the imputed income of the value of the death benefit inuring to his or her family.
- ¹⁵ *Ibid*. 10.
- ¹⁶ *Executive Benefits – A Survey of Current Trends*, 2009, Clark Consulting.
- ¹⁷ Treas. Reg. § 1.451-2(a). Also see *Davis v. Commissioner*, T.C. Memo. 1978-12.
- ¹⁸ See The Pension Protection Act of 2006, §863 – *Treatment of death benefits from Corporate-Owned Life Insurance*.
- ¹⁹ See PLR 200244001 – November 5, 2002; Revenue Ruling 2003-91 – July 23, 2003; PLR 200420017 – June 1, 2004; Revenue Ruling 2005-7 – January 3, 2005; Treasury Decision 9185 – February 28, 2005; Revenue Ruling 2007-7 – February 12, 2007; Treasury Decision 9385 – March 7, 2008.
- ²⁰ In a 1990 PLR, the IRS addressed the issue of deemed investments in a bookkeeping account of a participant in a deferred compensation plan. PLR 9101011, Oct. 5, 1990. In a number of private letter rulings the IRS has discussed circumstances in which a participant's "deemed" investment is merely a credit to a bookkeeping account and the employer has no obligation to invest in a particular investment selected by the participant. PLR 8804057 (Nov. 4, 1987); PLR 8804023 (Oct. 30, 1987); PLR 8507028 (Nov. 20 1984); PLR 8411022 (Dec. 8, 1983).
- ²¹ IRC §7702A(a).
- ²² Rev. Proc. 71-19 and Rev. Proc. 92-65.
- ²³ *Ibid*. 10.
- ²⁴ *Ibid*. 9.