Practical Applications of Non-Qualified Deferred Compensation

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My practice is people oriented and exclusively devoted to estate planning, estate and trust administration, estate and trust litigation, asset protection and business planning. My newsletter highlights wealth planning issues designed as helpful insights to your practice

This issue of The Wealth Counselor examines a topic that is critical to business owners and key employees - non-qualified deferred compensation (NQDC). NQDC is often a significant component of these individuals' compensation and employers often use NQDC to try to ensure the retention of key employees. Given the flexibility of NQDC plan design and funding, it is important that all wealth planning professionals have an understanding of NQDC and its application.

Who has NQDC Plans?
NQDC plans are not just for enormous companies. According to a recent study of Fortune 1000 companies,

- 95% sponsor NQDC Plans;
- 68% finance plan liabilities, with 3% considering doing so;
- 87% credit mutual funds and/or company stock;
- 72% credit earnings daily; and
- 79% use a 3rd -party administrator.

However, as the number of employees increases, so does the likelihood of a NQDC plan: from 13% of companies with less than 100 employees to 84% of companies with 50,000 or more employees. Also consider that there are approximately 64,000 companies that have NQDC plans in place for their key employees. Thus, these benefits certainly are not limited to just the Fortune 1000.

What are NQDC Plans?

As their name implies, NQDC plans are not ERISA-qualified plans. Because of that, they are not subject to most of the strict ERISA requirements for qualified plans. NQDC plans are very flexible and can help clients accomplish a variety of

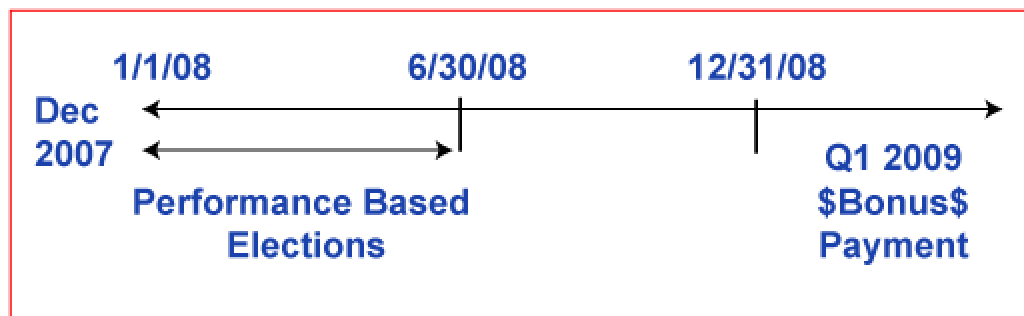
savings goals. Some examples are retirement, a second home, educational funding for children or grandchildren, and simply being an effective tool for income tax planning.

Planning Tip: Unlike ERISA plans, which require the plan sponsor to transfer ownership of assets to a trustee, an NQDC plan is unfunded. There is no "pot of money" to pay the benefit. Instead, paying the promised benefit is a contractual obligation of the employer. Plan participants who defer their income under an NQDC plan do not have receipt of the compensation for income tax purposes.

An example: Ms. Key Employee has a base income of $175,000 and an annual bonus of $100,000. If Ms. Key Employee elects to defer 10% of her base pay and 50% of her bonus, she will defer $67,500 per year. Ms. Key Employee has three objectives: (1) funding two kids' higher education; (2) buying a vacation home; and (3) saving for retirement.

Ms. Key Employee can break up and allocate the deferral as she pleases, and she can dictate how long each allocation should last. Thus, if her children are approaching college years, she can allocate to pay out 25% of her deferral ($16,875) for each child, but only for 5 years. She could also allocate to pay out 30% of her deferral ($20,250) for the vacation home, but only after year 2. She could then allocate the balance of her deferral towards retirement.

Planning Tip: Most plans have a November-December enrollment for "regular" deferrals and performance-based compensation (PBC), but plans generally allow changes to PBC if the employee so elects prior to June 30th (if on calendar year). (See Figure 1 that follows.) These elections must be both as to timing and form of payment and they are "irrevocable," but can be suspended.



Deferral Election Timeline

Planning Tip: Subsequent changes are permitted but require 12 months advance notice and payment(s) must be delayed at least five years, necessitating careful plan administration.

Planning Tip: Deferral agreements may be creative. For example, an employee can defer 10% of salary and a percentage of bonus that depends on the size of that bonus ("ladder" bonus):

- If bonus is less than x then defer 0

- If bonus is between x and y then defer 25%
- If bonus is between y and z then defer 50%

Planning Tip: "Separation from service" is the triggering event for retirement distribution elections. However, many plans do not distinguish between the employee retiring and the employee quitting (e.g., to go work for a competitor). Therefore, consider requirements for a minimum attained age, length of service, or both to create a distinction, such that the employee's distribution elected is valid only if the employee meets the requirements. If the employee does not meet the requirements, the plan can provide for a lump sum distribution.

Funding NQDC

There are three ways to address the liability of a NQDC plan: (1) do nothing; (2) purchase taxable investments (mutual funds); or (3) purchase tax-deferred corporate owned life insurance (COLI).

The "best" approach depends on the company's

- Income tax bracket
- Cost of money
- Earnings assumption
- Realized vs. unrealized distributions
- Cash flow

There are advantages and disadvantages to each funding method.

Do Nothing
The advantages of not financing NQDC are (1) simplicity; (2) if the company's ROE is greater than the promised benefit, the spread benefits the company; and (3) it does not tie up cash needed to grow the company. The disadvantages are (1) it depends on future liquidity (increased risk to participant); (2) the company is liable for benefit regardless of earnings; and (3) "Legacy vs. liability"- leaving future management the responsibility for generating the cash flow to pay the benefit liability.

Taxable Investments
The advantages of making taxable investments (typically mutual funds) to provide funds to pay NQDC benefits are (1) many investment options; (2) direct crediting of earnings; and (3) it is easy to understand. The disadvantages are: (1) earnings are "taxable" to the company; (2) it requires the highest cash flow to support the income tax on the earnings; and (3) transaction accounting and recordkeeping may be difficult.

Corporate-Owned Life Insurance (COLI)
The advantages to buying COLI to provide funds to pay NQDC benefits are (1) earnings accumulate "tax deferred"; (2) distributions are tax-free (subject to contract limitations/charges); and (3) life insurance death proceeds are tax free to

the company as beneficiary. The disadvantages are: (1) the cost of life insurance; (2) the underwriting process; and (3) the need to educate the client and potentially other advisors.

According to a Fortune 1000 survey, 72% of NQDC plans use COLI, either primarily or in combination with the other means for funding; 37% use primarily taxable investments; 14% use primarily employer stock; and 12% use other funding mechanisms.

Planning Tip: Mutual funds may be advantageous when the company pays little or no tax, or for a short-term plan. Alternatively, COLI is advantageous for many plans because of the tax arbitrage between the cash flow out for tax on the amount deferred and the income tax benefit at distribution.

Planning Tip: Technical Bulletin 85-4 provides the GAAP for corporate owned life insurance. In general, this accounting treatment, over the life of a plan, can result in a more favorable accounting treatment for the company when compared to the accounting used for the other NQDC financing methods.

Conclusion
Non-qualified deferred compensation creates significant planning opportunities for company owners and key employees, including increased retention of key employees. By working together, the planning team can ensure that clients' NQDC plans supplement their qualified plans to meet their unique planning goals and objectives.

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