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# Non-Qualified Deferred Compensation Plans:
# An Increasingly Critical Component of "Cutting Edge" Employee Compensation

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## Introduction

In an increasingly globalized and competitive workplace, businesses are racing to attract and retain the best talent. Many companies are now offering non-traditional benefits and perks to recruit employees and convince top performers to stay. Non-qualified deferred compensation (NQDC) plans are one solution to help companies retain key executives. They are designed as a retirement savings vehicle for the highly compensated to save in excess of their qualified plans, and allow a greater portion of their compensation to grow tax deferred. Non-qualified deferred compensation plans thus address the retirement saving gap for the highly compensated, and are a valuable recruitment and retention tool.

## The Retirement Savings Gap

Qualified retirement plans are often inadequate for the highly compensated. High earners are limited by statutory maximums, so they may max out their 401(k) or 403(b) savings plans but still want to save more for retirement or other financial goals. For example, the $18,000 limit on annual 401(k) contribution allows an executive earning $300,000 per year to save only six percent of his or her annual income for retirement. For the highly compensated, these limits create a savings gap in which high earners are not saving enough in their workplace plans to replace sufficient income needed when they retire. In most cases, it is the responsibility of the employee to find a place to invest post-tax income in excess of 401(k) contributions.

NQDC plans offer a solution to the retirement savings gap for the highly compensated. Unlike traditional qualified retirement options, NQDC plans do not have annual contribution limits set by the IRS. Instead, the company sets the maximum contribution amount. Highly compensated employees ultimately benefit from NQDC plans by having a larger portion of their compensation grow tax deferred than would be possible in qualified retirement plans.

## NQDC Plans Explained

NQDC is a voluntary savings program that allows highly compensated employees to save more for retirement and other financial goals on a tax-deferred basis. NQDC plans are established separately from an employee's 401(k) plan and help supplement the 401(k) plan due to their additional contribution potential. They are offered only to select group of management, highly compensated employees, and affiliates of the sponsoring firm (i.e. board members).

NQDC plans are an agreement between the participant and the employer to defer a portion of annual employee compensation until a date in the future. Unlike qualified retirement plans in which the employee's deferred compensation is held in a segregated account, NQDC accounts are unsecured assets and remain part of the firm's general assets. They are not designed solely for retirement, as distributions can be scheduled while the individual still works for the firm to cover shorter-term financial goals.

The plans also provide a tax advantage to their participants. Employees do not pay income taxes on the deferred portion of their compensation in the year it is deferred, so it has the potential to grow tax deferred until it is paid out. However, payroll taxes such as Social Security and Medicare still are deducted. Participants choose the amount of the deferral, up to 100% of compensation, and the timing of deferral payments. Contributions to a NQDC plan can come from salary as well as performance-based compensation and retention bonuses.

The balances in NQDC plans are not segregated from the company's assets, in contrast to those in qualified retirement plans. In order to offset their exposure to market volatility, many sponsoring companies will make corresponding investments. These investments typically include mutual funds and corporate-owned life insurance. Such investing is known as "informally funding" a plan. Sponsoring companies, however, are under no obligation to informally fund their plans. Companies may also choose to set aside assets in a trust – called a "rabbi trust"—to make payments when they are due. According to a survey conducted in conjunction with Boston Research Technology, 62% of companies surveyed had set up a rabbi trust and on average, 83% of NQDC plans were funded.[1] In the event of bankruptcy, however, the funds remain part of the company's general assets and are subject to creditors' claims.

## Benefits of Non-Qualified Deferred Compensation

NQDC plans offer compelling benefits to both participants and sponsors. Participants are able to set aside a greater portion of their income for retirement or other financial goals; have the potential to grow their compensation tax deferred until payout; and have the ability to receive distributions at a potentially lower rate in retirement.

For employers, NQDC plans can play a major role in attracting and retaining key personnel. NQDC plans can offer significant benefits to new hires, who are in turn given incentive to stay at the sponsoring firm. Deferring signing bonuses into the plan can also be an effective recruiting method for new hires. NQDC plans can help retain important personnel if employers implement conditions that forfeit deferred benefits if certain criteria are not met. NCQC plans also enable smaller companies to compete with larger companies by offering a more compelling benefits package. Lastly, NQDC plans can also serve as a viable alternative to equity-based compensation such as stock options for employers who do not have publicly traded stock, or for businesses that do not want to give a direct equity interest.

NQDC plans also provide employers a great deal of flexibility in structuring and customizing the plan. Employers select the individuals who can participate in the NQDC plan, determine matching contributions, set the maximum contribution amount, and decide the terms and conditions. Unlike a qualified benefit plan, sponsors also do not have the legal requirement to fund these benefits.

By providing benefits to only a select group of individuals, employers may spend less than they would on a traditional qualified plan. Thus, NQDC plans allow employers to focus their expenditures on their most valuable personnel. Sponsors can also choose whether or not to make matching or non-elective contributions. If a sponsoring company chooses to match employee contributions, those amounts are tax deductible in the tax year in which the employee receives the distribution from the plan.

Recent surveys on non-qualified deferred compensation plans further underscore their effectiveness. According to research conducted by MullinTBG, the vast majority of respondents were satisfied with their NQDC plans, 74% of survey respondents stated that their NQDC plans were "effective" or "very effective" at achieving their intended purpose. [2]

## Why now?

NCDC plans are becoming more relevant to the highly compensated. Tax increases implemented in January 2014 have made their ability to help participants manage current and future income taxes more pertinent. For example, an executive whose current income is taxed at the top rate has the ability to defer current compensation payments and receive distributions at a potentially lower rate in retirement. This ability to control the timing of tax liability also applies to recent Medicare taxes and levies on investment earnings. Deferred compensation allows participants to better manage and possibly lower current taxable income, benefit from pre-tax compounded growth, increase savings power, and potentially control future taxation.

NQDC plans are also more relevant than ever as life expectancy in the U.S. increases, and individuals must therefore save more for a longer retirement. In just the past few decades, average life expectancy in the U.S. has dramatically increased. In 1970, the average life expectancy in the U.S. at 65 was 15.2 years. By 2010, the average life expectancy at 65 jumped to 19.1 years. [3] As the average lifespan after retirement continues to lengthen, high earners will seek options beyond their 401(k) plans to sustain their lifestyles after retirement.

## Selecting a Provider

NQDC plans should be customized to add the highest value to participants and a strategy should be developed to maximize participation for eligible employees. An effective plan design that offers the participant flexible deferral options and a variety of investment choices combined with communication delineating the benefits of the arrangement is essential. It is also important to make sure existing participants are frequently reminded of the plan's value, by providing ease of access to key information, notifying participants about improvements in investment choices, and comprehensive education programs. Each of those components involves its own series of challenges.

An experienced and objective advisor can make the task of searching for an administrator to fulfil all of an organization's NQDC needs a manageable process. We have the expertise to understand the complexity of the rules, such as Internal Revenue Code 409A, which sets the rules for NQDC plans and mandates the timing of deferral and distributions elections, and create a needs-driven approach to focus on the specific characteristics of the plan sponsor. Most importantly, a consultant is capable of helping create a needs-driven approach to the search, focusing on the specific characteristics of the plan sponsor. By providing and helping to navigate a long list

[1] Moore, Rebecca. "Nonqualified Plan Issues" PLANSPONSOR. January 2015. Web. 15 July 2015.

[2] "Executive Benefit Survey." MullinTBG, 2015. Web. 15 July 2015.
[3] http://www.cdc.gov/nchs/data/hus/2011/022.pdf.

of criteria used to narrow high-quality administrator and investment options, a financial professional experienced in the space will help identify the best third party provider. This unbiased guidance can pay dividends in the long term as the plan is successfully established. The search process should compare all available options, taking everything from fee structure to typical plan size into account, to determine the provider that will best fit the organization's long-term strategy. An objective, solutions-based approach with an emphasis on open architecture and fee transparency will help a plan sponsor assess its needs, locate a specific selection of third party candidates, design the plan, choose investment options, educate employees, and oversee the NQDC program on an ongoing basis.

## Conclusion

NQDC plans are a retirement savings vehicle that allow the highly compensated to address their retirement savings gap. Highly compensated employees can save beyond their traditional qualified retirement plans, and allow a greater portion of their savings to grow tax-deferred. NDQC plans thus serve as a valuable recruiting and retention tool for employers. By developing custom vesting schedules, a firm can give key executives compelling incentives to stay with the company. The arrangement also serves as an important part of a total rewards model and can add value behind a company's holistic approach to compensation. NQDC plans also give sponsors a high degree of flexibility – sponsors select which individuals qualify for the plan, what compensation will be deferred, whether the company will make contributions, if informal funding will be used, and how distributions can be scheduled. The utilization of experts in the field can make the entire provider selection process and ongoing reporting and investment guidance more effective and less costly. Most importantly, consultants knowledgeable in NQDC programs can ensure that the best plan is in place to attract and retain the individuals necessary to the organization's long-term well-being.[i]

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[i] *Daniel R. Sirus Helen Donnelly and Mark Maizel contributed in writing this report.


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