LIFE ADVANCED MARKETS

Key employee compensation strategies

Nonqualified Deferred Compensation Plans

While each one of your employees may contribute to the success of your business in their own way, you may also have a number of employees who are critical to attaining your business objectives.

Incentivizing these key employees to remain with your company, motivating them to excel in their roles, and attracting new key employees when necessary requires a well-designed key employee compensation strategy.

A supplemental retirement savings plan specifically designed for those employees who are most vital to your business may be one option to consider. Qualified retirement plans such as 401(k) plans, defined benefit plans, and cash balance plans are commonly implemented by employers as part of their overall compensation/benefit package.

In order to achieve "qualified" plan status, the Internal Revenue Service (IRS) and the Employee Retirement Income Security Act of 1974 (ERISA) have established minimum participation requirements. The general effect of these rules is that qualified plans are meant to include most employees in the plan (at least those age 21 or older with minimal hours worked and minimal years of service). Qualified plans may not discriminate in favor of highly compensated employees based on participation or amount contributed. Due to these requirements, qualified plans may actually have a reverse discrimination effect on key employees.

One solution is to provide key employees with a nonqualified deferred compensation plan designed specifically for key employees.

A nonqualified deferred compensation plan (NQDC) is an agreement entered into between an employee and an employer whereby the employer promises to pay the employee compensation at some point in the future. The agreement creates a contractual employer obligation to pay future benefits.

While the NQDC plan may provide benefits similar to a qualified plan (e.g., tax-deferred growth), one primary difference is that the plan is not required to comply with the qualified plan rules on participation or contribution amounts. In fact, to be exempt from the ERISA eligibility, vesting, funding, and fiduciary rules, a NQDC plan must limit participation to a select group of management or highly compensated employees.

Advantages:

- The employer may be selective in which employees are permitted to participate.
- The employer may provide different plan benefits to different employees; there is no requirement to treat all participants the same.
- The employer may "informally" fund the plan without needing to comply with IRS or ERISA requirements. "Informal" funding simply means the employer may set aside funds to meet their future obligations under the NQDC plan, but the employee/participant has no claim or right to those specific funds.
- The employee will not pay income taxes on the promised benefits until they are actually received.
- Employer payments of deferred compensation are deductible by the employer (as long as it's reasonable compensation).
- A NQDC plan may act as a "golden handcuff" by including a vesting schedule, motivating key employees to remain actively engaged with the business.
- ERISA and IRS reporting and disclosure rules for NQDC plans are minimal.

Designing a NQDC Plan

Selecting participants

The employer may be selective in which employees to include in their NQDC plan, as long as those who participate constitute a select group of management or highly compensated employees. This rule is often referred to as the "top-hat" rule.

While guidance on how to determine which employees fit this definition is limited, it has been established that adding even one employee who is not highly compensated or management may cause the plan to run afoul of this rule.

Crediting the NQDC plan

There are two primary means of crediting a participant's account:

1. The employee may forego a portion of their salary and/or bonus compensation and defer it into the plan.
2. The employer may credit additional amounts to the participant's account on top of their current compensation. This is often referred to as a Supplemental Employee Retirement Plan (SERP).

A NQDC plan may be solely based on employee deferrals of their compensation, solely based on employer contributions, or a combination of both. Employer contributions are commonly based on a percentage of the participant's salary or based on a profit-sharing formula to tie contributions to company performance.

The NQDC plan may provide a formula, fixed rate, or other method for determining how a participant's plan balance shall grow.

Vesting

There are no IRS or ERISA imposed limits on vesting schedules for NQDC plans. The employer is free to choose the vesting schedule that is best suited to achieve the plan's intended goals.

Employee deferrals are typically 100% vested immediately since this represents salary and/or bonus compensation they deferred. Employers may decide to include a vesting schedule on the portion of the plan balance that represents additional employer contributions to the plan.

Informal funding

Unlike qualified retirement plans, there are no funding requirements for nonqualified deferred compensation plans. The employer is not required to establish a trust or specific side fund in order to meet their obligations under the plan.

The majority of employers do, however, set up an "informal" funding program. Cash value life insurance, such as indexed universal life (IUL) insurance, owned by the employer, may provide a tax-favorable source of funds to meet the employer's future obligations under the plan, while providing a generally income-tax-free death benefit to the employer should the key employee pass away.

The decision to establish an informal funding program, and the appropriate investment for the employer contribution, will depend on the specifics of the plan and the goals of the employer.

Considerations when using an IUL policy

- Employee must be insurable
- Life insurance requires health and financial underwriting
- Consult with your financial, tax, and legal professionals when exploring this strategy

Distributions

Distributions of a participant's vested account balance may be made in a lump sum or, more commonly, over a period of time. There are six specific distribution triggering events that are permitted by the IRS rules under IRC §409A:

1. When the employee separates from service
2. When the employee becomes disabled
3. When the employee passes away
4. At a specified time or pursuant to a fixed schedule
5. Upon a change of control of the employer
6. When there's an unforeseen emergency (hardship)

Considerations:

- The employer may not deduct the deferred compensation until it is paid to the employee. In order to be deductible by the employer, the payouts must constitute reasonable compensation when paid.
- A NQDC plan will create a liability on the business's balance sheet. As deferred compensation is paid out, that liability will decrease.
- A NQDC plan must comply with the provisions of IRC §409A in order to achieve income tax deferral for the participant (and avoid substantial IRS penalties). Provisions included in IRC §409A include:
  - Once a payout schedule is established under the NQDC agreement, payouts to the participant may not be accelerated earlier than scheduled.
  - If the plan allows the participant to elect to defer current income, the election to defer must be made no later than the close of the preceding taxable year.
  - If the participant would like to re-defer a scheduled payment, they must make the election no later than 12 months prior to the scheduled distribution and the distribution must be deferred for at least an additional 5 years.
- While NQDC plans avoid many of the reporting and disclosure rules of ERISA, the employer is required to file a simple statement (electronically) with the U.S. Department of Labor.
- The employee/participant becomes an unsecured creditor and must rely on the employer's ability to make the required payments when due. The employer may set aside funds in a trust (referred to as a Rabbi Trust) that prohibits the employer from using the funds for anything other than fulfilling their obligations under the plan; however, those funds remain available to other creditors who may have a claim against the employer.
- While income taxes may be deferred until the employee actually receives payments, Social Security and Medicare taxes on plan deferrals are due when the deferrals are no longer subject to a substantial risk of forfeiture (i.e., when deferrals become vested).
- If the employer acquires life insurance as a means of informally funding plan obligations, in order for the death benefits to be received income-tax-free by the employer, the IRS requires the employee to sign a notice and consent form; see IRC §101(j).

TALK TO YOUR FINANCIAL PROFESSIONAL for more information on how indexed universal life insurance could informally fund nonqualified deferred compensation plans.

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