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Nonqualified Deferred Compensation Beginners Guide
Plan Design Basics, Trends, and Pitfalls

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Nonqualified Deferred Compensation Plan Overview
What is an Executive Deferred Compensation Plan?

» With people living longer and retiring earlier to more active lifestyles, 401(k) plans and social security payments cannot provide enough retirement savings for the highly-compensated. Nonqualified deferred compensation ("NQDC") plans were developed to offer highly compensated employees a pre-tax savings opportunity commensurate to their income.

» For executives and other eligible key employees, an NQDC plan provides a financial-planning opportunity to defer taxable income until it’s needed; whether to pay for college, retirement, or other life events. For the Plan Sponsor, the NQDC plan offers a powerful financial tool to recruit, retain, and ultimately retire executives and key employees.
Why are these plans important today?

» Qualified retirement plan contribution cap and distribution penalties:
  • 401(k) contribution cap for 2016 is $18,000 ($24,000 for those age 50 and over)
  • Pre age 59 ½ distribution penalties

» Personal investment alternatives cannot replicate the economics and tax-efficiencies of employer sponsored NQDC plan.
  • Increasing State Income Tax rates: 5% to 11% + (NY, CA, IL, etc.)
  • Top marginal income tax bracket returned to 39.6%
  • There is a 3.8% (began in 2013) investment tax for joint filers with over $250,000 of income
  • These combined taxes could make the total marginal rate approximately 52%, depending on the state of residence
  • Capital gains rates increased to 20% in 2013 for joint filers with over $450,000 of income
Benefits Overview

Benefits of Deferred Compensation

- **Save more**
  No IRS limits on compensation or deferrals

- **Tax advantages**
  Reduce taxable income and delay tax on investment gains

- **Get your money when you need it**
  Penalty-free distributions while working or during retirement
What is the “Additional Income” Gap?

» A 401(k) plan and social security will likely provide only a small fraction of the income replacement needs for highly compensated professionals. If the target for retirement income is 80% of final compensation, the need for supplemental savings increases dramatically with income. NQDC plans are tax-deferred ways to fill the “Additional Income” gap.
Deferred Comp Plan vs. 401(k)

401(k) Plan
Foundation for retirement

Deferred Compensation Plan
Savings flexibility and supplementing your retirement income
Plan Eligibility, Benefits, and Features
NQDC Plan Eligibility

» Plan Eligibility:

• Key employees including highly compensated employees and management whose titles and job functions indicate policy making responsibility

• Rule of thumb - up to 10% to 12% of the total full time work force as measured by total compensation

❖ The Plan Sponsor has the full discretion to select the eligible group based on criteria as noted above
There are numerous benefits of an NQDC for the Participants......

» Benefits for the Participants

• No contribution limit – up to 100% of compensation
• Pre-tax deferral of compensation and tax-deferred earnings
• Investment options can be similar to 401(k)
• Enhanced planning flexibility for life-event purposes (college education, first or second home, etc.), as well as retirement
• No 10% IRS early withdrawal penalty for distributions prior to age 59 ½
• No minimum withdrawal at age 70 ½
• Tax Planning Opportunities
In-service Account Example

- **20%**
  - College
    - Payout Payments 2019
    - Conservative Portfolio
    - 1

- **20%**
  - College
    - Payout Payments 2021
    - Moderate Portfolio
    - 1

- **10%**
  - Boat
    - Payout Payments 2025
    - Moderate Aggressive Portfolio
    - 1

- **50%**
  - Retire
    - Retirement Payments
    - Aggressive Portfolio
    - 10
**Benefits for the Plan Sponsor**

- The Company defines and controls the eligibility to participate.
- NQDC plans align corporate and executive interests by connecting performance and accountability to compensation.
- NQDC plans are **not** subject to ERISA compliance testing, form 5500, or audit requirements.
- The Company has the discretion to make contributions and apply vesting schedules.

A best practice plan design matches the objectives of the employer with the financial goals of the executives.
Plan Design Pitfalls / Considerations

» Payroll processing

» Taxes
  • FICA and Medicare applied to contributions to the plan – up to IRS limits
  • Company contributions (and earnings) are subject to FICA withholding when vested
  • Federal, state, and local taxes are applied when amounts are distributed from the plan
Plan Structure
Plan Structure

- Nonqualified deferred compensation plans sit on the company’s balance sheet as a liability.
- The amount which the company owes to the employee (the same amount as the participant’s account balance) is a liability on the balance sheet of the Plan Sponsor.
- The Plan Sponsor has the option to own the same/similar funds that the plan participants allocate their account balances to. The assets hedge the plan liability.
- Assets are commonly held in a grantor “Rabbi” trust.
The primary reasons that corporate sponsors choose to informally fund a nonqualified plan:

- To match plan liabilities with a pool of assets to minimize the impact of equity market volatility which can negatively impact corporate P&L
- To reduce plan cost through tax advantage pre-funding
- Provide a source of liquid funds from which to pay future participant benefits
- To provide a degree of benefit security to participants with a source of liquid funds from which to pay future benefits
Informal Aggregate Funding Strategy

Liability
Participant Account Balances

Balance Sheet Separation Wall

Assets
Corporate Informal Funding Vehicle

The sponsoring company can hedge the non-qualified plan liability by purchasing assets which attempt to mirror the aggregate elections made by the participants. The asset and liability are trued up and/or reallocated periodically to mitigate P&L exposure and risk.
In recent years, the use of COLI/TOLI to fund NQDC plans has ranged from 60% to 72%. This utilization rate for COLI/TOLI fluctuates based on a number of plan sponsor specific factors (e.g. the duration of the benefit liability, the corporate tax rate, etc.).
Plan Funding Pitfalls / Considerations

» Corporate owned life insurance “COLI” vs mutual funds

» Asset liability matching
Industry Trends
Industry Trends

» Popularity of risk based portfolios

Expected Return

Risk

Capital Preservation
Conservative
Balanced
Growth
Aggressive

Cash 20
Bonds 60
Stocks 20

Cash 15
Bonds 45
Stocks 40

Cash 10
Bonds 30
Stocks 60

Cash 5
Bonds 15
Stocks 80

Cash 0
Bonds 0
Stocks 100

Portfolios are comprised of funds available in the investment menu.
Industry Trends

- Focus on administration platform flexibility
  - Smartphone access
  - Distribution reminders
  - Ability to manage investment allocations aggregately or per distribution account

- Use of Brainshark videos and interactive educational materials

- Plan sponsors using NQ plans as a retention tool:
  - Mandatory deferral of sign-on bonuses
  - Discretionary bonuses with specific/individual vesting schedules
  - Make-whole matches
  - Incentive bonuses
THANK YOU