How Truly Flexible Is a Nonqualified Deferred Compensation Plan? Answers to Your Questions, and Some May Surprise You

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By Eric Kaufman

Ninety-one percent of Fortune 1000 companies offer a Nonqualified Deferred Compensation Plan. Why so many? Most employers recognize that the limits under standard qualified retirement plans create critical issues related to the recruitment, retention and rewarding of key executives. Traditional qualified retirement plans often fall short of offering key managers the ability to meet their personal and financial goals. Nonqualified Deferred Compensation Plans offer solutions, but are often misrepresented in the key area and biggest benefit flexibility.

- **Flexibility.** Nonqualified Deferred Compensation Plans offer a flexible choice. The plan sponsor gets to decide who participates, how much a participant may defer, how much the employer will contribute, when the money is vested and the availability of investments.

The plan sponsor can take these components and create incentive plans for performance, longevity or other critical business milestones.

- **Leverage.** The plan sponsor may allow participants to defer money into the plan far in excess of what is permissible in qualified retirement plans. This allows participants to make meaningful strides in meeting their financial goals. Top executives are earning more, retiring earlier and living longer. Companies providing saving opportunities, which address these issues, have a significant attraction and retention advantage.

- **Easy In, Easy Out.** These plans include short- and long-term distribution windows. These give participants the ability to access their savings pre- and postretirement.

- **Vesting.** Nonqualified plans have different schedules in vesting, depending upon the deferrals you choose. Elective deferrals are 100 percent vested; however, company matching and discretionary company contributions may prove to be a little different. A company may choose any vesting schedule that will strategically support employee retention, business goals or milestones.

  Participant losses are possible, but the risk is what allows companies a free hand in designing and implementing selective benefit programs. The law requires that benefits accrued are subject to forfeiture, and participants are classified as unsecured creditors of the company.

- **Deferrals.** Nonqualified plans can allow any combination of elective deferrals, company matching or discretionary company contributions. Elective deferrals entail participants who defer their current compensation. In a company-matching deferral, the employer may match any of the participants' deferrals. Lastly, a discretionary company contribution is made by the employer, based on performance and business milestones.

- **Funding.** Funded or unfunded, it is your decision. Either way, one must understand the options and their implications. A company may choose not to set aside assets to meet participant liabilities and thereby not fund the plan. The company will track and account for liabilities, and then pay them as they come due from treasury.

  An election to fund the plan involves two alternatives:

  - **Taxable Investments**—mutual funds and individual securities may be set aside and dedicated to meet participant liabilities as they come due. The taxes on these investments must be managed in alignment with the corporate tax strategy as to minimize the tax drag in relationship to the tax-deferred growth of the participants' accounts.

  - **Tax-Deferred Investments**—corporate-owned life insurance is an asset dedicated to participant liabilities as they come due. These vehicles are designed to have low expense and high tax efficiency. This allows the company tremendous flexibility in managing its plan asset in relationship to the accruing participant liabilities.

    COLI is not always the best alternative; sometimes there may be a loss carryforward or the plan may be set up for an entity that is tax exempt. It may be a hybrid approach, but the point is to appropriately analyze and address the issues surrounding financing alternatives.

- **Administration.** Regardless of your design choices, Nonqualified Deferred Compensation Plans are often much more simple/easier to administrate than their restricted Qualified Plan counterparts. A "best-in-class" Nonqualified Deferred Compensation Plan will:
  - Allow the sponsor to define and control participation.
  - Have no discrimination testing.
  - Have no contribution limits.
  - Have unlimited vesting options.
  - Have minimal cost and financial impact.
  - Have profit and loss neutrality through judicious management of assets and plan liabilities.

At the end of the day, there are a number of key decision points to be made with a nonqualified plan. The good news is that the decision is up to you. There is a great deal of flexibility, and the impact can be invaluable. Motivating and rewarding your executives through flexible and cost-effective benefits is always a good choice.

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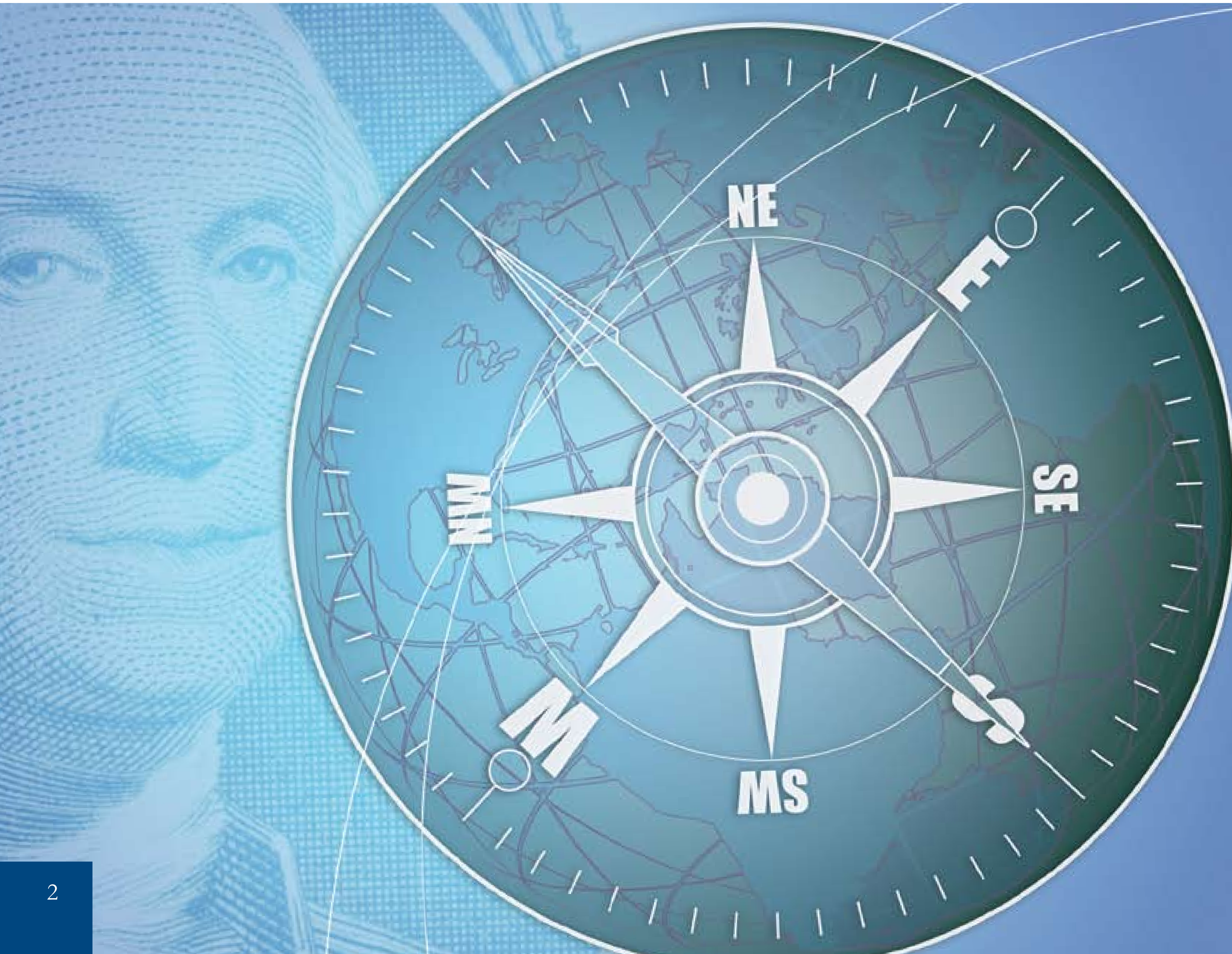

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