Improving the ROI on your Non-Qualified Deferred Compensation Plan

How to Effectively Use Your NQ Plan to Gain a Competitive Advantage in Today's Marketplace

SHERIDAN ROAD FINANCIAL

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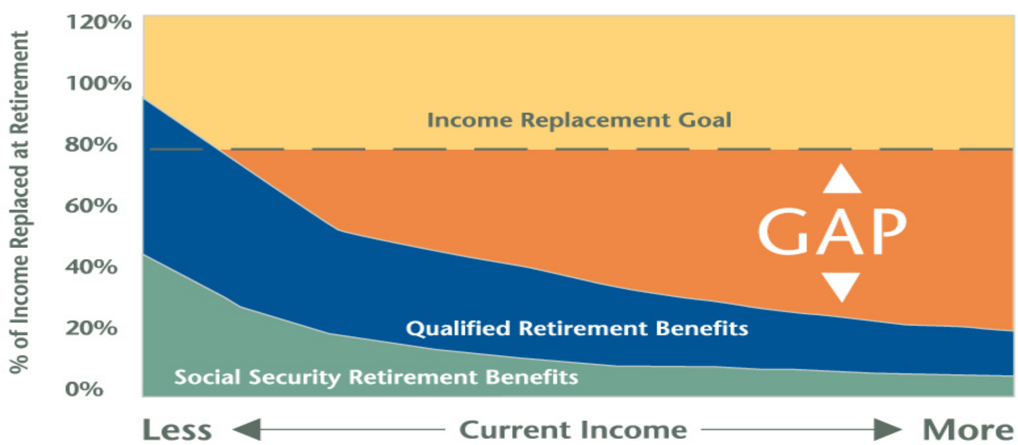
Companies are faced with the constant challenge of recruiting and retaining top level executive talent. While the national unemployment rate has risen above 9%, the unemployment rate for workers with a bachelor's degree or higher is 4.3% (*Source: July, 2011: Bureau of Labor Statistics*). To remain competitive, companies must look beyond traditional compensation and benefit packages to offer current and potential key employees a benefits package that is mutually beneficial for both the employee and the company. One of the main means by which employers are accomplishing this is through offering their most valued employees a Nonqualified Deferred Compensation Plan ("NQ plan").

The need for NQ plans has increased dramatically in recent years as retirement income generated from qualified retirement plans and social security is proving inadequate for key employees who wish to maintain their standard of living in retirement. Annually, qualified retirement plans such as 401k plans, cash balance plans and defined benefit pension plans must limit the amount of contributions made on behalf of their employees due to plan contribution limits and/or plan testing restrictions as defined by section 415(c) of the Internal Revenue Code ("IRC"). In addition, social security benefits, when expressed as a percentage of income replacement, decrease as incomes rise. This often results in a "Retirement Income Gap (RIG)" whereby highly compensated employees are not able to contribute enough through their traditional company retirement plan to adequately fund their retirement needs.



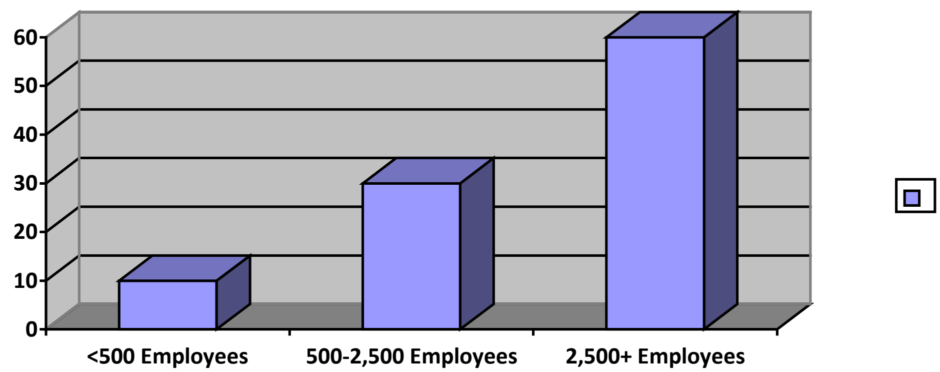
This information is from the Principal Financial Group Replacement Ratio Calculator with source information from the Annual Statistical Supplements to the Social Security Bulletin www.ssa.gov. It is intended to demonstrate the potential impact of Social Security and 401(k) plan benefits at various income levels. For more information on your individual circumstances, please speak with your financial professional.

To stay competitive, companies have established NQ plans as a means to attract, retain and reward their most valuable employees. However, NQ plans can have significant costs and risks for both the company and their employees. When evaluating a current NQ plan or considering adopting a new plan, the company should take steps to ensure that the plan is designed to achieve the objectives of the company while minimizing costs. A well designed plan will maximize the impact for the key employees while minimizing the costs and risks for the Company. In investment terms, this will maximize the Company's return on their investment (ROI).

NQ PLAN OVERVIEW

A NQ plan is so named as the plan does not meet the standards of a qualified plan under the Employee Retirement Income Security Act ("ERISA"). As such, NQ plans do not qualify for the preferential tax treatment, as well as creditor protection of qualified plans such as a 401(k) plans. In return for giving up the benefits of a qualified plan, NQ plans are exempt from the majority of the testing and reporting provisions of qualified plans.

NQ plans become more prevalent as companies get larger. As seen below, the adoption rate of NQ plans increases from 10% for companies with less than 500 employees to over 60% for companies with over 2,500 employees. *Source: Profit Sharing Council of America 2010 Nonqualified Benefits Survey ("PSCA Survey")*



When asked the reason for offering a NQ plan, PSCA Survey respondents listed the following as their two main reasons their organization offers a NQ Plan:

- Saving for Retirement
- Providing a Competitive Benefits Package

Despite the prevalence of NQ plans, the NQ participation rate among eligible employees is significantly less than the participation rate in 401k plans. In 2010, the average NQ participation rate was approximately 46% while 401k participation rates were approximately 76%. *Source: AON/Hewitt 2010 Client Survey*

Two of the primary reasons employees don't participate in their company's NQ plan is a lack of understanding on how the plan works and the perceived risks associated with the plan.

Lack of Understanding – Employees often have a much better understanding of their 401k plan than they do their NQ plan. 401k plan benefits are largely uniform among the thousands of companies that offer these plans. The 401k plan is the generally accepted means by which employees save for their retirement.

NQ plans, on the other hand, are generally custom built plans with plan design features that are unique to the sponsoring company. Features such as employer contribution formulas, vesting schedules and distribution options vary widely from one company to the next. It is easy to see how employees can feel overwhelmed when faced with the decision of how to use their company's NQ plan. Whereas there are countless books and websites dedicated to 401k plans, there are few resources a participant has at their disposal to learn about and effectively utilize their NQ plan.

Perceived Risks – NQ plan assets are often subject to employer creditor risk and distribution options that differ significantly from qualified plans. According to the Mullin/TBG Survey, approximately 45% of employees answered "Think NQ Plan is Too Risky" as a reason they did not participate in the NQ plan. Another 26% answered "*Too much wealth reliant upon company stability*" as their reason for not participating. NQ plans are generally unfunded or informally funded which subjects them to greater risk for the participants than qualified plans. In the event of company bankruptcy, the assets in the NQ plan can be subject to the company's creditors. For participants, they should be comfortable with the stability of the company prior to investing in the company's NQ plan.

DEFINING ROI

ROI is calculated by the simple mathematical ratio of a company's increase in revenue relative to its cost. It is difficult to accurately quantify the revenue generated as a result of offering a NQ plan. In theory, the NQ plan improves the revenue of an organization by increasing the ability to attract, retain and reward a company's most valuable employees. This will often result in a more productive, appreciative and in turn, loyal workforce.

Absent a NQ Plan, current and prospective employees will be susceptible to accepting positions at other companies that offer these benefits. For purposes of this discussion, we will define revenue as the level of employees' satisfaction with their NQ plan.

INCREASING "REVENUE"

If we agree with the premise that employees that are appreciative and motivated will be more productive, thus resulting in increased revenue for the company, then an increase in employee satisfaction with their NQ plan should result in increased revenue for the company. Below are areas to focus on when attempting to increase the employees' satisfaction with their company's NQ plan.

Review Plan Design – NQ plans come in variety of shapes and sizes depending on the resources and objectives of the company. Some plans attempt to link the executives' compensation directly to the profitability of the company while others look to remedy limitations that their existing qualified plans have on the key executives. The main benefit of a NQ plan is the ability to design the plan without concern for violating ERISA plan testing requirements. Therefore, a company can and should design their plan based on the objectives of the organization. The first step in designing an effective NQ plan is to clearly define the objective(s) of the plan. Is the objective to provide additional compensation to key executives or is it to remedy testing issues the company is having with their qualified plan? Does the company wish to share ownership with certain executives or reward employees based on growth targets? These are just some of the objectives a company may have and it is common for there to be multiple objectives. Once the plan objectives have been clearly identified, the company should review the following elements of the plan design:

Eligibility – The Company must decide who the plan is designed to benefit. This may be as simple as allowing all Highly Compensated Employees ("HCEs) into the Plan if the sole objective of the Plan is to "fix" testing issues associated with the qualified plan. If the objectives are to give an additional benefit to certain employees, the company should review the plan design to make sure it is covering the employees they wish to include.

Contributions – The Plan can allow for employee and/or employer contributions. The majority of NQ plans allow for employee contributions with approximately 40% of plans making matching employer contributions (Source: PSCA Study).

Employee Deferrals – Allowing employees to defer a portion of their salary and/or bonuses gives employees a tax advantaged way to save for future needs. Like a 401(k) plan, contributions into the plan are tax deferred for employees. However, unlike a 401(k) plan, the employer generally does not get an immediate tax deduction for the employee contributions. In addition, earnings on the assets in the plan may be taxable to the employer. The employer receives a deduction when assets are constructively received by the employee. Allowing an employee to defer most, if not all, of their compensation can be particularly attractive for a new hire that was previously covered by a NQ plan from their previous employer. In this situation, the new hire is likely to have a significant taxable distribution from their old NQ plan which can be offset if the new employer allows them to defer the majority of their income in the new NQ plan.

Employer Contributions – Employer contributions are often viewed as the most attractive component of both qualified and NQ plans. According to the 2009 Clark Consulting *Executive Benefits – A Survey of Current Trends*, approximately 55% of the companies they surveyed offered matching contributions in their NQ plan. The majority of the plans (71%) structured the match to be similar to the one offered in their 401(k) plan. If the goal is to design the NQ plan similar to a 401k plan, matching contributions are often the most logical choice. If the objective is to provide an additional incentive for the key employees, the company may decide to structure the employer contribution based on individual and/or company performance.

Distribution Options – Unlike qualified plans, distributions from NQ plans cannot be rolled over into an IRA or other qualified plan and therefore, are generally taxable to the employee at the time of distribution. If a Plan only allows for lump sum distributions, the participant will be taxed on their full account balance in the year of distribution. To provide flexibility to the participant, a Company may wish to add additional distribution options such as:

- *Installment Distributions* – Distributions which are paid over multiple years
- *In Service Distributions* – Distributions which can be made while the participant is still employed by the Company.

Participant Investment Options – Companies do not have the same fiduciary obligations when selecting and monitoring plan investments in NQ plans as they have in qualified plans such as 401k plans. Nevertheless, companies should take steps to ensure that they have a prudent process for the selection and monitoring of plan investments. In addition, companies should consider adding additional asset classes in the NQ plan that are not available in the 401(k) plan as this will give participants greater diversification opportunities.

Participant Education – Before participating in a NQ plan, the employee should have a firm understanding of how their plan works and what their benefits are for participating in the plan. According to the Mullin TBG Survey, 35% of respondents listed "Don't understand how the plan works" as a reason for not participating in the NQ Plan. It is easy to see why there is confusion as NQ plans differ significantly from their qualified plans such as 401(k) plans. Participants must consider the following factors when deciding how to utilize the NQ plan:

- How secure is the organization?
- What should be the timing of my distributions?
- How long should I defer contributions?
- What are the current and future tax implications?

Companies should provide a customized participant education platform to ensure employees have a thorough understanding of their plan and the benefits it can provide to the employee. In addition, providing employees with executive financial planning assistance further enhances the employees' understanding and appreciation for the NQ plan.

Plan Funding– A NQ plan is a promise to pay a benefit to the employees at a future date. In most instances, the company is not obligated to immediately fund this future liability. However, to maximize the comfort level of the employees, the majority of companies will use some type of informal funding strategy to accumulate assets in the plan to meet those future liabilities. Informally funding a NQ Plan requires that plan assets that are set aside for the plan are maintained as a corporate asset of the Company. Any income and capital gains on the assets are taxable to the corporation. To avoid this taxation, companies will often use Corporate Owned Life Insurance ("COLI") to finance the Plan instead of taxable accounts. If a company does not fund this liability or underfunds it, the employees are less likely to participate for fear that the assets will not be available when the employee is entitled to receive the distribution. Most companies will use some type of informal funding strategy to fund their NQ Plan.

COST MANAGEMENT

Cost is the denominator in the ROI calculation and should receive similar attention as the "revenue". NQ Plan costs generally fall into the following categories:

Employer Contributions – The amount of the annual employer contribution will be mainly a function of the plan formula, the eligibility requirements and the plan's vesting schedule.

Plan Formula – the most common NQ matching formula is one that mirror's the matching formula for the 401k plan. As plan's become more generous and add additional matching and/or profit sharing contributions, the costs naturally will increase.

Eligibility Requirements – Careful consideration should be made when determining which employees will be eligible to participate in the NQ plan. This is where a clear identification of the plan's objectives is critical. For example, if the sole purpose of the plan is to remedy 401(k) plan testing issues, the plan should attempt to limit eligibility to strictly those employees who have been adversely affected (this may or may not be all of the HCEs).

Vesting Schedules – Vesting schedules can be much more creative in NQ plans than they can in qualified plans. There can be longer vesting schedules as well as "rolling" vesting schedules whereby each employer contribution has its own vesting schedule. However, the longer the vesting schedule, the less attractive the plan will be for the employees.

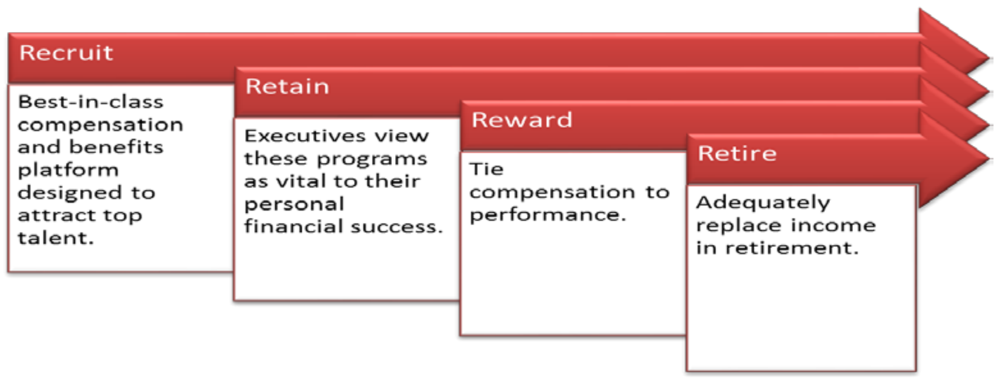
Taxation – Generally, companies will not be able to immediately deduct employee and employer contributions to the NQ plan. Instead, the employer takes the deduction when it becomes taxable to the employee. This can have a significant impact on a company's tax flow especially in the early years of the plan. Limiting the amount the employee and employer are able to contribute will decrease the impact on taxation but will make the plan less attractive for the employees. Also, if a company informally funds the plan, the assets remain on the company's balance sheet and any income or capital gains are taxable to the employer. One way companies address this is by funding the plan using COLI. Income and capital gains inside COLI are tax deferred for the employer.

Funding Costs – Most companies will attempt to match plan assets with plan liabilities when informally funding a NQ plan. To do so, companies will generally either use taxable accounts or COLI to fund the assets. As mentioned in the previous paragraph, if a company uses taxable accounts, the company will pay taxes on the income and capital gains inside the portfolio. If a company uses COLI, the company will be responsible for the insurance costs in the plan but will be able to defer the taxation on the gains and income of the assets in the plan. However, the cost of the insurance may be recovered in the event of the death of any of the insured participants. Companies should do a thorough analysis of their funding strategy to ensure they are using the best method of informally funding their plan for their organization. In addition, an asset/liability analysis should be done at least annually as part of the cost management process.

Administrative Expenses – Administrative expenses are generally minimal in NQ plans as these plans are not subject to the testing and reporting requirements of qualified plans. However, administrative expenses should be quantified and evaluated relative to the services that are received. NQ plan administration is a specialized service and a competent administrator with a strong platform is often worth the additional administrative expense that may be incurred.

SUMMARY

Attracting, retaining and motivating talented employees are a constant challenge for companies regardless of their size or industry. To remain competitive, companies must be able to offer an attractive benefits package that will attract employees and motivate them to perform at their maximum level. One way employers are accomplishing this is through offering their most valuable employees a Nonqualified Deferred Compensation Plan ("NQ Plan"). NQ Plans have proven to be an effective means to attract, retain and reward key employees. The challenge for companies has been to design and manage them as they would any other company investment – maximize the revenue generated relative to the cost of the plan (ROI).



To maximize the revenue, the plan should be designed based on the company's objectives and be an attractive, easily understood benefit for the employees. The employer contribution is often viewed as the most attractive feature of a NQ plan. The most common type of employer contribution in a NQ plan is a matching contribution however; profit sharing contribution types are also commonplace and can be an effective incentive for employees. In addition to the employer contribution, additional plan features such as in service distributions and installment distributions are often highly valued by employees.

The costs of a NQ plan vary greatly from company to company. The main costs are the employer contributions, potential taxation implications and administrative costs. Each of these components should be thoroughly analyzed to ensure they are appropriate for the organization.

A well-constructed and maintained NQ plan will be a tremendous benefit for the employees and allow companies to compete for the most talented employees in their industry, while minimizing the costs to the organization. When this is accomplished, the ROI can be an essential component of the long term success of the organization.

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