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Nonqualified Deferred Compensation
It's not a Perk --- it's an Equalizer

Introduction

A nonqualified deferred compensation (NQDC) plan is meant to be a retirement planning tool and not to be confused as a perquisite or excessive executive compensation. An NQDC plan is offered by the executive's employer as a vehicle for him or her to offset the benefit accrual limits imposed by the government on 401(k) plans or other qualified pension plans. Oftentimes, the press will try to exploit the deferred compensation balance of an executive disclosed in the company's proxy as another indication of excessive compensation being paid to the already highly compensated executive. What the press is obviously trying to ignore is the fact that this deferred compensation balance is nothing more than the executive's own compensation which he or she elected to defer with the anticipation of supplementing their own company's 401(k) or defined benefit pension plan.

In addition, this executive has also agreed to put his or her own compensation at risk since these deferred compensation assets remain the assets of the employer and subject to forfeiture in the case of the employer's bankruptcy. Lastly, the executive has only deferred his or her income tax liability. These income taxes will still be due when the deferred compensation balance is paid out to the executive at either their retirement or some other agreed upon distribution date. Yes, the company is accruing an interest liability on these deferred compensation funds, not unlike what it does on their 401(k) plan. With a 401(k), the company takes its compensation expense deduction on the pre-tax deferrals made by the company's employees. With a 409A nonqualified deferred compensation plan, the compensation expense deduction is deferred until the actual payout of the deferred compensation occurs.

Sometimes the company will add a match, which is oftentimes nothing more than the match that the executive is unable to earn from their company's 401(k) plan because of a company 401(k) discrimination testing problem. In other words, the employer match is not excessive and simply mirrors the same formula offered in the qualified 401(k) plan.

What is most important to remember is that a well-designed and administered nonqualified deferred compensation plan is meant to be an *equalizer* so that the executive can retire with a percent of final average earnings that is somewhat comparable to what the majority of the other rank-and-file employees can earn as a percentage of their final average earnings.

Plan Design Options

One of the most critical components of a deferred compensation plan is its design. Nolan Financial utilizes a prescriptive process that requires the client to focus specifically on the plan design requirements. We will present to them not only the concepts of deferred compensation, but what it is they are trying to accomplish with the introduction of a nonqualified deferred compensation plan. It is most important to us to understand the “Why” of their desire to introduce a deferred compensation plan.

Is the company dealing with an executive retention problem or an executive recruitment concern? Is there a concern with a competing employer that might be a public company and thus using equity-based awards as a retention or recruitment device? Are they constantly failing their 401(k) discrimination testing and creating refunds for their highly-compensated executives? Does the organization have a performance culture and wants a plan that will only match an executive’s pre-tax deferral with a performance match? Do they have a pre-409A deferral plan that is now frozen but the company would like to be able to give their executives access to this frozen plan through their current deferred compensation administrative platform?

All of these and other issues need to be resolved during the design phase. It is our intent to help the company make this a true executive benefit and one where the executive understands and appreciates the “Benefit of the Benefit”.

Funding, Communications, Administration

Three additional components are also very important to a well-designed and well-accepted nonqualified deferred compensation plan.

Funding is important because it helps the organization underwrite the liability it is creating through the benefit it is providing to its participants. Funding in the context of a nonqualified plan is called informal funding. There are two primary funding mechanisms used by employers today, Corporate-Owned Life Insurance (COLI) or Mutual Funds. There are advantages and disadvantages to each. We have elaborated upon these differences in other Nolan Financial Reports and frequently revisit both funding mechanisms. Our approach is oftentimes a combination of both funding sources and is often driven by the corporate tax rate, discount factor, particular census information and plan design.

Communications is often not given the attention it deserves during the enrollment and on-going administration of a nonqualified deferred compensation plan. We will spend an inordinate amount of time with the client understanding the culture of the company and their normal forms of employee communications. Not only are all of our communications custom designed with the company’s logo and colors but also are written with the language and style that the company’s executives will understand. There is an old tagline that states that an educated consumer is your best customer. We take that same approach with our communication materials. The more we can help the company educate its eligible executives about their deferred compensation plan, the greater will be the participation and the “Benefit of the Benefit” will be realized.

Administration is oftentimes overlooked and many of our competitors sometimes outsource this critical function to a third party. Nolan Financial performs all of the administration for our clients in house due to the complexities involved. We feel it is an important message to the client company to let them know that when

Nolan Financial is engaged, our role is a continuous one through the life of the plan. Many of our clients have been with us for multiple years. When we ask them why they have chosen to stay with Nolan Financial, they will invariably tell us that with our on-going administration, we stand behind our solutions and are available to help them when their administrative functions need to be modified to suit their changing needs.

The administrative platform that Nolan Financial utilizes was designed explicitly for nonqualified plans and is entirely 409A compliant. It is an extremely flexible system and we have added additional features such as single sign-on with the company's qualified plan provider.

Summary

A well-designed and properly-implemented nonqualified plan is a solution to meet a company's executive deferred compensation plan needs. A customized nonqualified plan with the flexible options discussed above, can help to effectively distinguish a company from its competitors and help to create the executive benefit solution they are trying to achieve.

We expect that the attraction and retention of key management personnel will always be among the top five concerns of CEOs, especially as companies retool themselves for improving economic conditions. We also know that there are many nonqualified plan solutions available to address the financial security and retirement concerns of top executives. All of the components discussed above are important components and they must be designed carefully to improve the effectiveness and impact of nonqualified plans.

Nolan Financial has designed and implemented nonqualified plans for all types of organizations, including for-profit and non-profit. If you have any questions or interest in regards to designing, funding or administering a nonqualified plan, please contact:

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