Nonqualified Deferred Compensation (NQDC)

Overview, Opportunities & Considerations in the NQDC Marketplace

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FINANCIAL PLANNING ASSOCIATION
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First things first…

What is a nonqualified plan?

It’s perhaps easier to discuss what a qualified plan is!

- ✓ Qualified retirement plans — for lack of a better term — have to fit in a nice neat little box.
- ✓ There are some variations — defined benefit (DB) versus defined contribution (DC) — for example.
- ✓ Must comply with the multitude of guidelines and regulations enforced under ERISA.
- ✓ Plans that meet ERISA’s stringent requirements can generally receive favorable tax treatment.

Nonqualified (NQ) plans, by contrast, fly outside ERISA’s oversight:

- ✓ Plan designs can vary wildly
- ✓ Not subject to statutory limits on contributions or benefit amounts
- ✓ The “WILD WEST” of retirement plans
- ✓ Governed by §409A of the Internal Revenue Code

A deferred compensation plan is simply…

- An employer-sponsored benefit — limited to “Top Hat” employees
- Not subject to qualified plan restrictions, contribution limits or discrimination and coverage testing
- “Unfunded”
- Contractual agreement between the plan sponsor and the participant
- Not subject to the fiduciary and reporting requirements of ERISA

NQDC Overview

Why do they exist?

+

What problems do they help solve?

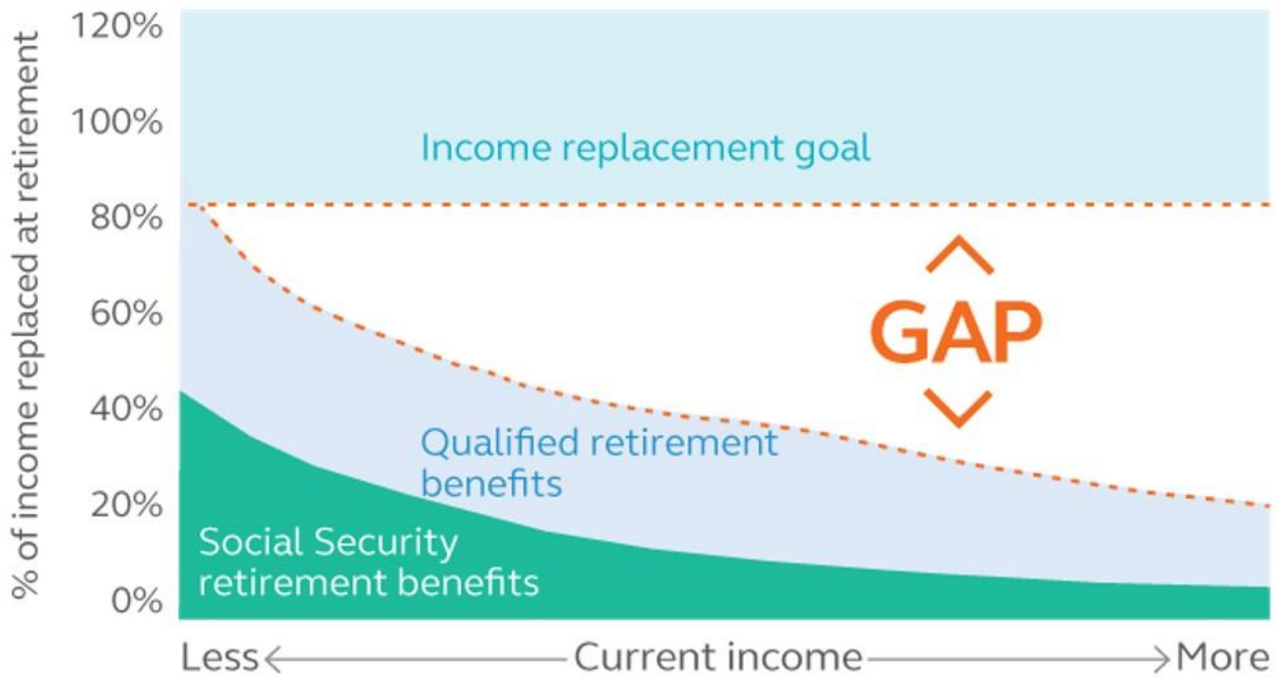
What you can achieve

Save more

For retirement

The more you make, the harder it gets

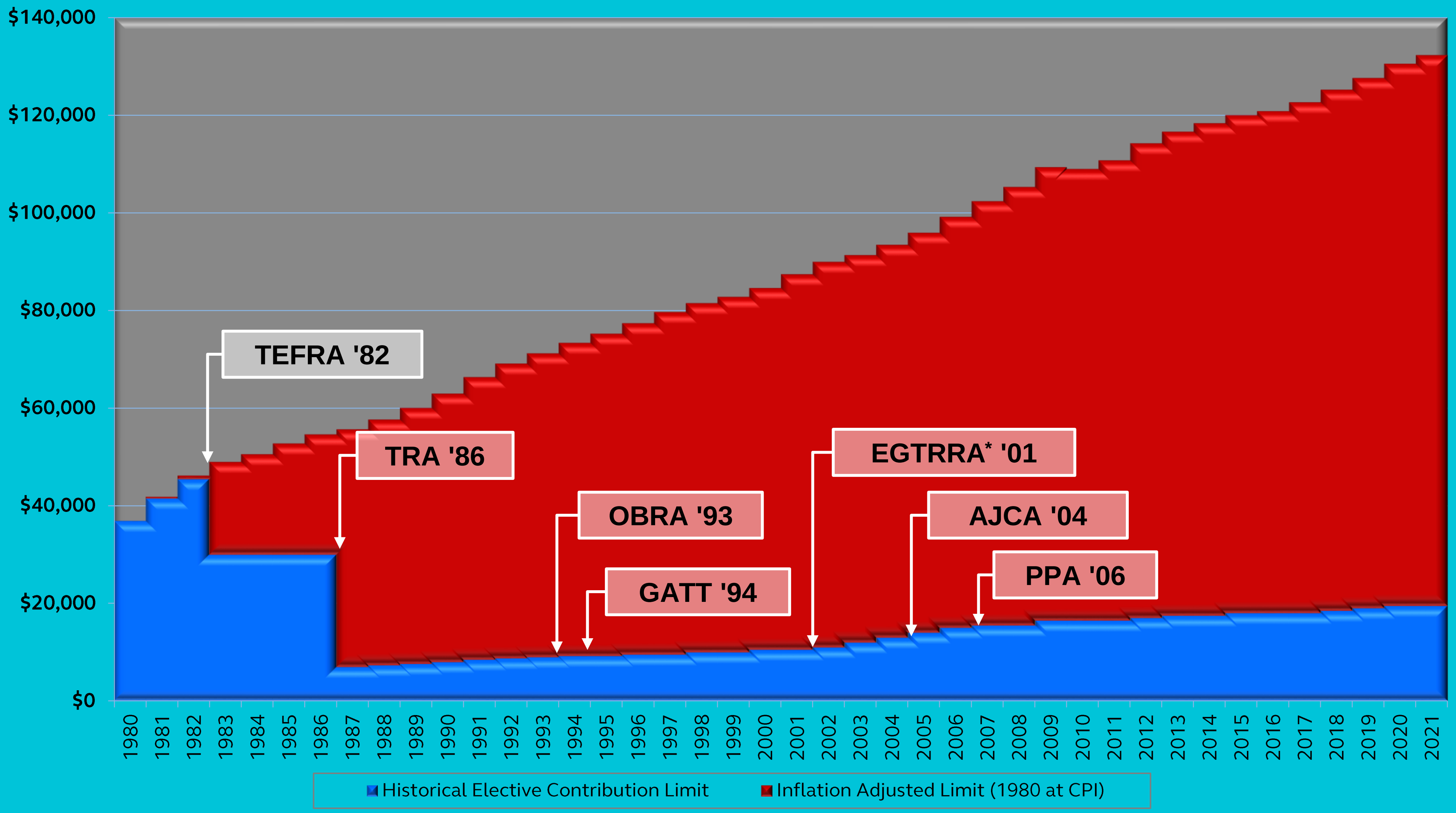
Effects of “reverse discrimination”



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 or tax professional.

Why Does the Problem Exist?

Historical 401(k) Participant Contribution Limits



Replace or Augment Safe Harbor 401(k)

NQDC and safe harbor may be good options, and valued benefits.

- It's important to consider which plan — or a combination — is right for your client's organization.
- Cost of adoption?
- Four primary limitations that restrict participation
  - Safe Harbor only eliminates: ADP/ACP
  - Fails to address:
    - Employee Contribution Limit: [$19,500]
    - Considered Compensation Limit: [$290,000]
    - Combined Contribution Limit: [$58,000]
  - AND plan sponsor also loses control over vesting!

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	Safe Harbor	NQDC
Type of Plan	Defined Contribution	Defined Contribution
Nondiscrimination Testing	No	No
Plan may discriminate	No	Yes
Employer is Fiduciary	Yes	No
Income Tax	Pre-Tax	Pre-Tax
Employer Tax Deduction	Yes, at time of contribution	Yes, at time of distribution
Contribution limits	Up to qualified plan limits [$19,500 in 2021]	Up to 100% of annual compensation
Employer contributions	Required for all participants [may be restricted by qualified plan limits]	Optional/Discretionary, no statutory limits
Eligibility	Key employees and non-key employees	Key employees the employer chooses
Vesting	Immediate	Flexible; including “rolling”
IRS Reporting	Annual form 5500	None
Early withdrawal penalty	10% penalty for withdrawals before age 59½	No age restrictions

“4 Rs”

Customized, tactical solutions to address corporate needs…

Recruit, Retain, Reward & Retire Key Employees

Recruit
Attract top talent via signing bonuses tied to tenure or performance.

Retain
Influence tenure with structured bonuses that use vesting schedules.

Reward
Drive both organizational and personal performance with incentive-based contributions to the plan.

Retire
Restore company match benefits you're unable to make in qualified plans due to testing or compensation limits.

Top reasons why plan sponsors offer deferred comp plans

98% Help participants save for retirement above qualified plan limits

96% Provide a competitive benefits package for key employees

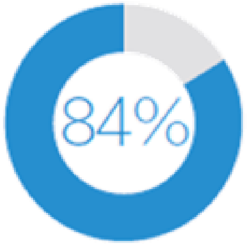
95% Retention tool for key employees

90% Help key employees manage current taxation

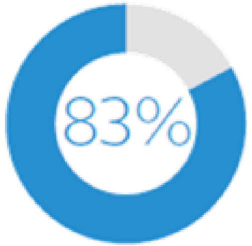
88% Replace benefits reduced or lost by IRS restrictions on qualified plans

87% Match benefits offered by competitors

Recruiting and retention



View the plan as a valuable **recruiting** tool



View the plan as a valuable **retention** tool

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Open Architecture Plan Design Decisions

Eligibility

Who will be eligible to participate?

Examples:

- ✓ Employees earning over $130,000
- ✓ Assistant Vice Presidents and above

Elective Deferrals

What compensation can be deferred?

Examples:

- ✓ 0% – 80% of Base Salary
- ✓ 0% – 100% of Bonus
- ✓ 0% – 100% of Performance Based Comp.
- ✓ 0% or 100% of 401(k) corrective refunds

Sponsor Contributions

Will the employer be making contributions?

Examples:

- ✓ Employer Match: $0.50 match up to 6%
- ✓ Discretionary employer contributions
- ✓ Based on performance metrics
- ✓ Not required

Vesting

How will employer contributions vest?

Examples:

- ✓ Employee Deferrals are 100% vested
- ✓ Employer Match mirrors 401(k) vesting schedule
- ✓ Discretionary Employer Contributions vest on a rolling 3-year basis (from year of contribution)

Distributions

What type of distributions options to allow?

Examples:

Time of distribution:

- ✓ In-service distribution
- ✓ Separation from service distribution

Form of distribution:

- ✓ Lump sum
- ✓ Annual installments

Investment Menu

What investment options are available?

Examples:

- ✓ Mirror the 401(k) menu
- ✓ Custom list funds

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What you can achieve

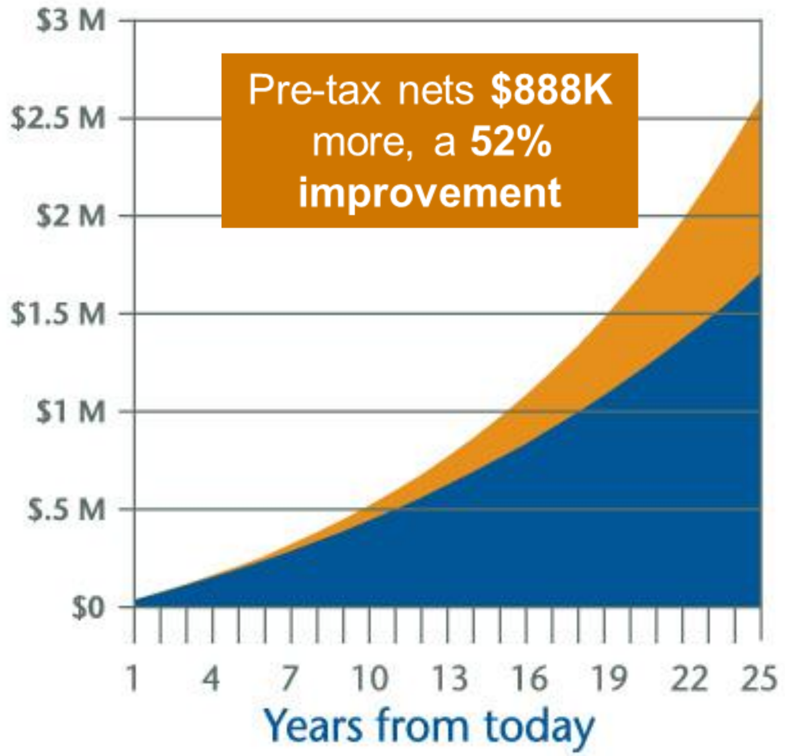
Save more

With pre-tax

Every dollar is working for you

Your pre-tax deferrals at work

NET ACCOUNT VALUES



Pre-Tax NQ Deferred Comp

Taxable Investment

Assumptions:

35% Marginal Tax Rate

	Pre-tax NQDC	Taxable Investment
Annual deferral amount:	$50,000	$50,000
Net amount invested:	$50,000	$32,500
Earnings rate:	8%	8%
Net investment return:	8%	5.2%
Account balance after 25 years:	$3.948M	$1.678M
Net account value after 25 years:	$2.566M	$1.678M

Net amount invested for Taxable Investment based on assumed 35% federal tax bracket. Lower maximum tax rates on capital gains and dividends would make the return of the taxable investment more favorable, thereby reducing the difference in performance between the options shown. Consider your personal investment horizon and income tax bracket, both current and anticipated, when making an investment decision as these may further impact the results of the comparison. Pre-tax NQDC value based on taking lump sum distribution after 25 years at federal tax rate of 35%.

Manage taxes

Defer highest tax bracket income to lower your actual tax rate

Customizable, user-friendly, participant-driven distribution elections

20%
College

August 2026

4 annual installments

Conservative/ Short-term

20%
Vacation home

April 2029

Lump sum payment

Moderate/ Middle-term

60%
Retirement

Pay at separation

Installments based on account balance

More aggressive/ Long-term

Debunking misconceptions

1. Pass-through entities can’t do deferred comp!

2. My client (owner) won’t put in a plan if he/she loses their tax deduction!

Pass-through entities can't do deferred comp!

WRONG!!!

- ✓ It is true that sole and majority shareholders cannot directly benefit from deferring their income into a NQDC plan.

- ✓ However, nearly 40% of plans are for pass-through entities — just not directly for the owner(s).

    - ❖ Instead, the owners are using the plans to recruit, retain, and reward top talent…which ultimately benefits the owner(s)

Owner won't put in a plan if they lose their tax deduction!

First: The deduction is not lost, it's deferred.

Second: The fundamental concept of deferring ANYTHING is that it will be worth MORE in the future!

- The Marshmallow Test
- The owner(s) <u>actually do participate</u> in the plan; not <u>directly</u>, but passively
- If a participant defers $100,000 now…

Deferred comp overview

Financing ***(a.k.a., Informal Funding)*** Considerations

Key point #1 — the method the company chooses has NO bearing on participants!

Understanding Funding — Qual vs NQ

"Formal" Funding
Qualified Plan

- Has met federal requirements to receive favorable tax treatment
- Is *formally* funded under ERISA
- Qualified plan trust is a separate legal entity from the company
- Company receives a current tax deduction for trust contributions
- Assets grow tax-deferred

"Informal" Funding
Nonqualified Plan

- Has not met federal requirements to receive favorable tax treatment
- Not formally funded, limited ERISA impact
  - Nonqualified benefits such as Deferred Compensation Plans are unsecured promises to pay and are not required to be informally funded
- Commonly use a rabbi trust — an extension of the company
- Company receives a tax deduction for benefit payments, not for funding/trust contributions
- Asset growth is taxed at corporate rates

Potential financing strategies

Corporate owned taxable investments

Comprehensive platform consisting of a broad array of well-known mutual funds and fund managers.

Corporate-owned life insurance

Tax-deferred earnings vehicle which permits allocations of premiums paid into investment divisions of the separate accounts, managed by well-known fund managers.

Or a combination of strategies creating a custom solution

Taxable Investments vs COLI

Comparison	Taxable Investments	COLI
Large selection of available funds	Yes	Yes
Simple to implement	Yes	Yes
Quality investment choices and advisors that can provide valuable diversification to existing 401(k) funds	Yes	Yes
Taxation on investment, dividends, and interest	Yes	No
Taxable event when changing allocation	Yes	No
Tax due on any unrealized gains upon Plan withdrawal	Yes	No
Tax-deferred investment income	No	Yes
Annual expenses	Depends on annual tax exposure: realized gains, dividends, reallocations, portfolio turnover, etc.	Properly structured, tax advantages outweigh insurance costs
Tax-free proceeds	No	Yes
Cash accumulation tracks deferred compensation balances	Yes	Yes
Eliminates taxes on investment income	No	Yes
Tax-free access to cash to make benefit payments	No	Yes
Can be accretive to corporate earnings	No	Yes

Informal Funding Options

Understanding and comparing different asset structures…

Key assumptions

Throughout this demonstration we've used these assumptions

Tax pass-through	corporate structure	**$1,000,000**	employee deferrals
5.0%	cost of money on cash	**$0**	employer credits
2.9%	after-tax rate for NPV	**19**	years of contributions
42.00%	corporate tax rate	**7.00%**	earnings rate
25.00%	capital gains rate	**Lump sum**	benefit payment

Plan-related liabilities only (no financing assets)

Year	1 Employee deferrals	2 Employer credits	3 Plan balance	4 Owner's future tax benefit	5 Employee deferrals (cash in)	6 Benefit payments (cash out)	7 Delayed tax benefit (cash effect)
1	$1,000,000	$0	$1,070,000	$449,400	$1,000,000	$0	($420,000)
2	1,000,000	0	2,214,900	930,258	1,000,000	0	(420,000)
3	1,000,000	0	3,439,943	1,444,776	1,000,000	0	(420,000)
4	1,000,000	0	4,750,739	1,995,310	1,000,000	0	(420,000)
5	1,000,000	0	6,153,291	2,584,382	1,000,000	0	(420,000)
⋮	⋮	⋮	⋮	⋮	⋮	⋮	⋮
16	1,000,000	0	29,840,217	12,532,891	1,000,000	0	(420,000)
17	1,000,000	0	32,999,033	13,859,594	1,000,000	0	(420,000)
18	1,000,000	0	36,378,965	15,279,165	1,000,000	0	(420,000)
19	1,000,000	0	39,995,492	16,798,107	1,000,000	0	(420,000)
20	0	0	0	0	0	(39,995,492)	16,798,107
Total					$19,000,000	($39,995,492)	$8,818,107

See the detailed information pages for year-by-year numbers

Cash flow from columns 5-7 **($12,177,385)**

Net present value (NPV) **($4,713,959)**

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Plan-related liabilities + corporate-owned mutual funds

Year	1 Employee deferrals (cash in)	2 Mutual fund deposits (cash out)	3 Tax on Earnings (cash out)	4 Benefit payments (cash out)	5 Delayed tax benefit (cash effect)	6 Asset withdrawal (cash in)	7 **Mutual fund balance**
1	$1,000,000	($1,000,000)	($17,660)	$0	($420,000)	$17,660	**$1,052,340**
2	1,000,000	(1,000,000)	(38,442)	0	(420,000)	38,442	**2,157,562**
3	1,000,000	(1,000,000)	(61,352)	0	(420,000)	61,352	**3,317,240**
4	1,000,000	(1,000,000)	(85,923)	0	(420,000)	85,923	**4,533,524**
5	1,000,000	(1,000,000)	(111,955)	0	(420,000)	111,955	**5,808,916**
⋮	⋮	⋮	⋮	⋮	⋮	⋮	⋮
16	1,000,000	(1,000,000)	(499,766)	0	(420,000)	499,766	**24,650,868**
17	1,000,000	(1,000,000)	(546,091)	0	(420,000)	546,091	**26,900,338**
18	1,000,000	(1,000,000)	(594,659)	0	(420,000)	594,659	**29,258,702**
19	1,000,000	(1,000,000)	(881,754)	0	(420,000)	881,754	**31,495,057**
20	0	0	0	(39,995,492)	16,798,107	23,197,386	
Total	$19,000,000	($19,000,000)	($5,712,676)	($39,995,492)	$8,818,107	$28,910,062	

See the detailed information pages for year-by-year numbers

Cash flow from columns 1-6	($7,980,000)
Remaining assets	$8,297,671
Total Cash Flow	**$317,671**
Net present value (NPV)	**($1,385,255)**

Balance of $31,495,057 minus withdrawal of $23,197,386

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Plan-related liabilities + corporate-owned life insurance (COLI)

Year	1 Employee deferrals (cash in)	2 Premium payments (cash out)	3 Tax on Earnings (cash out)	4 Benefit payments (cash out)	5 Delayed tax benefit (cash effect)	6 Asset withdrawal (cash in)	7 **Policy surrender value**
1	$1,000,000	($1,000,000)	$0	$0	($420,000)	$0	**$1,064,723**
2	1,000,000	(1,000,000)	0	0	(420,000)	0	**2,172,553**
3	1,000,000	(1,000,000)	0	0	(420,000)	0	**3,327,553**
4	1,000,000	(1,000,000)	0	0	(420,000)	0	**4,537,152**
5	1,000,000	(1,000,000)	0	0	(420,000)	0	**5,802,037**
⋮	⋮	⋮	⋮	⋮	⋮	⋮	⋮
16	1,000,000	(1,000,000)	0	0	(420,000)	0	**25,523,398**
17	1,000,000	(1,000,000)	0	0	(420,000)	0	**28,134,649**
18	1,000,000	(1,000,000)	0	0	(420,000)	0	**30,909,302**
19	1,000,000	(1,000,000)	0	0	(420,000)	0	**33,858,189**
20	0	0	0	(39,995,492)	16,798,107	23,197,386	**11,264,919**
Total	$19,000,000	($19,000,000)	$0	($39,995,492)	$8,818,107	$23,197,386	

See the detailed information pages for year-by-year numbers

Cash flow from columns 1-6	($7,980,000)
Remaining assets	$45,556,615
Total Cash Flow	**$37,576,615**
Net present value (NPV)	**$8,449,393**

By keeping the policy in-force until the assumed death you receive a tax-free death benefit of $45,556,615

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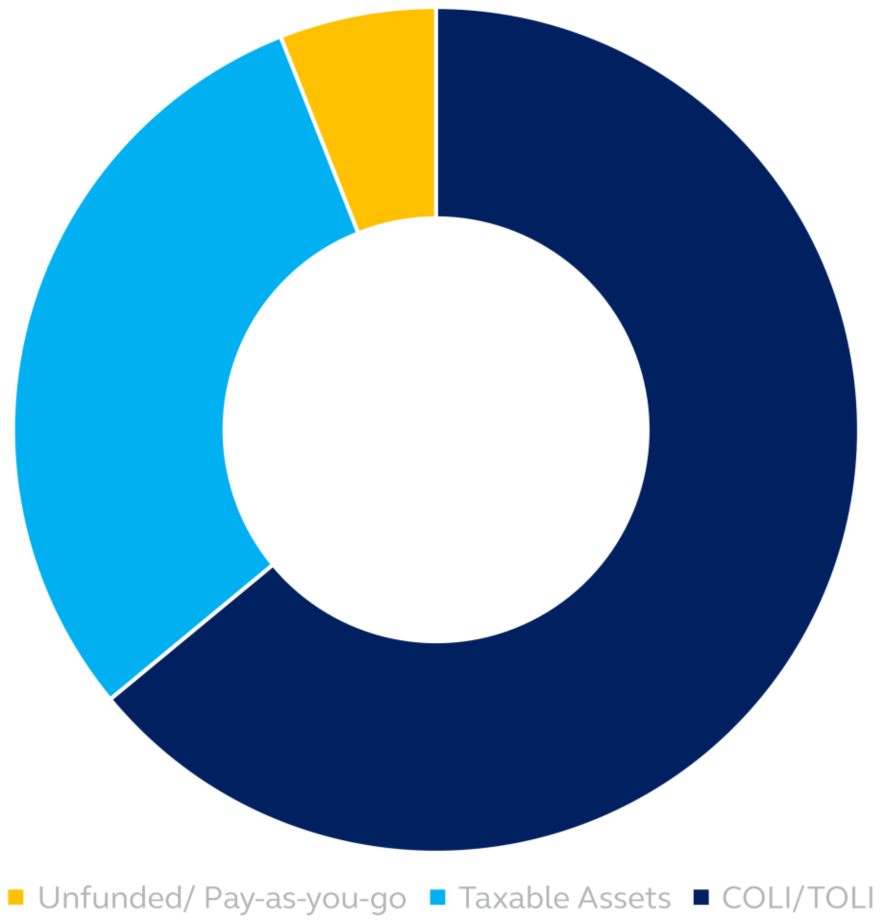
Informal Funding/Financing Prevalence



Nonqualified focus

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No. 1 provider of nonqualified deferred compensation plans[1]

Provide administrative services for more than **4,600 clients** and **5,200 plans**[2]

More than **150 dedicated employees** to nonqualified operations[2]

Over **25 years** dedicated to serving nonqualified clients and their participants[2]

Serve almost **72,000 participants**[2]

[1] Based on total number of Section 409A plans and non-governmental 457 plans, *PLANSPONSOR* 2017 NQDC Recordkeeping Survey, June 2017.
[2] As of September 30, 2017.

Questions?

Thank you

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