THE FINANCIAL CORNER

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EXECUTIVE NON-QUALIFIED RETIREMENT PLANS

The growth of 401(k) and other qualified employer-sponsored retirement plans has been a boon for those seeking to save for retirement while reducing their current tax bite. But for the growing numbers of individuals earning over $100,000 per year, the benefits of these "qualified" plans can be restricted. Because of limitations set by the Internal Revenue Code, contributions to qualified plans (both employee and employer matches) are capped and decline proportionately as the individual's income rises.

In response to this dilemma, many companies offer nonqualified plans to certain highly compensated employees. Such plans come in many shapes and sizes: defined benefit excess plans, defined contribution excess plans, voluntary deferred compensation plans, and supplemental executive retirement plans (SERPs). Nonqualified plans are not subject to most of the requirements of the Employee Retirement Income Security Act (ERISA) and are not subject to the contribution limitations imposed by the Code. However, these plans are also not protected by ERISA, and executives who participate in them should be aware of their drawbacks as well as their benefits.

Contributions

The first point to keep in mind with nonqualified retirement savings plans is that they are all different. Since they are not subject to most of ERISA's rules, they generally can be tailored to a specific company's -- or individual's -- needs. Accordingly, contribution limits, employer matches, and vesting schedules may differ significantly from plan to plan. And even within the same company, plan specifics may vary from individual to individual. For example, a Senior VP-level plan is likely to differ from the CEO's plan.

But most nonqualified plans do have certain common features. For one, contribution limits for nonqualified plans have no legal caps and are often significantly higher than for qualified plans. As with qualified plans, contributions to properly designed nonqualified plans are tax deferred; taxes are not paid until funds are distributed. Unlike qualified plans, however, contributions are not technically owned by plan participants until they are paid; fund liabilities -- including employee contributions -- represent an unsecured promise to pay on the part of the employer. This can present issues in the event of a sale of the company or if it goes bankrupt. Depending on the plan's investment structure, an employee may find himself at the end of a line of creditors making dibs on what he thought were "his" plan assets.

Structure

To qualify for tax-deferral status, nonqualified plans must pass muster with the IRS on two basic principles: constructive receipt and economic benefit. These fundamental precepts require a plan to be structured in such a way that plan participants do not have unlimited discretion as to when they can receive payments and have not had their benefits funded in some separate arrangement outside of the company's assets -- that is, participants do not own plan assets in any way or have any rights to any specific company property. Also, nonqualified plans may not be "funded" the same way as a 401(k) and other qualified retirement plans are with a separate trust that is specifically dedicated to only the payment of plan benefits. This means that nonqualified plans may only use indirect methods of "funding" for plan benefits.

Typically, a company provides for plan benefit payments in one of three different ways: "Pay-as-you-go," mutual funds (and other publicly traded investments), and life insurance. Under the "pay-as-you-go" approach, plan benefits are paid directly by the company with available cash. As benefits come due, they are paid and deducted as business expenses. In practice, this structure is seldom used nowadays, as it can pose significant cash flow issues to the sponsoring company and offers little in the way of guarantees that the company will meet its payment obligations in the future.

In a plan funded by mutual funds (and other publicly traded investments), assets are held directly by the company or in a special type of trust -- a "rabbi trust" (so named because of a 1981 IRS ruling granting tax-deferred status to a trust established by a synagogue for its rabbi) -- which is invested in mutual funds (and other publicly traded investments). A rabbi trust is a trust that holds assets contributed by the company that are intended to be used to pay benefits, but that are treated as property of the company for tax purposes and are subject to the claims of the company's creditors in the event of the company's insolvency or bankruptcy. The company or trust will typically invest in the same mutual funds (and other publicly traded investments) available in the company's qualified plan, thus "mirroring" the qualified plan, and offering participants identical fund selection and weightings. Plans structured with a rabbi trust offer simplicity to plan sponsors and a certain amount of security to plan participants, whose plan benefits are assured even if the company is acquired or management tries to renege on its promises.

One popular funding mechanism is through corporate-owned life insurance (COLI). In this arrangement, employers fund plans with life insurance. Although COLI-funded plans can be complex, they offer tax-free growth[1], can be cost effective, and are attractive to sponsors seeking to match assets with liabilities created by deferred compensation plans.
Special rules apply to nonqualified plans maintained by tax-exempt organizations.

Distributions

Unlike with qualified plans, distribution options under nonqualified plans are determined by the sponsoring company subject to the requirements of Section 409A. A given employer may design and plan to limit your choices on how and when you receive distributions.

While employee contributions to most plans are typically 100% vested from day one (although not owned until paid), vesting schedules are often imposed for the employer contributions --

earning some nonqualified plans the nickname "the golden handcuffs," in that vesting periods are usually stretched out long enough to encourage the executive to remain with the company sponsoring the plan.

Most importantly, nonqualified plans must satisfy the requirements of Section 409A of the Internal Revenue Code, which was added to the Code in 2005 and which substantially changed the tax treatment of nonqualified plans. Section 409A sets forth a variety of requirements applicable to nonqualified plans, including rules on distribution options and deferral elections. Failure to comply with the requirements of Section 409A results in the early taxation on nonqualified plan benefits as well as a 20% penalty tax and additional interest payable to the IRS.

Unlike qualified plans, nonqualified plans do not permit you to roll over plan assets into an IRA or another nonqualified plan when changing jobs. Instead, you must begin receiving payouts -- and pay taxes on them -- in accordance with the plan's terms.

Points to Remember

1. Nonqualified retirement plans are primarily offered to executives and other highly compensated employees whose participation and benefits from qualified plans may be significantly restricted.
2. Nonqualified plans differ significantly from company to company, and from individual to individual within the same company.
3. Unlike with qualified plans, there are no legal contribution limits for nonqualified plans.
4. Typically, nonqualified plans are funded in one of three diverse ways: "Pay-as-you-go," mutual funds (and other publicly traded investments), and life insurance.
5. Life insurance is a popular and typically cost-effective funding mechanism.
6. Nonqualified plans do not permit you to roll over plan assets into an IRA or another nonqualified plan when changing jobs. Instead, you must begin receiving payouts -- and pay taxes on them -- in accordance with the plan's terms

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[1]Certain taxes may apply if the sponsor company is subject to the alternative minimum tax.

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