Consider a Third Party Administrator For Nonqualified Deferred Compensation Plans

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Nonqualified Deferred Compensation (NQDC) Plans have been a very popular mechanism for providing supplemental benefits to an organization's key executives. Their popularity has been increasing over the past few years, due mainly to the constantly expanding limitations on benefits that may be provided through Qualified Plans. According to the Department of Labor, at the end of 2010 there were almost 100,000 nonqualified Plans covering over 1,500,000 executives. Plan popularity can also be attributed to companies desiring to "lock in" their key employees for competitive reasons as well as flexibility in plan design and the ability to provide benefits for only a select group.

Plan administration and recordkeeping are key components with any benefit plan, whether performed in-house, or outsourced to a third party. The outsourcing of administration and recordkeeping to a Third Party Administrator (TPA) for any fringe benefit plan is ultimately a question resolved by cost-benefit analysis and/or the availability of in-house expertise. However, recently enacted federal tax legislation has significantly increased both the complexity and reporting requirements for such Plans. The following describes some areas that should be considered when making outsourcing decisions:

<u>Legislative Compliance</u>
IRC Section 409A and its associated regulations set forth rules and procedures that must be followed in order to avoid significant tax penalties to the participant. *NQDC plans must be compliant with 409A from both a documentation and operational basis.* Plan documentation must conform to required definitions, such as the definition of "disability" or "unforeseen emergency." Plan documentation and operation must conform to other items such as timing of deferral elections, permissible payment events, and time and form of payouts.

NQDC plans must also be supported by comprehensive legal agreements between the Plan Sponsor and the Participant(s). A TPA can often provide compliant Plan agreements for the client and their legal counsel to review, thus reducing overall client costs and expediting Plan implementation.

Ongoing monitoring of timely deferral elections, payouts, and general conformity to the 409A compliant document is critical. Detailed recordkeeping of all Plan transactions will play a substantial role in case of an IRS audit. A qualified TPA should be equipped to monitor and track all Plan transactions efficiently and accurately. State-of-the-art software and broad-based experience should be part of the critical evaluation process.

Reporting

Reporting plays an important role in plan administration from both a compliance and informational perspective. Certain information is required to be reported to the IRS for income tax purposes on an annual basis such as FICA and split dollar imputed income, for W2 and 1099 purposes. 409A requires additional information disclosure entries with regard to the reporting of deferrals and earnings. Payroll companies often lack the experience and expertise necessary for reporting these potentially complex calculations.

NQDC Plan liabilities and assets affect the Plan Sponsor's financial statements based on Generally Accepted Accounting Principles (GAAP). The Federal Accounting Standards Board (FASB) dictates what must be reported and how to calculate the numbers (FASB 87, FASB 106, FASB 109, TB 85-4, etc-as re-codified.). TPAs often employ financial professionals who enjoy expertise in these specialized accounting areas. Quality record-keeping involves calculating detailed and accurate current period General Ledger entries, accounting for Plan events and changes in actuarial assumptions, as well as projecting future cash flows and the net effect on earnings.

Plan sponsors informally funding their Plan liabilities with Corporate Owned Life Insurance (COLI) or mutual funds also require periodic analysis of funding requirements and asset/liability balancing … a skill not usually found in-house.

Flexible Plan Features

As mentioned above, one of the reasons for the popularity of NQDC Plans is the flexibility in design feature – being able to design a Plan to meet the specific objectives of the Plan Sponsor and individual participants. For instance, a NQDC Plan designed to "look and feel" like a 401(k) plan could be established that would be even more flexible than a traditional Qualified Plan. The NQDC Plan could permit the deferral of salary, bonus, or fees, and allow participants a distinct set of deemed investment options and distribution choices for each deferral source. In addition, each year's deferral could be associated with its own vesting schedule (commonly called "class year vesting," a feature no longer permitted in 401(k) Plans).

In Summary

NQDC Plans continue to be as popular today as they have been in the past. Plan Sponsors are encouraged now, more than ever, to carefully evaluate a variety of factors when making outsourcing decisions. Compliance, complexity, accounting, reporting and cost may often lead Plan Sponsors to the services of a qualified TPA.