Nonqualified Deferred Compensation Plans
'The Perfect Storm'

By
Howard D. Stern, FSA, MAAA
Sr. Vice President & Actuary

Wayne A. Pangburn, CLU
President

The Pangburn Group
December 1, 2015

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, mainly due to the constantly expanding limitations on benefits that may be provided through qualified plans. According to the Department of Labor, between 1975 and 2015, U.S. companies have established over 113,000 NQDC plans covering over 1,754,000 participants. 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.

In the last few years, the landscape has changed considerably with regard to NQDC plans. There has been a perfect storm with the convergence of complex compliance, reporting, disclosure, and accounting requirements. The good news is that practitioners and their clients have very specific, albeit very complex, rules and guidelines for designing, implementing, and administering NQDC plans. Once considered "simple" in contrast to their qualified plan cousins, NQDC plans remain a viable but now more complicated benefit solution. No longer the exclusive domain of large public companies, NQDC plans have broad appeal to employers of all sizes.

The average number of participants in all U.S. plans is approximately 21, whereas the average number of participants in 90% of all those plans (plans with 100 or fewer participants) is only 8, with 26% of all plans having only 1 participant. As smaller companies with smaller budgets and less in-house expertise attempt to navigate through the perfect storm, reliance on consultants, advisors and third party administrators and recordkeepers becomes more and more critical. Since noncompliance with federal regulations now results in substantial financial penalty to plan participants, plan sponsors are under increasing pressure to insure that all parties play by the rules. What follows is a brief synopsis of the factors contributing to today's perfect storm:

IRC Section 409A

Clearly the single most significant development in the last eight years was the enactment of IRC Section 409A which promulgated for the first time an extensive and complex set of rules and regulations governing nearly all deferred compensation arrangements. In April 2007, the IRS published the final regulations to IRC Section 409A. A knee-jerk reaction to certain real and imagined abuses, primarily by a handful of large public companies, Section 409A has dramatically changed the landscape for NQDC plans by imposing, for the first time, significant financial penalties on the plan participant rather than the plan sponsor.

Although exhaustive (over 300 pages) the final regulations issued in April 2007 focus on 4 main areas: (1) election restrictions, (2) distribution restrictions, (3) acceleration restrictions, and (4) definitions.

(1) Election Restrictions – In general, a participant's election to defer compensation for a taxable year must be made no later than the close of the preceding taxable year. A valid election is comprised of: (i) the amount of the deferral and (ii) the desired time and form of the deferral distribution. There are a few exceptions to the "previous taxable year" rule. A new participant has up to 30 days following eligibility to make a deferral election. An election to defer "performance based compensation" (i.e., compensation based on achievement of a pre-determined performance criteria) can be made up to 6 months before the end of the performance period (performance period must be at least 12 months). The regulations, however, allow the time and form of payment selected to be modified if certain requirements are met (Subsequent Deferral Rules).

(2) Distribution Restrictions – Distributions may be made only upon the occurrence of one or more of the following "permissible payment" events: (1) a separation from service, (2) death, (3) disability, (4) a specified time, (5) a change in control (i.e., ownership), or (6) an unforeseeable emergency. There is an additional rule that permits payments to begin on the occurrence of a vesting event provided that the time and form of payment is designated. The regulations allow some additional flexibility by permitting a distribution to be made upon the "later of" or "earlier of" two of the above events. In addition, each payment event may have a different form of payment. For example, a plan may state that upon death or disability, the distribution will be made in lump sum, while upon a separation from service the benefit will be paid in periodic installments.

(3) Acceleration Restrictions – The regulations prohibit the acceleration of a payment subject to a short list of exceptions. For example, if a deferral election is made to distribute funds at age 65, it would not be permitted to distribute the funds at age 55. The regulations permit the acceleration of payments under the following conditions: (i) a domestic relations order, (ii) inclusion of income due to violation of 409A, (iii) in order to pay FICA tax, (iv) certain conflicts of interest, (v) plan termination if certain conditions are met, and (vi) lump sum cash out if the deferred amount is below an amount stipulated in the plan document.

(4) Definitions - Plan documentation must conform to required definitions such as the definition of "disability," "separation from service," "change in control," or "unforeseen emergency."

IRC Section 101(j) – COLI (Corporate Owned Life Insurance) Best Practices

The Pension Protection Act of 2006 created IRS Section 101(j), which affected the taxation of COLI. Under Section 101(j), life insurance proceeds received by an employer will only be tax-free, to the extent that the death benefit exceeds the premiums (or other basis), unless one of the stated exemptions applies, ***AND*** certain notice and consent requirements are met. With regard to COLI used to informally fund an NQDC arrangement, the most important exemption is the "employee exemption." If the insured falls under the employee exemption **and** the notice and consent requirements are met, the full proceeds will escape income tax. The employee exemption will apply when the insured:

(a) was an officer, director, or "highly compensated employee" (i.e., a 5% shareholder, or earning at least $120,000 in 2016 - indexed for inflation) at any time during the 12-month period before the insured's death, or

(b) is at the time of policy issue a director, "highly compensated employee," or "highly compensated individual" (i.e., one of the 5 highest paid officers, a 10% shareholder, or among the highest paid 35% of all employees).

The notice and consent rules require:

- the employee provides written consent to being insured,
- the employee is made aware that coverage may continue after the insured terminates employment, and
- the employee is informed that the employer is the beneficiary under the policy

The employer is also required to file an annual report with the IRS (Form 8925) which will disclose such items as: (i) the number of employees insured and (ii) the total amount of insurance in force at the end of the year.

These rules apply to all policies issued after August 17, 2006. In addition, these rules will apply to any policy issued prior to August 17, 2006, that is "materially modified."

Reporting and Disclosure – W2 and 1099 Requirements

The IRS has added a number of W-2 and 1099 requirements for NQDC plans. In general, participant annual deferrals, earnings, and distributions will require special handling on the appropriate form (e.g., W-2s for employees, and 1099-Misc for non-employees, such as independent contractors). The rules require careful placement of deferrals, earnings, and distributions in the appropriate box(es) on the forms. Tax advisors should be consulted for specific rules.

Reporting and Disclosure - SEC Disclosure Requirements

On July 26, 2006, the SEC adopted amendments to the rules on executive compensation disclosure rules for public companies for fiscal years ending on or after December 15, 2006. Final rules were promulgated as of August 29, 2006. The final rules require information regarding nonqualified plans be reported for certain specified executives by entries to the following tables for the fiscal year:

- Summary Compensation Table – Summarizes and reports all forms of compensation earned by the specified executive (i.e., salary, bonus, stock options)

- Pension Benefits Table (Defined Benefit Plans) - For each executive, reports years of credited service, the actuarial present value of accumulated benefits, and distributions for the year

- Nonqualified Deferred Compensation Plans Table (Defined Contribution Plans) – Disclosure of contributions, earnings, and distributions for each executive

Accounting for Defined Benefit Plans - FASB 158

In September 2006, FASB issued Statement No. 158, which significantly modified the rules for accounting and reporting liabilities for Defined Benefit Pension Plans, Nonqualified Defined Benefit SERP Plans, and other Post-Retirement Defined Benefit Plans. FASB has collectively re-codified Statement 158 under Accounting Standards Codification (ASC) 715. The new rules apply to publicly traded companies (effective for fiscal years ending on or after December 15, 2006) and private companies (effective for fiscal years ending on or after June 15, 2007), that currently report obligations and expenses under FASB 87 or FASB 106. The focus of the new rules is on accounting for plan liabilities on the Balance Sheet.

Previous Accounting Standards

Previous accounting standards permitted the reporting of a liability on the Balance Sheet as an Accrued Pension Expense (subject to a minimum). This number was substantially smaller than the "Unfunded Obligation," which is measured as the Projected Benefit Obligation (PBO), less Plan Assets (for nonqualified plans, Assets = 0). The PBO is the actuarial measure of the present value of accrued projected future benefits taking into account all future salary increases for plan benefits based upon salary. The nature of the "Unfunded Obligation," or "Funded Status," was disclosed in footnotes to the financial statements. Each year, the Balance Sheet Liability was increased by a current year's pension cost (Service Cost), an Interest Cost, and an "Amortization Component." These three components (together called the Current Year's Pension Expense) would gradually bring the Balance Sheet Liability in line with the "Full Liability" (PBO) over time.

New Accounting Standards due to ASC 715

ASC 715 requires immediate recognition of the Full Liability of the plan to appear on the Balance Sheet. For nonqualified plans this means that the full PBO will now be immediately recognized as the Balance Sheet Liability instead of the Accrued Pension Expense. The new accounting standard requires that the Equity side of the Balance Sheet (Other Comprehensive Income) be decreased as the offsetting entry to the increase in Balance Sheet Liability. This could materially affect companies with loan covenants that are equity sensitive.

It should be noted that FASB 158 does not alter the accounting rules under APB 12 (re-codified under ASC 710), and therefore will not affect these plans.

Accounting For Post-Retirement Split Dollar

In 2006, FASB ratified directives relating to the appropriate accounting for post-retirement split dollar life insurance arrangements. Both endorsement and collateral assignment are affected by the FASB ratification of EITF 06-04 and 06-10, respectively, which have been re-codified as ASC 715-60. In essence, Post-Retirement Split Dollar arrangements that: (a) require an employer to maintain a life insurance policy during an employee's retirement or (b) require the employer to provide a post retirement death benefit, will require recognition of a balance sheet liability.

The liability should be computed in accordance with ASC 715-60 or ASC 710, depending upon whether a formal plan exists, or the arrangements are individual agreements with selected employees. The liability will be based upon:

(a) the present value of the expected cost of insurance charges in the policy if the employer's obligation is to maintain the life insurance policy, or

(b) the present value of the expected death benefit to be paid if the employer's obligation is to provide a post-retirement death benefit.

The new accounting rules apply to fiscal years beginning after December 15, 2007. Most existing split dollar plans will offset the initial liability set up by a cumulative adjustment to Equity.

Plan Designs

One of the reasons for the popularity of NQDC plans is flexibility in design – being able to design a plan to meet the specific objectives of the plan sponsor and individual participants. Although regulations have placed some limitations on plan design, there remains enough room for creativity. For instance, a NQDC plan designed to "look and feel" like a 401(k) plan could still be established that would be 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). Although regulations require the selection of a time and form of payment at the time of deferral, the regulations permit the modification of the time and/or form, if certain conditions are met. A nonqualified 401(k) "look-a-like" plan typically allows the participant to select a year or an age for in-service distributions under any circumstances.

Qualified 401(k) plans may provide non-hardship, in-service distributions only after meeting certain conditions (typically attaining age 59½). Defined benefit plans are also getting a second look especially in situations where the participants do not have a lot of investment risk tolerance, where the accumulation window is less than 10 years, or where participants would rather bargain for the guaranteed benefits of a defined benefit plan in lieu of salary or bonus increases and the complexity of account balance plans.

In Summary

The perfect storm of compliance, reporting, disclosure, and accounting has focused attention on NQDC plans and mandated that clients and practitioners play more active roles in the design, implementation and administration of these most important of fringe benefits. Regardless of bundled or unbundled servicing, design, funding, and administration require a higher than ever level of expert knowledge and technology. Failure to comply and the accompanying financial penalty, on what could be an unwitting participant, makes **compliance** (documentary, tax, accounting and reporting) the new mantra for NQDC practitioners.