Practical Solutions for NQDC Plans

(January 2017)

What is the "Average Non-Qualified Defined Contribution Plan"?

If you're short on time….I'll summarize….*"there is no average non-qualified defined contribution plan".*

This statement is based on 20+ years of in-depth experience with non-qualified plans and my recent review of 200 medium-to-large company non-qualified defined contribution plan design features, where I found:

- 94 different types of eligibility provisions
- 124 different company contribution allocation formulas
- 95 plans with unique lineups of mutual funds as investment alternatives with 25 including company stock
- 61 different vesting schedules

<u>Eligibility Provisions (94 Different Types)</u>

Unless they are designated as excess plans[1]; most non-qualified plans start off by listing the customary ERISA Top Hat group definition[2] in the plan's summary paragraph then further customize the eligible group later in the document.

In my review, there were 94 different types of eligibility group designs in the 200 Plans:

- In 1 of the 94 different groups, 25 plans used the IRC Code Section 415 excess plan contribution limit ($54,000 for 2017) <u>and</u> the 401(a)(17) compensation limit ($270,000 for 2017) to define the eligible group. This was the most common eligibility definition used in the survey.
- In another group in the 94, 17 plans used only the IRC Section 401(a)(17) compensation limit to define the eligible group. This common eligibility definition, however, does not necessarily qualify as an IRC Code Section 415 Excess Plan.
- The remainder use, or use a combination of: specific executive or management titles, pay grades/levels or bands, certain named individuals, qualified plan limits, specific management groups, etc…

My comments and recommendations on determining the non-qualified defined contribution plan eligible group:

- *Keep it to an exclusive group.* While the government has never officially defined a "non-qualified plan eligible group" we do have a history of lawsuits and court cases to help us. A recent lawsuit, *Sikora, Plaintiff, v. UPMC, Defendant,* gave us a refreshed look at several different opinions related to a safe definition of the eligible group, and included a rather notable discussion of the government's use of the word "<u>or</u>", as in "…*a select group of management <u>or</u> highly compensated employees*".
- *Never include all of the highly compensated employees* ("HCEs") who are affected by the 401(k) plan's deferral cap, currently $18,000 for 2017. This HCE group is determined in the 401(k) plan ADP/ACP[3] non-discrimination testing, which usually includes all those making over $120,000 in look-back year pay, for 2017's testing. This one time yearend snapshot of pay is much too low for determining an ongoing non-qualified exclusive group.
- *Keep the "409A difficult to remove employees" out of the plan.* These are employees who could somehow make it into the plan and must remain in the plan for long periods of time due to the payout restrictions of 409A.

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The comments and opinions expressed in this article are those of Russell Morgan only. They are for informational purposes and should not be construed as legal advice. For legal advice, contact your legal counsel.

<u>Non-Qualified Plan Company Contributions (124 Different Allocation Formulas)</u>

There are several different reasons why firms make company contributions to non-qualified plans. In an excess plan formula, the plan is designed to continue the company's qualified plan benefits impacted by the qualified plan IRC Code Section

415 limits ($54,000, for 2017). In non-excess plans, company contributions are allocated for a multitude of reasons and are usually flexible as conditions change over time. Some use them as an incentive to encourage financially beneficial behaviors, others reward good unit or corporate earnings and/or long service.

In my review, there were 124 different company contribution allocation formulas:

- 35 of the 124 company allocation formulas use "profit sharing only" formulas. Out of those 35 "profit sharing only" formula plans, there were 24 different profit sharing allocation formulas.
- 65 of the 124 company allocation formulas use "match only" formulas. Out of those 65 "match only" formula plans there were 26 different match allocation formulas.
- The remainder of the plans employed other methods from a rather long list of possibilities.

My comments and recommendations on company contribution allocations:

- *Keep the company contribution allocation simple and flexible.* If it is not an excess plan formula, a "flexible % of total pay as determined by the Board of Directors" is my favorite. On the other hand, a "fixed allocation formula", unfortunately, may only last until the next management change or the establishment of a new and improved company or industry "measure of success".
- *It should be easy to communicate*. Remember that it will not necessarily be the executive compensation team that created the allocation formula or the legal team that approved it who will be answering your executive's questions. Instead it will be the CSRs at the recordkeeper or that new payroll clerk….so keep it simple.
- *Avoid confusing or difficult to administer formulas.* Before you add or change any allocation feature check with payroll and your non-qualified plan recordkeeper to see if they can handle the change in administration.

Vesting Schedules for Company Contributions (61 Different Vesting Schedules)

Vesting for all qualified plan employer contributions after 2006 is based on years of service and is limited to a maximum 3-year cliff or a 2-to-6 year graded vesting schedule. Vesting in non-qualified plans, however, is fully flexible, down to the individual participant level. Plans with 20 year vesting schedules, non-compete agreements and bad-boy forfeitures for all money types, including employee deferrals, are not uncommon. Some plans may include specific individual participant vesting or vesting by class year to support ongoing new hire and/or retention initiatives.

Immediate FICA tax calculation on the 100% vested company contribution(s) is by far the easiest to administer and is, in most cases, the least expensive FICA tax cost solution for the participant.

In my review, there were 61 different vesting schedules for company contributions:

- 70 plans out of 200, or 35%, use 100% immediate vesting (most common and easiest to administer)
- 29 plans out of 200, or 14%, use 3-year cliff vesting (second most common)
- 11 plans out of 200, or 5%, use 5-year cliff vesting (third most common)

My comments and recommendations on company contributions:

- *Make sure that the non-qualified plan team, including payroll and the recordkeeper, are fully aware of the different vesting schedules for different company contributions, if applicable.* This is especially challenging where the company match vests at one time and the profit sharing contribution vests at another.
- *Remember that vesting equals FICA tax time.* FICA taxes on newly vested "company contributions" are usually taken from other current pay sources, such as base pay. FICA taxes on newly vested "company contribution accounts" are typically taken from other current pay sources, such as base pay or can be deducted from the vested portion of the accounts which can be very difficult for payroll and the recordkeeper to process.
- *Vesting can also be increased at any time* but may not lead to an accelerated payment under Code Section 409A. Under non-qualified plans, vesting could also be decreased, or the account could be forfeited at any time.

Plan Funding and Investments:

Plan funding discussions will quickly grab the attention of the Board of Directors, corporate finance and tax, the auditors, plan participants, and a myriad of other parties. Its main focus in the Code Section 409A regulations, so far, is related to off-shore funding, under-funded pension plans and non-qualified plan funding for the top executives. Code Section 409A-5, which is related to funding, is currently listed as *[Reserved]*.

The topic of investment rates of return was discussed in the Code Section 409A regulations, but then they quickly jumped to FICA tax penalties for excessive rates of return. There has been no real guidance on investment funds, but with the reduction in SERPs and the increase in NQDC plans that look like 401(k) plans, the topic of investments will continue to develop.

In my review, from a funding perspective, out of 200 plans:

- 106 were listed as being unfunded
- 20 were listed as being fully funded
- 17 were listed as being partially funded

In my review, from an investment(s) offered perspective, out of 200 plans:

- 95 use mutual funds similar to those offered under their qualified plan (most common)
- 25 use or include company stock

My comments and recommendations on plan funding and investments:

- *Both funding and investment strategies must be able to answer this one question: "Is this the best use of our company money?"* The company is essentially "borrowing the money" from its executives. If instead, you borrowed money from a financial institution, what would be the best use of that money?
- *Executives should be rewarded for putting their money at risk, but not to the detriment of the company.*
- *Pay attention to what the big company plans are doing.* Walmart's Supplemental Executive Retirement Plan, as of February 1, 2012, switched from an overall rate of return based on the Participant's 401(k) Plan accounts to a single rate of return based on 10-year U.S. Treasury securities. This 10-year rate is close to Walmart's current weighted-average interest rate on corporate debt.

In conclusion:

When asked to provide non-qualified defined contribution design solutions, be wary of using relatively small industry surveys, surveys that don't contain many plans of your type or size and surveys from those selling investment products and services. Instead of using survey shortcuts, you should first determine a high-level plan design, or plan design feature, that best suits your company and your executive population. Do your homework to find out what others, especially competitors and larger companies, are doing. If you need help developing a non-qualified plan solution, email me at russmorgan@nqdcsolutions.com, visit me on LinkedIn or my website at www.nqdcsolutions.com.

Footnotes:

[1] As recently as June 2015 when the IRS released the *Nonqualified Deferred Compensation Audit Techniques Guide*, they stated that *"Excess Benefit Plans are NQDC plans that provide benefits solely to employees whose benefits under the employer's qualified plan are limited by IRC § 415"*.

[2] Common Top Hat language: "*This plan is primarily maintained for the purpose of providing deferred compensation for a select group of management or highly compensated employees, 29 U.S.C. § 1101.*"

[3] Average Deferral Percentage/Actual Contribution Percentage non-discrimination test ("ADP/ACP"), one of approximately 20 qualified plan compliance tests.