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Providing Clarity and Confidence in Insurance, Investment and Benefit Solutions

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News in Brief: Market Update

Nonqualified Deferred Compensation — Restoring Lost Deferral Opportunity

Special points of interest:

- Significant limits from qualified plans
- Reverse discrimination to your Executives
- Flexible designs & deferral periods

Your company's success depends on your ability to attract the most talented employees you can. Once you find them, you need to keep them from leaving for a better offer. This guide will explain how a nonqualified deferred compensation plan can help your business succeed.

Why Qualified Plans May Not Be Enough

With a qualified plan such as a 401(k), you have a great way to help the majority of your employees prepare for retirement. They can save pretax compensation and let it potentially grow tax deferred until they need it for retirement. But a qualified plan may not fully prepare you and your key employees for retirement.

What are some limitations of qualified plans for your business?

- Minimum coverage rules[1]
- Nondiscrimination requirements
- Top-heavy testing

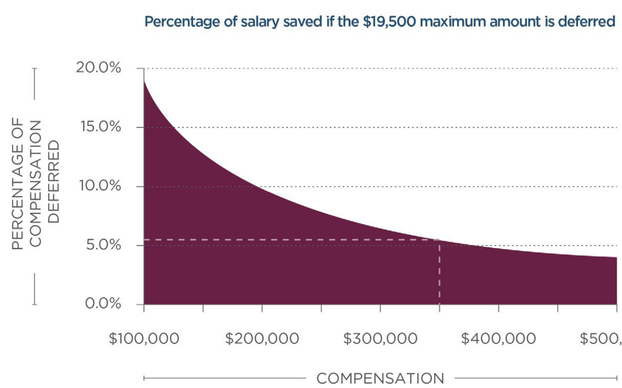
What are some limitations of qualified plans for your key employees?

- Contribution limits
- 10% penalty tax on withdrawals prior to age 59½
- Required minimum distributions

The percentage of income deferred decreases as income increases.
As you reward your key employees and their salary levels increase, the percentage of compensation that they can defer into a qualified plan rapidly decreases.

- Someone with a $100,000 salary who contributes the $19,500 maximum into a 401(k) plan is saving a respectable 19.5% of compensation for retirement
- But someone with a $350,000 salary who makes that same $19,500 maximum contribution is saving only a little over 5% of compensation

What's worse is that nondiscrimination testing for the 401(k) plan may even prevent your highly compensated employees from contributing the maximum amount otherwise permitted.



[1]Generally, at least 70% of all non-highly compensated employees must participate in the qualified plan (IRC Section 410(b), 1986, as revised).

Remember these important points:

About Taxes

- Your company takes an income tax deduction when it distributes money to the employees
- Your employees pay income taxes at ordinary rates when they receive the distributions (employment taxes are due when amounts are deferred or vested)

About Ownership

- Your company, or potentially a trust, owns any assets that offset the liability established by the plan, and the assets are subject to the claims of your company's creditors
- Your employees have no ownership rights in the plan assets and become general, unsecured creditors of your company with respect to the benefits you owe them under the plan

About Earnings:

- Your employees bear the risk that deferred amounts will not be credited with earnings and that they may lose principal

Qualified Plan Contribution Limits for 2020

401K Deferrals:

- $19,500 maximum employee deferral
- $6,500 catch-up contribution (if age 50 or **older)**

SEP IRA:

- $57,000 or 25% of compensation, whichever is less, maximum employer contribution
- $19,500 or 25% of compensation, whichever is less, maximum employee elective deferral plus $6,500 catch-up contribution (if age 50 or older) for SARSEP participants

Simple 401(k)

- $13,500 maximum employee deferral
- $3,000 catch-up contribution (if age 50 or older)

Defined Contribution and Defined Benefit Plans

- $57,000 annual contribution limit (including employee deferrals)
- $230,000 maximum annual benefit payout from
- defined benefit plans

$285,000 eligible compensation limit

How Nonqualified Deferred Compensation Plans Help

The Employee Retirement Income Security Act (ERISA) includes what is called the "top hat exemption," which requires that a plan is unfunded and maintained primarily to offer deferred compensation to a select group of managers or highly compensated employees. Your nonqualified deferred compensation plan allows your employees to supplement their retirement savings by deferring some or all of their current compensation into it — before taxes.

Potential Advantages & Disadvantages for your Key Employees

Advantages

- **They can save more for retirement.** This is in addition to what they defer into a qualified plan, and there aren't any contribution limits.
- **They may reduce their current taxable income.** Deferrals are pretax, so they can delay paying taxes on more of their current compensation.
- **Their savings grow tax deferred.** This increases the potential to grow, because taxes aren't reducing them every year.
- **They may increase their retirement income.** All of this works together and creates the potential for more income when they retire.

Disadvantages

- **They're relying on the stability of their employer.** If the employer becomes insolvent, participants could lose some or all of their benefits.
- **They can't change deferral elections midyear.** Their elections are irrevocable during the year and can be changed only at annual enrollment.
- **Distributions are subject to income tax**. Income tax will be payable when employees receive distributions.

Potential Advantages & Disadvantages for your Business

Advantages

- **You can attract the talent you need.** Offering more than just the normal benefits and addressing key employees' unique concerns can encourage them to consider your company.
- **You can give them incentive to stay.** For any amounts the company credits to employees' accounts, you can apply a vesting schedule.
- **You choose who gets to participate.** Unlike a qualified plan, you don't have to offer it to everyone.
- **You have flexibility in funding it.** You can use your employees' deferred amounts or company cash to informally fund the plan.
- **You own and control the assets.** This gives you more flexibility when it comes to financing the plan.

Disadvantages

- **You don't get an immediate tax deduction.** The company takes an income tax deduction later when it makes distributions to employees.
- **You must maintain records.** Nonqualified deferred compensation plans require a plan document and ongoing administration.

Nonqualified Deferred Compensation — Restoring Lost Deferral Opportunity (cont.)

Let's take a closer look at the impact on highly compensated employees' (HCE) retirement income

The example below illustrates how an NQDC plan can help HCEs fill their retirement savings gap compared to rank-and-file employees without an NQDC plan. The three HCEs are able to contribute to their NQDC plan to reach an approximate replacement ratio of 80%. If this plan had not been made available, these employees would be able to reach replacement ratios of only 55%, 30% and 17%, respectively. Sure, they could make up the gap by investing their after-tax dollars in other retirement savings vehicles, but they would probably be subject to taxable gains each year on their investments.

	Rank-and-file employee	Highly compensated employees[2]		
Annual compensation	100,000	150,000	275,000	500,000
401(k) annual deferral	19,500	19,500	19,500	19,500
Projected balance in 20 years	677,025	677,025	677,025	677,025
Estimated pretax annual payment for 20 years	51,739	51,739	51,739	51,739
Estimated annual Social Security benefit at Full Retirement Age[3]	26,688	36,132	36,132	36,132
Total estimated pretax annual payment	78,427	87,871	87,871	87,871
Approximate post-retirement income replacement ratio without NQDC	80%	59%	32%	18%
NQDC plan annual deferral	N/A	12,000	50,000	118,000
NQDC projected balance in 20 years		416,631	1,735,963	4,096,872
Estimated pretax annual payment for 20 yeras		31,840	132,665	313,089
Total estimated pretax annual payment with NQDC	78,427	119,711	220,536	400,960
Approximate post-retirement income replacement ratio with NQDC	80%	80%	80%	80%

[2]Each account is assumed to earn 5% annually on deferrals and balances.
[3]Based on current law and income thresholds. Figures are approximate in nature.

Nonqualified Deferred Compensation — Restoring Lost Deferral Opportunity (cont.)

How Nonqualified Deferred Compensation Plan Works

1. Your company and the employee enter into a legal agreement that defines the plan's features, benefits and requirements.
2. The employee elects to defer a specific dollar amount or percentage of future compensation and chooses how those deferrals should be allocated among a variety of deemed investment choices.
3. Your company may make matching contributions based on a formula or discretionary contributions as outlined in the agreement.
4. All contributions are credited to the employee's deferred compensation account, along with any gains or losses.
5. The employee takes distributions to supplement retirement income, and your company then takes a tax deduction.

Your Plan Design Options

Your nonqualified deferred compensation plan must fit your company's needs, so let's look at some ways we can help you customize it.

Plan Eligibility
You decide who can participate in the plan. It can include full-time or part-time employees, or independent contractors, provided they are part of a top-hat group.

Employee Deferrals
You may let your employees defer up to 100% of compensation, which can include:

- Base salary
- Commissions
- Annual bonuses
- Long-term incentives
- Performance-based compensation

You may also limit deferrals to less than 100% and exclude certain types of compensation.

Employer Deferrals
Your company may credit amounts on behalf of the employees, such as:

- Matching components similar to what is offered in the company's 401(k)
- Discretionary contributions based on: Performance, Percentage of salary, Flat dollar amount or a determined combination, or a Hybrid (for example, performance combined with a percentage or dollar amount)

You may make these on a discretionary basis and decide whether an employee can make voluntary deferral contributions.

Plan Deferral Cycle
Employees make annual elections for base salary deferrals during annual enrollment prior to the beginning of the year in which they earn the income. They make elections for performance based compensation no later than six months before the end of the performance period. (Performance-based compensation is compensation earned during a period of not less than 12 consecutive months that is contingent upon written criteria established within 90 days of the start of the performance period.)

Crediting Earnings, Gains and Losses
Employees' accounts are credited with earnings and losses based on their elections from among a broad range of options chosen by the company.

Vesting Schedule
Employee deferrals are always 100% vested, but company contributions may vest in a number of ways:

- 100% vesting
- Cliff vesting
- Graded vesting
- Custom vesting

You may also base the vesting on length of employment, age and/or contribution dates.

Plan Distributions
Your employees may receive distributions under the following circumstances:

- Separation from service (voluntary or involuntary)
- Death or disability
- An unforeseeable emergency
- At a specified time prior to separation from service
- A change in control of your company

Distribution options
Employees may elect to receive benefit payments in a lump sum or annual installments.

Rabbi Trust
You may want to place the assets that informally fund the plan in a rabbi trust. This may make your employees feel more comfortable, because assets held by the trust can be used only to pay plan distributions to employees. However, any assets held by the trust are subject to claims of the company's creditors in the event of insolvency or bankruptcy.

Plan Financing Options

The benefits you'll pay to employees under the nonqualified deferred compensation plan are considered an unfunded company liability. The company promises to pay benefits in the future, and you can do that out of current cash flow when payments are due. As a result, you have several financing options.

Unfinanced
You don't have to set aside assets or finance the future benefit payments. Instead, deferrals into the plan remain company assets that you can use for day-to-day operations. When employees are due benefits in the future, you can pay them out of company assets.

Advantages:
- **Deferrals provide a source of cash for current business operations**

Disadvantages:
- Future benefit payments may be a strain on future operations
- Employees may see this as an added risk
- No asset is established to offset the profit and loss statement impact associated with the plan

Taxable Investments
You could invest deferrals into taxable investments such as mutual funds. That's one way to match an asset with the liability you're accruing because of the employee deferrals.

Advantages:
- Professional money management
- A wide array of investment options
- Simple to implement

Disadvantages:
- Taxable investments such as mutual funds may have taxable distributions such as dividends and long-term capital gains; gains on the sale of the investments will be taxable
- Lack of alignment of the accounting treatment with the plan (i.e., mark-to-market) can result in adverse profit and loss statement impact
- Increased cash flow costs to pay taxes incurred on investment earnings with no potential for long-term cost recovery

Corporate-owned life insurance (COLI)
Although the main reason to purchase life insurance is the need for death benefit protection, in this arrangement, your company uses deferrals to pay premiums on corporate-owned life insurance policies. The policies insure the key employees and provide a stream of income during their lifetime.

Advantages:
- Tax-deferred policy gains — increases in the policy cash value aren't taxed
- Tax-free death benefits — your company receives the death benefits tax free and can use them to offset plan costs
- Variable universal life offers a wide array of investment options from well-known fund families
- Distributions can be received income tax-free via policy loans and withdrawals up to basis
- Mark-to-market (i.e., fair value) accounting treatment aligns with the accounting of the liability associated with the plan

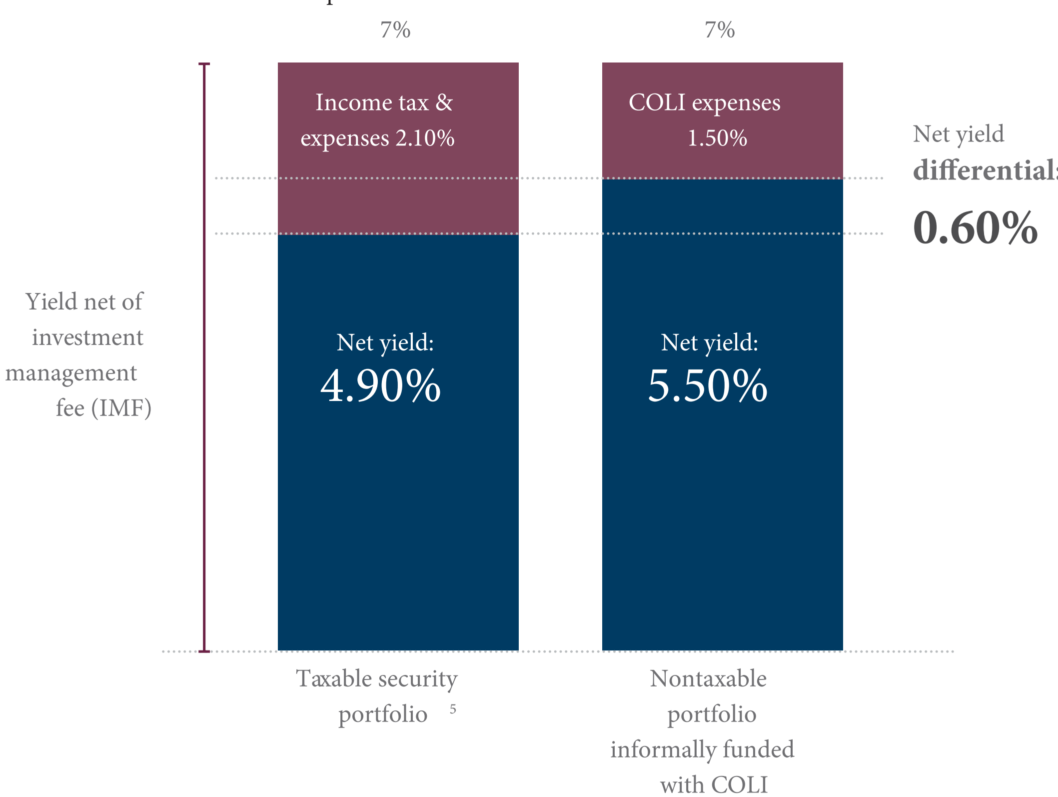
Disadvantages:
- Some plan designs may not qualify for guaranteed issue underwriting, so there is the potential for medical underwriting
- Life insurance has fees and charges associated with it, including costs of insurance that vary with the sex, health, age and tobacco use of the insured, as well as underlying fund charges and expenses
- Investment losses cannot be deducted

Nonqualified Deferred Compensation — Restoring Lost Deferral Opportunity (cont.)

Compare Your Financing Option			
	Unfinanced	Taxable Investments	Corporate-Owned Life Insurance
Plan liability matching		•	•
Wide array of investment options		•	•
Professional money management		•	•
Plan cost recovery			•
Tax-deferred gains			
Tax-free death benefit			•
Preferential accounting treatment[4]			•

<u>Let's take a look at a hypothetical comparison between informally funding the plan with taxable securities versus COLI</u>

The example below illustrates how a portfolio informally funded with COLI can earn a higher net yield for the business when compared to a portfolio funded with taxable securities earning the same gross rate of return. It is important to note that income associated with death proceeds is not taken into consideration in this example.



[4]Preferential accounting treatment assumes a tax-paying C corporation: The annual cash surrender value increase of corporate-owned life insurance is recorded as income on the income statement and is treated differently from taxable investments under Accounting Standards Codification (ASC) 320 (formerly FAS 115). Under ASC 320, securities are considered "available-for-sale" securities and are reported at fair value with unrealized gains, net of deferred taxes, reported in a separate component of shareholders' equity.
[5]Assumes a 30% tax rate.

Nonqualified Deferred Compensation — Restoring Lost Deferral Opportunity (cont.)

How Clearpoint Advisors LLC Can Help

If you have chosen to utilize a financing option, it is important that the plan is informally funded.

A nonqualified plan is an unfunded and unsecured contractual obligation (liability) to pay a future benefit. Unlike qualified plans, nonqualified plans cannot be formally funded via segregated trust assets. As a result, businesses must maintain the assets and benefit liabilities as separate components.

No direct financing offset may occur on the balance sheet in order to maintain tax advantages.

While this may seem complex, a third-party administrator (TPA) can help alleviate many concerns of the business by handling services on both the asset and liability sides.

Services for informal funding:

- Conducting request for proposal if rabbi trust is desired
- Obtaining consents to insure if applicable
- Invoicing for contribution amounts
- Reallocating assets to mirror plan liability
- Facilitating distributions to fund plan benefits
- Tracking Social Security searches for terminated employee mortality

Services for NQDC plan services:

- Creating plan document
- Managing enrollment
- Providing plan information website for participants and plan sponsor
- Tracking daily account balances
- Allocating deferrals and investment earnings
- Tracking vesting
- Tracking benefit payments

Let us help you recruit, reward and retain the best people for your business. Many of the employees at your company may need to save more for retirement. If you can help them, you're bound to increase their loyalty to you. Talk to Clearpoint Advisors LLC today and find out whether a nonqualified deferred compensation plan is the right way to do it.

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