Using Nonqualified Plans to Enhanced Executive Compensation: ERISA, Tax and Funding Issues

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Agenda

- What are “nonqualified” plans? (12 minutes)
- What are “top hat” plans? (12 minutes)
- How are nonqualified plans “funded”? (12 minutes)
- Nonqualified plan funding strategies (12 minutes)
- Alternative investments in nonqualified plans (12 minutes)

What are Nonqualified Plans?

First – What are “qualified” plans?

- “Qualified” plans are plans qualified under Code § 401(a)
  - Pension, profit sharing, 401(k)

- Qualified plans have great advantages
  - Tax deferred
  - Protected from employer’s creditors
  - Can be rolled over to an IRA
  - Employer can take a deduction for plan contributions

- BUT …

What's the Catch for Qualified Plans?

- Qualified plans have major limitations
  - Contribution and accrual limits
    - § 401(a)(17): $330,000
    - § 402(g): $22,500 (with $7,500 catch-up)
    - § 415: $66,000 (DC), $265,000 (DB)
  - Minimum participation and vesting requirements
  - Nondiscrimination – cannot favor "highly compensated employees"

- If an employer wants to provide "premium" retirement benefits to its executives, it must use a <u>non</u>qualified plan

What's the Catch for <u>Nonqualified</u> Plans?

- Nonqualified plans <u>also</u> have major limitations
  - Cannot be "funded" – benefits subject to employer's creditors
  - Cannot be rolled over to an IRA
  - Employer cannot take a deduction until benefits are paid

- Nonqualified plans are subject to Code § 409A
  - Major restrictions on timing of deferrals and payment
  - Complex and inflexible rules
  - Severe tax penalties for non-compliance

What are Top Hat Plans?

Basic ERISA Pension Plan Rules

- Most nonqualified retirement plans are ERISA pension plans

- ERISA has strict requirements for most pension plans
  - Minimum participation and vesting standards (like qualified plan rules)
  - Funding requirements
  - Fiduciary duties

- Nonqualified plans don't meet these standards

- BUT …

Top Hat Plan Exemption

- Most ERISA rules don’t apply to “top hat” plans:
  - “a plan which is unfunded and is maintained by an employer primarily for the purpose of providing deferred compensation for a select group of management or highly compensated employees”
- Top hat plans exempt from ERISA’s participation/vesting, funding, and fiduciary rules
  - ERISA §§ 201, 301, 401

What Rules Apply to Top Hat Plans?

- ERISA's reporting rules apply, but are very minimal
  - Brief top hat plan statement to DOL when plan is formed

- ERISA's claims procedure rules apply
  - Employer must review claims and offer appeal rights
  - Judicial deference <u>if</u> claims procedures are followed (big if)

- ERISA preemption applies
  - Subject to federal common law of contracts
  - Litigation in federal courts

Top Hat Plan Litigation

- Often comes up where participant has forfeited a benefit
  - ERISA’s favorable vesting requirements don’t apply to top hat plans
- “Select group” analysis
  - Percentage of workforce covered
  - Average salary comparison
  - “Management or highly compensated”
  - Bargaining power of participants

How are Nonqualified Plans "Funded"?

What is “Funding”?

- Qualified plans are backed by assets in a qualified trust
  - Assets are not employer assets – not subject to employer’s creditors
  - Qualified trust income exempt from normal income tax rules

- Nonqualified plans can’t be backed by a qualified trust
  - Nonqualified plan ⟶ nonqualified trust
  - Nonqualified trust ⟶ taxable to employee when contributed
  - Funded plan ⟶ not a top hat plan under ERISA

- BUT …

Informal Funding through "Rabbi" Trusts

- Rabbi trusts are "grantor" trusts
  - Trust assets are employer assets
  - Plan participants have <u>no rights</u> to trust assets

- Trust assets subject to claims of employer's creditors
  - Trust must provide that payments to participants cease if employer is insolvent

- Rabbi trusts are not required by the Code or ERISA

Why Use a Rabbi Trust?

- Rabbi trusts are still trusts
  - Trust assets set aside for nonqualified plan purposes
  - Some trusts contain change in control protections
- Nonqualified plans can be major liabilities
  - Benefits often track investment performance
  - Rabbi trust administration often mirrors 401(k) trust

What About Secular Trusts?

- "Secular" trusts are more secure than rabbi trusts
  - Employees are beneficiaries
  - Assets not subject to employer's creditors

- Unfavorable tax outcomes
  - Vested trust contributions taxable to employees – no tax deferral
  - Highly compensated employees taxed on trust buildup
  - Trust pays income tax on its income
  - Employer does not get deduction for trust income

Nonqualified Plan Funding Strategies

Informal Funding Options

- Pay as you go
  - Uncommon
- Set aside cash and earn interest
  - ~35% of employers
- Mutual funds
  - ~45% of employers
- Corporate-owned life insurance (COLI)
  - ~53% of employers

- 2020 Plan Sponsor Pulse Survey: The NQDC Landscape

Comparison	Taxable investments	COLI*
Large selection of available funds	Yes	Yes
Simple to implement	Yes	Yes
Can match 401(k) breadth of funds	Yes	Yes
Quality investment choices and advisors that can provide valuable diversification to existing 401(k) funds	Yes	Yes
Taxation on investment, dividends and interest	Yes	No
Taxable event when changing allocation	Yes	No
Tax due on any unrealized gains upon plan withdrawal	Yes	No
Tax-deferred investment income	No	Yes
Annual expenses	Minimal	Initially higher; tax advantages outweigh insurance costs long term
Tax-free proceeds	No	Yes**
Cash accumulation tracks deferred compensation balances	Yes	Yes
Eliminates taxes on investment income	No	Yes
Tax-free access to cash to make benefit payments	No	Yes
Can be accretive to corporate earnings	No	Yes

*Taxation of life insurance is subject to IRC sections 72, 101, 817, 7702 and 7702A and assuming the taxpayer is not in AMT.

**Must have proper Insurable Interest

Alternative Investments in NQ Plans

How are Nonqualified Plans Valued?

- "Account balance" plans
  - Analogous to 401(k) plans
    - Participant-elected deferrals, company match
    - Account balances grow based on investment elections
- "Nonaccount balance" plans or SERPs
  - Analogous to defined benefit pension plans
- Employer's contractual promise to pay amounts in the future

Alternative Investments

- Alternative to traditional funds (TDFs, index funds)
  - Hedge funds
  - Private equity

- Usually relatively illiquid
  - Not publicly traded
  - Longer investment horizons

Can NQ Plans Offer Alt Investments?

- In theory: Yes!

- In practice: Some hurdles to clear …
  - 409A Amounts: Payment Timing
  - FICA Issues
  - Pre-409A Amounts: “Material Modification”

Alternative Investments: The 409A Issue

Section 409A: (Very) Briefly

- Applies to deferred amounts earned or vested after 2004
- Onerous restrictions on time and form of payment
  - Amounts must be paid upon pre-specified payment “trigger”
    - Separation from service and specified date most common
  - Accelerations and delays very difficult
- Severe tax penalties for failure to comply
  - Immediate inclusion in income
  - 20% additional tax
  - Premium interest

The 409A Issue with Alts

- Example 1: Traditional Investment
  - Plan provides that employee's account balance is payable in a lump sum 6 months following separation from service
  - Employee's account is deemed invested in S&P 500 index fund
    - Valued daily, price publicly reported
  - Employee separates from service on April 30, 2023

- Result: Plan payment is based on price of S&P 500 index fund on October 30, 2023

The 409A Issue with Alts (cont'd)

- Example 2: Alternative Investment
  - Plan provides that employee's account balance is payable in a lump sum 6 months following separation from service
  - Employee's account is deemed invested in private equity fund
    - No liquidity event expected until 2025 or later
  - Employee separates from service on April 30, 2023

- Result: Plan payment is based on … ?

The 409A Issue: Potential Workarounds

- Valuation is based on most recent valuation report
  - Reports may be only quarterly or annual
  - Participant may miss out on gains in interim

- Valuation is estimated pursuant to plan formula

- Valuation is determined in discretion of fund manager

Alternative Investments: The FICA Issue

FICA Taxation: (Very) Briefly

- Income tax can be deferred
  - Earned in one year but taxes paid in a later year

- FICA (Social Security and Medicare) tax cannot be deferred

- Example:
  - Employee defers $10,000 in 2023, to be paid in a lump sum in 2026
  - Employee pays income tax on $10,000 (plus earnings) in 2026
  - Employee pays FICA tax in 2023

Nonduplication Rule: § 3121(v)(2)

- FICA tax <u>not owed</u> on nonqualified account balance plan earnings, IF:
    - Predetermined actual investment, OR
    - Reasonable rate of interest

- Predetermined Actual Investments
    - Must be "actual" investments (but not necessarily publicly available)
    - Can include 401(k) plan investment offerings
    - Employer cannot have discretion to adjust the rate of return

The FICA Issue with Alts

- Valuation may require exercise of discretion
  - Fund value may not be known at the time the amount must be paid
  - Valuation based on estimates may not be "predetermined actual investment"
- Possible consequence: FICA applies to "excess" earnings
  - Employer calculates FICA tax each year – recordkeeping burden
  - Alternative investments not as competitive

Alternative Investments: The Pre-409A Issue

Pre-409A Amounts: (Very) Briefly

- Amounts earned and vested before 2005 are exempt from 409A
  - Referred to as "grandfathered" amounts

- Typically subject to pre-409A plan terms – not 409A compliant

- "Material modification" ends grandfather status
  - Typically causes 409A failure and penalties

The Pre-409A Issue with Alts

- What is a "material modification"?
  - Material enhancement or addition of new material benefit or right
- Change in investment lineup not a "material modification" if new investment options are "predetermined actual investments"
  - Cross-references FICA definition
- If alternative investment is not "predetermined actual investment", it should not be offered to pre-409A amounts

QUESTIONS?

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