Nonqualified Benefit Programs

Solutions to Attract, Retain and Reward the Highly Compensated

NOLAN FINANCIAL

For use only with plan sponsors or administrators. Not for use at the participant level.

Introduction

The growing need for supplemental retirement income

Across the country, two trends are profoundly affecting the compensation of executives and highly compensated employees. People are living longer and looking forward to more active retirement years.

At the same time, government limits on tax-qualified plans are severely restricting the ability of executives to derive a substantial portion of their retirement income from qualified plans.

How much income do executives need after retirement to maintain their pre-retirement standard of living?

Studies have shown that the most common suggested replacement ratios fall between 70-85% of pre-retirement income.

Unfortunately, traditional qualified benefit plans, such as pension plans and 401(k) plans may not come close to providing the necessary benefit levels for executives and key employees.

Out of necessity, employers are turning to nonqualified plans to provide the extra income executives need to comfortably live out their retirement years.

As a result, nonqualified benefit programs are being used to attract, reward and motivate key executives.

Solutions

Plans that provide pre- & post-retirement benefits

Nonqualified benefit programs are designed to provide pre- and post-retirement benefits to executives and highly compensated employees in addition to the benefits that can be paid from 401(k) and other qualified retirement plans.

Nonqualified plans have developed over the last 30+ years to fill the retirement income "gap." Qualified plan limits dictate how much can be paid out or contributed to qualified retirement plans. Due to qualified plan limits, on average, highly compensated executives may expect to received only 30-40% of their final average compensation (FAC) at retirement from qualified plans and Social Security.

Companies are addressing these problems by establishing or expanding nonqualified programs. Nonqualified programs are flexible arrangements established for a select group of management or highly compensated employees without Federal qualified plan restrictions concerning discrimination, vesting, reporting, etc. Unlike qualified plans, they do not qualify for favorable corporate tax treatment and nonqualified benefits are unsecured.

Nonqualified programs typically fall into one of three general areas:

- Supplemental Executive Retirement Plans (SERPs)
- Nonqualified Deferred Compensation (NQDC) Plans
- Supplemental Executive Insurance Plans

Nonqualified Plans help fill the retirement income "gap" caused by qualified plan limits.

Nonqualified Plans

Highly compensated executives face unique challenges when saving for retirement years

Nonqualified plans can provide the retirement income levels that executives need to comfortably live out their retirement years and can contribute to employee retention.

According to a recent MetLife study, 72% of those surveyed agree that having benefits customized to meet their needs would increase their loyalty to their employer.[1]

A number of approaches to nonqualified plans have been developed over the last several years. Nolan Financial is well versed in available nonqualified benefit plans and offers a variety of nonqualified benefit solutions to help close the retirement gap that executives may face.

Based on a company's goals and objectives for a nonqualified benefit plan, Nolan Financial will thoroughly discuss a variety of possible solutions as well as the available funding alternatives.

Nolan Financial has worked with for-profit and non-profit companies and can help your company determine which solution will meet your company's unique needs.

To maintain a high standard of plan quality, Nolan Financial follows a series of key steps in designing and implementing a nonqualified plan. These steps are vital to the success of the plan.

Discovery and Custom Plan Design

- Assess the client's current situation
- Define and understand the client's financial goals

Detailed Funding Analysis

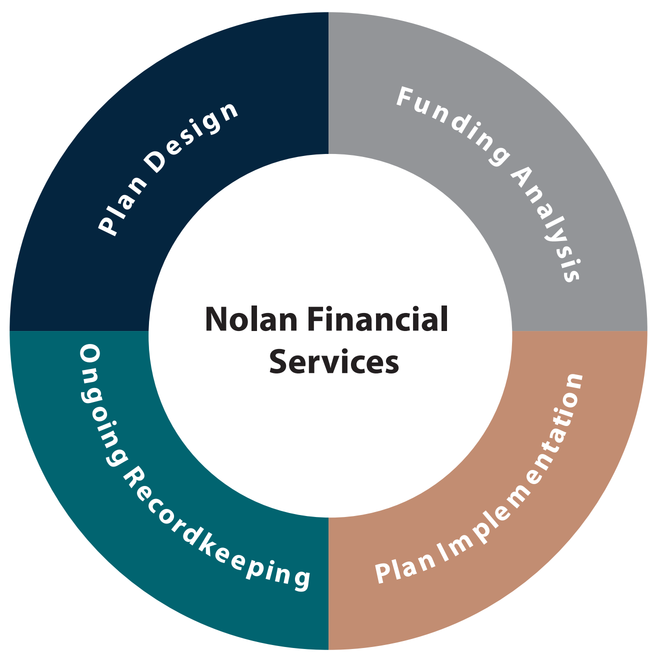
- Research and analyze alternative solutions
- Prescribe a recommended solution and explain each aspect thoroughly, adjusting as necessary

Plan Implementation

- Implement and support the approved solution

Ongoing Plan Recordkeeping

- Evaluate and revise the plan on an ongoing basis to ensure optimal results



1. *MetLife's 17th Annual US Employee Benefit Trends Study; 2019*

Why A SERP?

Offering a SERP can provide your company the competitive edge needed to attract, retain and motivate valuable executive talent

One common way companies supplement the limitations on income from regular pension plans is by establishing a Supplemental Executive Retirement Plan, commonly referred to as a SERP.

A SERP is an agreement between an employer and a key executive, where the employer agrees to provide either a stated amount of retirement income or a set contribution amount to the executive, who may have contributed the legal maximum to their qualified to plan(s).

This type of plan helps bring executive retirement percentages more in line with the typical 60-70% benefits received by employees at lower compensation levels.

Offering a supplemental executive benefit such as a SERP can provide the competitive edge needed to retain and motivate high-caliber executive talent. By incorporating a "Golden Handcuff" provision in a SERP, an employer can offer a cost-effective plan that can further increase the retention of executive talent.

SERPs generally fall under three categories:

Defined Contribution SERP

- Provides for specific annual employer contributions as a percentage of compensation
- The Employer may also offer an option for executive contributions into the plan

Target Offset SERP

- Provides a specific percentage of final average compensation (FAC)
- For example, 60-70% of FAC offset by other sources of retirement income from other plans

Excess Benefit SERP

- Provides a defined benefit without regard to other retirement plans
- For example, it may provide annual retirement income of $50,000, but may not target an overall percentage of FAC. Hence the SERP benefit is provided on a 'stand alone' basis

How SERPs Work

- The company selects key personnel who will participate in the plan
- The company pays retirement or survivor benefits from general assets
- The company can take tax-deduction for benefits as they are paid
- The company can utilize one of many informal funding solutions to offset the plan's liability

Deferred Comp Plans

Voluntary Deferred Compensation Plans are popular Nonqualified solutions

Voluntary deferral arrangements allow executives and other highly compensated employees the opportunity to make a pre-tax contribution of a portion of their compensation to generate additional retirement income on a tax-advantaged basis.

- Employer agrees to pay retirement or survivor benefits in exchange for the executive's deferral of current compensation
- Employer may opt to match a certain percent of the executive's deferral (i.e. the lost match on executive's 401(k) plan)
- Executive reduces current taxes and has tax-deferred growth potential on deferrals
- No income taxes are paid until benefits are received, and the employer deducts the cost of benefits as they are paid

A popular type of voluntary deferral arrangement is a Nonqualified Deferred Compensation Plan (NQDC).

Most companies give employees the opportunity to build retirement benefits through pre-tax deferrals under qualified 401(k) plans. However, 401(k) deferrals are limited to a specific annual dollar cap and discrimination testing that may further limit executive contributions.

Consider the following example of how qualified plan limitations can negatively impact the highly compensated.

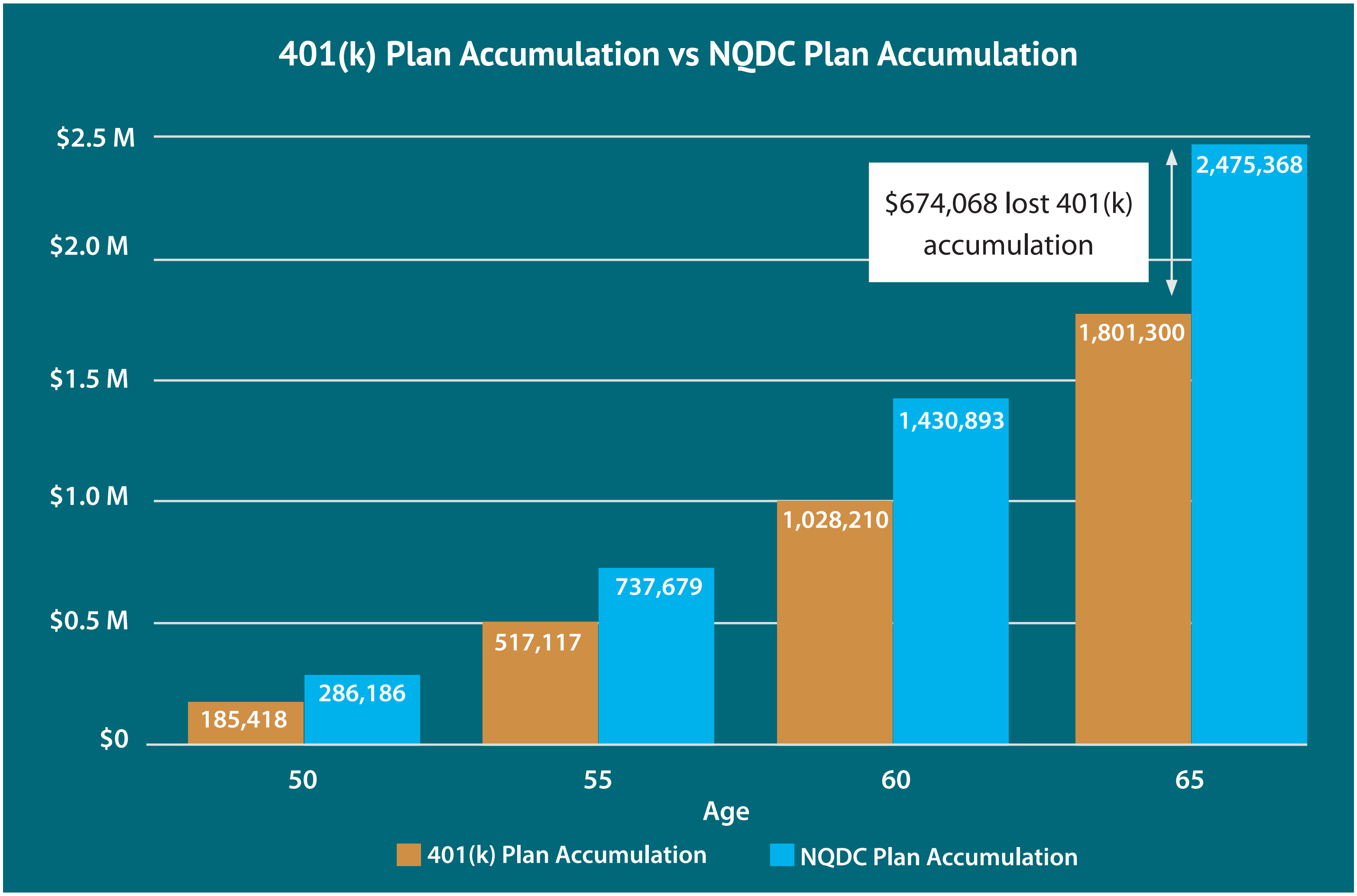
A 45-year-old executive with a $300,000 current annual salary and $50,000 annual bonus, both indexed at 3%.

The executive would like to defer 10% of base salary and bonus every year. However, the 401(k) plan only permits deferral of base salary.

The employer match is 50% of the first 6% of employee deferrals. The rate of return is 7% and the account is distributed over 20 years following retirement at age 65.

Results

Due to qualified plan limits, this executive is projected to have lost the opportunity to accumulate over $674,000 in the plan that could have provided about $62,349 of retirement income per year, or about 10.5% of final average compensation.


401(k) Plan Accumulation vs NQDC Plan Accumulation
$2.5 M
$2.0 M
$1.5 M
$1.0 M
$0.5 M
$0
185,418
286,186
517,117
737,679
1,028,210
1,430,893
1,801,300
2,475,368
$674,068 lost 401(k) accumulation
50
55
60
65
Age
401(k) Plan Accumulation
NQDC Plan Accumulation

"With an NQDC plan, an executive can save for retirement with pre-tax deferrals."

Why an NQDC Plan?

NQDC plans provide executives the opportunity to defer income above the intended 401(k) limits

The example on the previous page shows the long-term effects that qualified plan limits can have on a highly compensated executive's ability to adequately save for retirement. This is where a Nonqualified Deferred Compensation Plan can provide an attractive solution to this problem.

This type of arrangement gives an executive the opportunity to defer income above the qualified 401(k) limits. An employer will often offer a match similar to the 401(k) match.

Employers may also give executives the opportunity to defer performance based compensation, such as annual bonuses, into an NQDC plan. With many companies, bonus compensation is not covered under pension formulas or deferrable through the 401(k) plan.

Allowing executives to defer bonus payments pre-tax and accumulate earnings tax-deferred until retirement provides a valuable additional savings opportunity.

The result, as shown in the example, is the potential for significantly greater retirement plan accumulations than would be available under a qualified 401(k) plan alone.

Supplemental Insurance

Executive Welfare Benefits

A key component of a comprehensive, competitive benefit program often includes Supplemental Insurance and Welfare Benefits. More and more companies are providing these options to their executives to complement their existing group programs.

According to a MetLife study, more than half of highly compensated employees say they are very concerned about the financial effects of a loss of income in the event of a disability and/or premature death.[2]

The study highlighted several interesting findings about highly compensated employees (defined as employees earning $100,000 or more):

- 53% are very concerned about having enough money to pay bills during a period of sudden income loss
- 53% are very concerned about having financial security for their family in the event of premature death
- 57% are very concerned about having financial security if no longer able to work because of disability or serious illness

2. *MetLife "Watch the Gap! Recalibrating Income Protection Benefits for Highly Compensated Employees"*

Life Insurance

Provides high levels of protection for beneficiaries

Executive Life Insurance provides high levels of protection.

Group Variable Universal Life (GVUL) insurance plans are a cost effective approach to providing executives and other key employees with significant life insurance benefits plus access to cash values.

Employees are provided significant amounts of life insurance protection at costs that are usually well below what the company could obtain using guaranteed issue group term coverage.

GVUL provides high levels of life insurance protection for their dependents while providing an opportunity for the executive to accumulate cash values on a tax advantaged basis to help meet future needs such as retirement, children's education or even a second home.

These plans are easy to enroll and administer and require very little in the way of employer resources to maintain.

These programs may be structured to be:

- In addition to customary group term life insurance benefits
- In lieu of all or a portion of customary group term life insurance benefits
- Entirely different design to suit executive needs

A Closer Look

Group Variable Universal Life

With GVUL, key employees are given the opportunity to make additional payments that they can allocate among a number of diverse investment options. These investments options cover a broad spectrum of investment objectives and risk tolerances.

These additional payments are generally flexible as to timing, frequency and amount. Within limits, additional unscheduled payments can be made to help accumulate cash value.

These separate account cash values are not subject to corporate creditors and in most states are protected from personal creditors. Values within the investment options accumulate on a tax-deferred basis.

In addition, the premiums paid by the employer for the basic life insurance protection will be included the taxes that may ultimately be owed.

Cash values will only be taxed at the time the employee actually receives a distribution from the account above the cost basis.

Any death benefits paid to the employee's beneficiary are usually exempt from income taxes.

Group Variable Universal Life Insurance

Combine individual life insurance protection with cash values that have the attractiveness of tax-deferred growth potential on separate account investment options.

Benefits of GVUL

- Offer especially competitive term insurance rates based on a white-collar risk pool and high limits of guaranteed issue coverage
- Combine individual life insurance protection with cash values that have the attractiveness of tax-deferred growth potential on separate account investment options
- High amounts of insurance - $500,000; $1,000,000; $2,000,000 or even more – can usually be offered on a Guaranteed Issue basis depending on group size and composition
- Typically employer paid, but the plan participants can be given the opportunity to purchase additional benefits on a voluntary basis
- Fully portable and may continue regardless of employment status (insurance company simply bills the former employee individually)

Disability

Close the coverage gap for your key executives

Executives are nearly always covered by their company's Group Long Term Disability plans, but those benefits frequently will not deliver the level of income replacement that executives really need.

Maximum monthly benefit amounts under Group LTD can often limit highly paid executives to a replacement ratio of 40% or less. Most plans cover only base salary, so incentive compensation is left totally uncovered. Group LTD benefits are also typically taxable and are offset by any Social Security benefits received, further eroding their value to the executive.

Some companies are implementing Supplemental Executive Disability Insurance plans using individual disability insurance policies. These plans can be structured as a flexible and cost-effective solution to the problem. Features often found in these plans include:

- Guaranteed issue underwriting
- Guaranteed renewability and premium rates
- Full portability with no cost increase
- Multi-life premium discounts
- No Social Security or other benefit offsets
- Definition of disability based on the executive's "own occupation"
- Optional Cost of Living Adjustment (COLA) rider
- Enhanced benefits for catastrophic disabilities

These plans can be structured as an employee benefit paid for by the employer (taxable benefits) or can be established as a voluntary plan paid for by the executive (tax-free benefits).

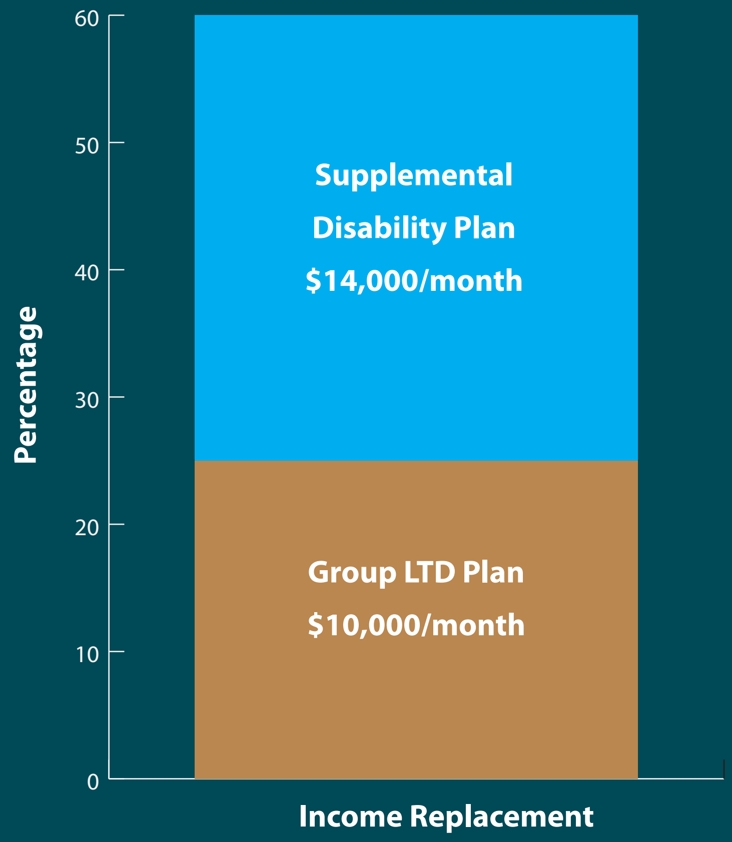
A well-designed and comprehensive supplemental disability plan can help to stabilize group plan costs while providing a company with another attractive recruiting and retention tool.

Supplemental Individual Disability Insurance can deliver the level of replacement income executives need.

Adequate Disability Income Protection for Highly Compensated Employees

A Hypothetical Example: Tiered Approach to Adequate Income Protection

Jane Smith is an executive earning a salary of $480,000 per year ($40,000 per month). Her Group LTD policy will cover 60% of base salary up to $10,000 per month. Based on her income, she is eligible for an additional $14,000 of monthly disability benefits with the Supplemental Disability Insurance Plan.



Informally Funding

A variety of funding options are available

To avoid current taxation of participants, the benefits under SERP and NQDC plans cannot be legally or technically funded and secured. This is one difference between qualified and nonqualified plans.

In a qualified plan, benefits are secured by assets held in a trust, legally separate from the company and its creditors. However, assets in a nonqualified plan can be "informally" set aside, or earmarked, to pre-finance nonqualified benefits as long as the assets remain within reach of the company's general creditors. Since nonqualified benefits are becoming a larger part of retirement benefits for key employees and a significant financial obligation for employers, pre-financing benefit obligations is increasingly viewed as a necessity.

Informal funding can provide comfort to nonqualified plan participants and current managers who are reluctant to leave the cash flow obligation for their benefits to future management or owners.

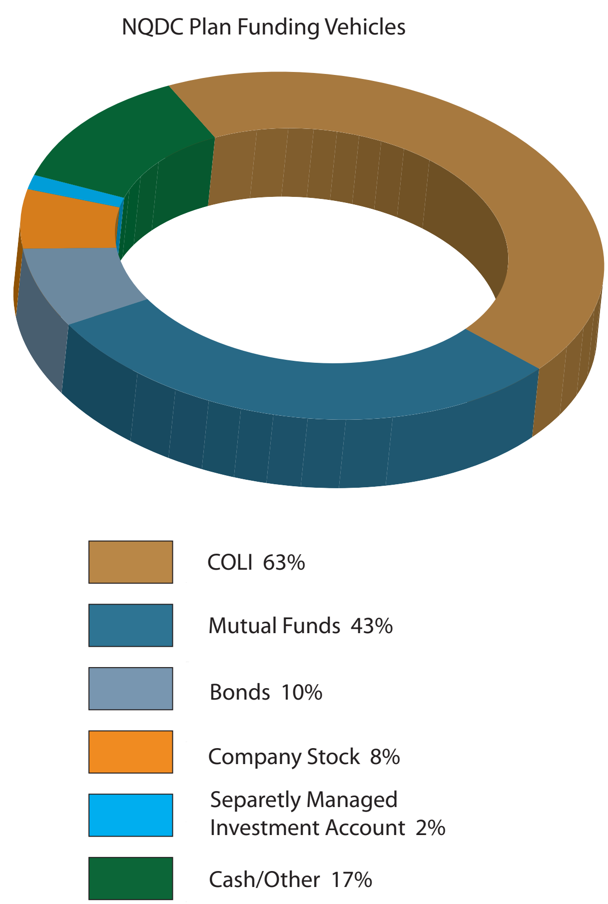
With informal funding, benefits are still unsecured and at risk from company creditors and repudiation by future management or owners, for example after a change of control of the company.

Companies are informally funding their nonqualified plans utilizing a myriad of financing mediums:

- COLI
- Mutual Funds
- Bonds
- Company Stock
- Separately Managed Investment Account
- Cash/Other
- Unfunded
- A combination of funding options

According to a survey of NQDC plan sponsors, those companies that choose to informally fund their plans, often choose COLI as part of their funding solutions.[3]

Nolan Financial can help you determine which funding option may be the best solution for your company.



3. Executive Benefits Survey; 2020 Edition

Summary

Nolan Financial has more than 30 years of experience

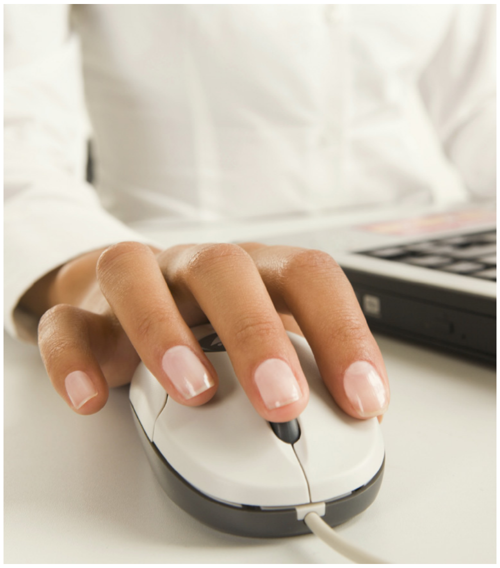
A company should choose a nonqualified recordkeeper based on experience, expertise and administrative capability.

Nolan Financial has more than 30 years of experience with nonqualified executive benefits and has worked with a wide variety of clients. We have effectively administered a variety of plans for both for-profit and non-profit organizations.

Nolan Financial is dedicated to providing best-in-class service and the latest technology to our clients. Our recordkeeping system incorporates high-level checks and balances to assure plan administration integrity and accuracy.

Our detailed administrative procedures have built-in safety steps that impose double checks on information processing, assuring our clients that they are in good hands. Nolan Financial has consistently obtained SOC-1 audit reports with no material exceptions noted.

Since a company's nonqualified plan will have a life at least as long as its youngest participant (longer if new participants enter the plan in later years), an executive benefit firm's recordkeeping capability and service is vital to the plan's success.



Nonqualified benefits are complex and require unique knowledge of a broad range of areas:

- Tax regulations
- Legal matters
- Funding alternatives
- Funding issues
- Accounting implications of various benefits and funding options

It is likely that a company's staff personnel will find it difficult to develop the expertise needed to deal with the complexity of matching nonqualified plan design, funding and securing choices to the company's goals and priorities.

Contact Nolan Financial today to learn more about our services.

Recognizing Performance

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