10 Key Features of Deferred Compensation

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With many baby boomer executives approaching retirement and wanting to save significantly more than permitted through qualified retirement plans, deferred compensation programs are increasingly important components of contemporary executive benefit program offerings.

Plan advisers have an excellent opportunity to expand the value and service they bring to clients through qualified retirement plans by implementing supplemental or non-qualified deferred compensation plans.

When properly designed, financed and administered, non-qualified deferred compensation plans can help companies cost-effectively retain and attract quality executives who maximize shareholder value. Plans are generally not subject to ERISA (other than a one-time notification letter filing) and allow executives to contribute much more than they otherwise could contribute to a qualified 401(k).

Here are 10 key features of these plans which plan advisers should be aware of before including deferred compensation plans in their service offerings.

Well established savings vehicle. Non-qualified deferred compensation plans are commonly used instruments in most industries, and in both public and private companies.

Numerous potential plan participants. The $150,000 annual compensation threshold is the level at which it often makes sense for executives to participate in deferred compensation plans. In some cases, executives making $125,000 or less (particularly those approaching retirement who want to save aggressively and have other sources of investment income) will make large non-qualified deferred compensation contributions.

Tax efficient. Plans can be structured so they have similar tax advantages as qualified plans, particularly for plan participants. By deferring tax liabilities until distribution, a participant's contributions can accumulate on a pre-tax basis.

Unlimited contributions. Unlike qualified plans, non-qualified deferred compensation plans have no annual contribution limits.

Companies usually finance plans. Because they are non-qualified, deferred compensation plans do not require company financing. However, most companies opt to do the financing because the benefits of prudent asset/liability management facilitate benefit security.

Rabbi trusts are advantageous. This IRS-approved mechanism allows a company to place deferred compensation assets into an account protected from a company takeover ("change of control") or future attempt by management to rescind these benefits ("change of heart"). With this safeguard, executives are more likely to participate in plans. Even with a rabbi trust, however, executives are unsecured creditors of the company with regard to their account balances.

Specialized administration is essential. A recently enacted tax law (IRC Sec 409A) which governs non-qualified plans has "raised the bar" for plan administrators. More than ever, high-quality administration is very important. Just as many plan advisers are understandably leery of the intricacies of ERISA as it applies to qualified plans, the penalty provisions of Sec 409A make it equally important not to merely "dabble" in non-qualified plan design and administration.

High-caliber service is the norm. The industry standard today is for deferred compensation plan participants to be able to call service professionals for personal and effective assistance. Sophisticated, easy-to-use technology is also the industry norm. In general, there is a much higher service expectation than with qualified plans.

Flexible distributions. While some companies choose to have distributions mirror the provisions of qualified plans, most take advantage of the greater flexibility deferred compensation plans offer regarding distributions. Plans can be structured to provide pre-retirement distributions for specific life events such as funding a college education or buying a vacation home.

Access to high-level executives. Because chief financial officers and other senior executives typically approve (and participate in) these plans, there is an opportunity to gain access to and build relationships with them.

Given these many opportunities and challenges, plan advisers may want to form alliances or partner with specialists in the executive benefits field. As more baby boomer executives approach retirement—and realize that Social Security, savings, and qualified plans may not meet their retirement needs—non-qualified deferred compensation programs will increase in importance.

For More Information

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