



Nonqualified Compensation Plans Avoid Contribution Limitations of Qualified Plans

Do you have clients who are limited on the amount they can contribute to their qualified retirement plans?

It is not uncommon for an employer to have minimal participation in a 401(k) plan from lower paid employees. This impacts the ability of higher paid key executives to make meaningful contributions to their qualified retirement plans. Often, the employer is forced to, in effect, “bribe” the lower paid employees in order to have a benefit package attractive enough to retain their key employees. This frequently comes in the form of large matching contributions, which can be very expensive for an employer. An alternative solution may be to supplement the key executives’ qualified plan with a nonqualified deferred compensation (NQDC) plan.

Facts: ABC Company is a management company that operates sixty fast-food franchises. The company has a 401(k) plan. On average, the rank and file employees are contributing less than 3% of their income to the plan, causing a limitation on the amounts that can be contributed by the highly compensated. Is there a solution?

Several options are available to the employer:

- 1) Do nothing, and risk losing his key employees to competitors who provide better pay or benefits.
- 2) Make the 401(k) plan more attractive to the rank and file to increase participation.
- 3) Offer a NQDC plan for selected key employees.

Solution: The employer and the key employee enter into a NQDC arrangement. This type of plan is not subject to discrimination testing and is not limited in terms of the amounts that can be deferred. When properly designed, the amounts deferred are not currently taxable to the key employees. When the deferred compensation is distributed, or is no longer subject to a substantial risk of forfeiture, it becomes tax-deductible to the employer (subject to reasonable compensation limits), and is reported as taxable income to the executives.

NQDC designs plans are meant to be flexible and may provide for matching employer contributions along with a vesting schedule that encourages achievement of specific results.

Although the employer is not required to set aside assets to pay future plan obligations, many employers choose to “informally” fund the benefit promise. Given an adequate duration of time, corporate owned life insurance (COLI) is often the option of choice.

With the consent of the executive, the employer purchases life insurance on his/her life with the business named as owner and beneficiary. NQDC benefits are paid to the executive in accordance with the agreement as they come due. The business recovers its cost through death benefit proceeds – generally received income tax free under IRC Section 101(a). Or, where business cash flows are limited, the employer uses the policy’s cash value as a source of benefit payments.¹

A properly structured plan “informally” funded with a corporate owned policy provides the following benefits:

Employer

- Minimal ERISA requirements
- Ability to pick and choose who participates
- Maintain full control of the policy cash values
- Achieve tax-favored cash accumulation
- Deductions at the time benefits are paid
- Cost recovery of any incurred expenses

Employee

- Avoid current taxation on deferred amounts
- Tax deferred growth on the account balance
- Avoids “reverse discrimination” associated with qualified plans

Depending on the client’s plan design and investment philosophy the arrangement can be “informally” funded using universal or variable universal life products. The questions on the reverse side are designed to help you determine if a non-qualified deferred compensation arrangement is an option for your business clients.

QUESTIONS TO ASK ON OTHER SIDE

¹ Life insurance cash values are accessed through withdrawals and policy loans which reduce cash value and death benefit; may affect any policy guarantees against lapse; and may have tax consequences.

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Questions To Ask The Employer

| <i>Questions</i> | Yes | No |
|---|------------|-----------|
| Does your business need an employee fringe benefit to recruit, retain and reward key executives? | | |
| Do you want an arrangement that provides “golden handcuffs” (“strings” controlling the employee’s right to receive benefits until certain conditions are met) to encourage executive loyalty and retention? | | |
| Do you have executives who are limited by the amount they can contribute to their qualified plans? | | |
| Do you want the ability to pick and choose who participates in the arrangement? | | |
| Do you want the flexibility to tailor the arrangement’s contributions and timing of distributions to fit the individual needs of each executive? | | |
| Is your business taxed as a separate corporate tax entity? | | |
| Do you have executives who want to defer income until a future date? | | |
| Do you want to keep benefit reporting and administration to a minimum? | | |
| Are your executives leery of benefits that could potentially be lost through ownership or management changes? | | |
| Is there a desire for the business to recover some or all of its costs? | | |

If the answers to these questions are “yes” . . .

**Fax this questionnaire to Advanced Marketing to learn more about
Nonqualified Deferred Compensation Arrangements**

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