Crafting a Competitive Nonqualified Plan

Nonqualified deferred compensation (NQDC) plans allow employers to offer tax-deferred savings opportunities to key employees, typically executives. Unlike qualified plans—like 401(k)s, defined benefit pensions, or profit-sharing plans—NQDCs operate mostly outside of the Employee Retirement Income Security Act (ERISA). This makes it possible for employers to offer them only to a subset of employees and to create a level of flexibility not permissible within qualified plans.

The benefits to employees are clear: Participants can make pre-tax contributions of their base salaries, bonuses, or other compensation in one tax year, then withdraw the assets—and therefore pay income tax on them—in a later year. In the meantime, the deferred funds can be self-directed in a portfolio that is typically similar to the employer's qualified plan menu and allows the possibility of growth.

The biggest advantage to employers is the ability to leverage NQDC savings as an executive benefit when hiring, retaining, or rewarding employees. In today's tight talent market, NQDC plans feel especially attractive, and the industry is seeing a steady uptick.

Industry Uptick

In recent years, the NQDC industry has seen a shift to larger plans, and total assets have increased 130 percent, from $80 billion in 2015 to $183 billion in 2021, according to the 2021 "*PLANSPONSOR* NQDC Market Survey." As the Government Accountability Office shared in a January 2020 report on private pensions, the vast majority (83 percent) of S&P 500 companies now offer nonqualified plans.

There is also an increase in employee participation. In fact, according to the same *PLANSPONSOR* survey, 66 percent of employees who were eligible to enroll in their employer's nonqualified plan chose to participate, up from 53 percent in 2018.

"These trends can be attributed to historically low unemployment and the greater need for employee retention," says Katie Securcher, a manager on CAPTRUST's nonqualified executive benefits team. "For employers looking to expand their holistic benefits offerings, nonqualified plans offer a way to further entice key executives to join and stay at their organizations."

Discretionary Eligibility

Part of the uptick may also be the result of several key plan design elements that have increased in popularity in recent years. These features allow nonqualified plans to have a greater degree of flexibility that benefits both the employer and employee. The first is flexibility in who is eligible to participate.

"While nonqualified plans can, in theory, be open to employees at many different levels, they are typically focused on those employees who are limited in other retirement savings vehicles that plan sponsors offer," says Jason Stephens, senior director of nonqualified benefits at CAPTRUST. For many organizations, this means taking a strategic approach that focuses on a few employees at the top of the organization.

As an example, in 2022, under ERISA law, 401(k) participants could save a maximum of only $20,500 and plan sponsors could provide a match on savings up to only $305,000 of compensation. An executive who earns $500,000 a year is therefore only able to save a combined total of $41,000, or 8.2 percent of their salary, with dollar-for-dollar employee matching. But retirement best practice is for employees to save 10 to 15 percent to maintain their current lifestyle.

These limitations mean highly compensated executives who are contributing the maximum amount and receiving generous employer matches still would not be able to maintain a retirement lifestyle that aligns with their expectations. NQDC plans can provide an additional savings opportunity that will help them bridge the gap.

Typically, these plans are designed for no more than 10 percent of a total employee population, although in practice, they have been more limited. Eligibility is most commonly based on job title or base salary. In recent years, Stephens says, organizations are expanding eligibility to attract new hires and retain valuable employees who may have been previously ineligible for the company's NQDC plan.

In its "2021 NQDC Market Survey," Plan Sponsor Council of America (PSCA) found that 6.1 percent of total employees were eligible to take part in nonqualified plans in 2020, up from 5.2 percent in 2018.

"Determining who is eligible for nonqualified plans means finding the right balance for your organization," added Stephens. "It's the balance of identifying employees who will truly benefit the most from this type of plan but also not overextending the benefit. Having a bit more discretion in who can participate can be impactful in the recruiting process, especially if those employees are leaving behind a nonqualified plan at their previous organizations."

Cost and Operational Efficiency

Another aspect contributing to the increased popularity of NQDC plans is the low initial and recurring costs of offering these plans. "Obviously, there will be fixed costs relative to some of the operational aspects of the plan, but when you look at those fees in totality, the per-person expense to have this offering on the table is usually small," says Stephens.

For efficiency, most plan sponsors (61.2 percent) bundle their NQDC plans with the same administrator that is managing their qualified retirement plan, according to PSCA. "Administration is simply more efficient when you're sharing information with just one party," Stephens says, "and bundling helps create a cohesive experience for participants too, so it's mutually beneficial."

It's worth noting that, in recent years, a few of the large qualified recordkeepers have acquired some smaller nonqualified recordkeepers, allowing for better bundled solutions and improved operational efficiency.

Contribution Flexibility

Perhaps the most attractive feature of NQDC plans is their flexibility to include both sponsor and participant contributions. According to PSCA, while nearly all plans (93.5 percent) allow participants to defer their base salary and bonus pay (90 percent), until recently, many plan sponsors didn't allow for employer contributions. Now, both matching and discretionary employer contributions are becoming more common.

"There's huge flexibility in the amount that employers can contribute," says Securcher. "If they build the right provisions into the plan, employers can basically give a contribution to all participants within the NQDC plan or a subset of NQDC participants, can assign different vesting schedules to different individuals, or can simply let the employer discretionary contribution option lie dormant until they need or want to leverage this provision."

Securcher explains, "Some organizations smartly incorporated employer discretionary contribution allowances when they created their plans, but they've never used them. Now, faced with a competitive labor market, they might say 'OK, let's give people bonuses via NQDC plans because we need to keep our folks here.' They're a good option to have available, even if you're not going to utilize them all the time."

Another popular employer contribution formula allows discretionary non-matching contributions plus a *restoration match* designed to fill the gap between 401(k) contribution limits and Internal Revenue Service (IRS) limits.

Distributions and Withdrawals

There are two key points to understand about NQDC plans and distributions. First, these plans are not useful solely for retirement. Second, unlike a qualified retirement plan, when taking withdrawals from an NQDC, participants must schedule distributions in advance.

For participants who want to take a withdrawal, there are six lawful types of triggering events: a fixed date, a separation from service, disability, death, a change in ownership of the company, or an unexpected emergency that could not have been planned for, like a sudden medical expense. A large tax bill, volatility in the stock market, or a change in the company's financial health are not considered triggering events.

Usually, NQDC plans incorporate what's called a fixed date election, in-service election, or specified payment date election. "They all mean the same thing," says Securcher. "Basically, the employer is giving each employee the option to pick a date in the future when the employee is still working with this company, and that's when the account will start paying out."

Fixed date elections are helpful to participants because they allow people to plan for big expenses that aren't tied to retirement goals, like sending a child to college or buying a second house. "Of course, the money is taxable when it's distributed," says Securcher, "but unlike a 401(k) plan, if you take money out of an NQDC before you are 59 1/2, you won't be penalized." Some plans only offer lump-sum payment options, while others offer the option for installments.

Participants can elect the time and form of fixed-payment accounts during enrollment. Typically, the date or form of payment associated with a fixed-payment account can be changed, but those changes are subject to 409A restrictions. According to PSCA, more than 60 percent of plan sponsors allow for emergency withdrawals, but 83.3 percent of those organizations report that none of their participants took one in 2020.

Enhanced Investment Menus

By default, and for administrative simplicity, most plan sponsors simply mirror the investment options available in their qualified plans. Securcher and Stephens say roughly half of CAPTRUST clients choose that option.

But because NQDC plans are not subject to laws regarding fiduciary responsibilities, they sometimes have broader investment menus than qualified plans. This is another attractive benefit to employees, especially if your key executives represent a different investor profile than your employee base. They may be saving for specific life goals, may have a more advanced understanding of investments, or may have better access to outside advice.

For instance, one participant may want to defer their entire compensation for five years in preparing to pay for a parent's long-term care. Another participant may want to use their NQDC plan as a retirement savings vehicle over the course of the next 20 years. These choices will drive different investment behaviors that may require an expanded investment menu.

Retention Features

NQDC plans work as an employee retention tool not only because they are attractive savings vehicles but also because employers are allowed to apply discretionary retention features. For example, an employer may choose to give the employee a large bonus that vests over the course of five to ten years, thereby incentivizing retention.

Unless a plan has specialized provisions, typically a separation from service will trigger a distribution. This can cause a large tax bill for employees who leave the company unexpectedly. In some cases, leaving before retirement can also result in the forfeiture of unvested employer contributions.

"The level of choice that a plan sponsor has in how it designs its NQDC plan will vary by recordkeeper," says Stephens, "but overall, these plans are highly flexible and highly attractive to executives, especially in today's talent market."

An NQDC offering can help you attract new executive talent but also retain and reward your current team. After all, turnover is costly, and executive turnover costs even more.

For employers who are just getting started, Securcher says, "Build the provisions in now as a safeguard. Then, you can bring them out later with the big guns if you need them; for instance, when you're building out your executive team. And for existing plan sponsors, if you don't have an NQDC plan in place, talk to your financial advisor about possibly adding one in the future." Your financial advisor can help you determine the best plan design for your organization and your future needs.

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