# ADVANCED MARKETS INSIGHT

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*M Financial Group continues to lead the industry in insurance due care and client advocacy, providing valuable insight and analysis that delivers significant value to clients.*

# Non-Qualified Deferred Compensation: Elective Deferral Plan

## Overview of Non-Qualified Deferred Compensation Plans

A non-qualified plan can provide tax deferral for the employee, as well as meet employer and employee compensation objectives.

A deferred compensation plan that is "non-qualified" is one that falls largely outside the provisions and purview of the Employee Retirement Income Security Act (ERISA). Non-qualified plans do not receive some of the tax benefits and creditor-protection rights associated with ERISA-conforming "qualified" plans.

The primary difference between a qualified and a non-qualified plan is that non-qualified plans do not generate an income tax deduction for the employer during the employee's working years. Instead, the employer must wait until the year in which the deferred compensation is distributed to its employee to take its deduction.

## What is an Elective Deferral Plan?

An elective deferral plan is a plan joined voluntarily by the executive to enhance long-term income and retirement accumulation. The plan is funded by the employee's own income; funds deferred for payment at retirement. The employer may choose to match the employee's deferral, up to certain limits, similar to a 401(k) plan. There exist strict rules governing the timing of both the employee's deferral election and the distribution of benefits.

Under a properly designed plan, no income taxes are incurred by the participant until the money is received. Life insurance policies are often used by the employer as an informal vehicle for holding and growing the deferred funds.

## Comparison to a Supplemental Executive Retirement Plan (SERP)

A Supplemental Executive Retirement Plan (SERP) is a form of non-qualified deferred compensation for a select group of executives. In a SERP, the employer and the executives enter into an agreement in which the employer promises to pay future retirement benefits. In doing so, a deferred compensation liability is created which the employer will account for annually. Benefits are supported solely by employer funds; the employee does not defer any income today.

## Funding the Elective Deferral Plan with Life Insurance

Corporate owned life insurance (COLI) with cash value build-up is often chosen as the informal financial vehicle used for holding and growing the deferred funds because of the advantages to the employer.

Cash value build-up in life insurance:

- Accumulates tax-deferred
- Can be considered a corporate asset, offsetting the benefit plan liability
- May be accessed to meet the deferred compensation liability by way of tax-free policy loans and withdrawals [1]
- Are available to the employer for use at all times

The death benefit proceeds of the insurance can be used to:

- Reimburse the employer for premiums paid
- Provide money to fund retirement benefits for other executives
- Provide a survivorship benefit to an employee's heirs should the employee die prior to receiving all of his/her deferred compensation

As the name implies, COLI is purchased and owned by the employer and insures the lives of its employees. Each employee must consent to the purchase of the insurance policy.[2]

## Advantages of Establishing a Non-Qualified Elective Deferral Plan

- A deferred compensation plan can save the costly expense and administrative burden of maintaining a qualified plan such as a 401(k), and is not subject to an annual limit on the amount of benefits that can be provided (though it may only deduct amounts that are "reasonable compensation" for a given employee). [3]
- A non-qualified elective deferral plan can be provided for select employees in addition to an existing 401(k) plan as there are no deferral limits on the non-qualified plan.
- Elective deferrals can be complimented by employer match to mirror a 401(k) plan.
- The employer is free to choose which employees will be participants without violating any anti-discrimination requirements, as long as the plan is limited to management and highly compensated employees.[4]
- Cost recovery and survivorship death benefits are possible when funded with COLI.
- Deferrals reduce the employee's current taxable income, and the full amounts grow tax deferred until benefits are received.
- IRS, ERISA, and other governmental requirements, including reporting and disclosure, fiduciary responsibilities, and funding requirements are reduced and simplified.

1 Subject to the rules and regulations of IRC Section 7702; policy withdrawals, loans, and loan interest will reduce policy values and may reduce benefits.

2 IRC Section 101(j)

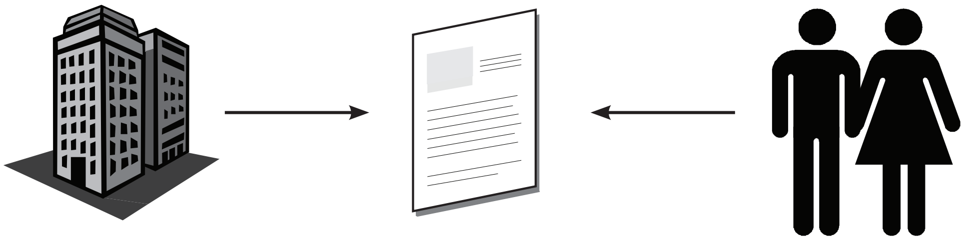
3 IRC Section 162 and 83

4 Under ERISA, if a non-qualified plan is unfunded and maintained by an employer for the purposes of providing deferred compensation for a "select group of management or highly compensated employees," the plan is exempt from all provisions of ERISA, except for the reporting and disclosure requirements, and ERISA's administrative and enforcement provisions. The reporting and disclosure requirements can be satisfied by providing plan documents, upon request, to the Department of Labor and by filing a simple, one time statement about the arrangement with the Department of Labor.

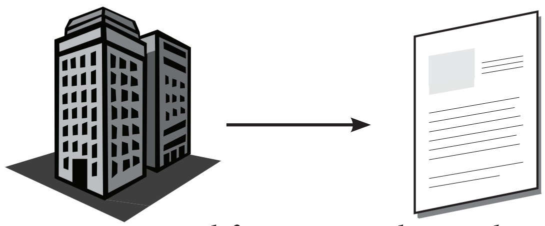
## Elective Deferral Plan

1.

The employer and employee enter into an agreement in which the employee agrees to defer a portion of his/her income until retirement.

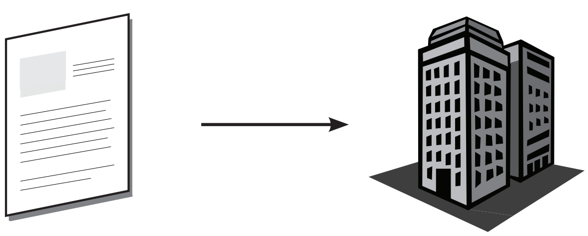


2. The employer obtains a life insurance policy (COLI) on the life of the employee, with the employee's consent.



3. At retirement, or upon a qualifying event, the employer accesses policy cash value via tax-free loans and withdrawals to fund the after-tax cost of retirement income payments to the employee.

4. At death, the employer will receive partial cost recovery via the death benefit of the policy.



## For More Information

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