Callan

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The ABCs of NQDCs: They're Not DC Plans, Despite the Similarities

"If it looks like a duck, and quacks like a duck, it probably is a duck."

Or not. Non-qualified deferred compensation plans (NQDCs) may look and sound like qualified defined contribution (DC) plans, but the two are actually quite different. NQDC plans are targeted at a small number of high-paid employees, and managing the investment menu and associated liabilities of NQDC plans is quite different from managing a DC plan. And assuming certain preliminary conditions are met, NQDC plans are usually not subject to the fiduciary and reporting requirements of the Employee Retirement Income Security Act (ERISA).

Under ERISA, an NQDC plan is "unfunded and maintained by an employer for the purpose of providing deferred compensation for a select group of management or highly compensated employees." Unlike a qualified DC plan, in which plan assets are segregated from the employer's general assets in a trust or custodial account, the compensation deferred into an NQDC plan remains commingled with the employer's general assets.[1] Plan sponsors can choose to hedge the liabilities generated by these arrangements by "informally" funding the NQDC plan (i.e., the money may be set aside but is not preserved or protected in a trust) to minimize risk due to market volatility or organizational instability.

This article explores approaches to designing the NQDC plan investment menu as well as some of the considerations around informally funding the liabilities.

> According to PSCA's 2016 Non-Qualified Plan Survey, 80% of plan sponsors who offer an NQDC plan informally fund it.

Landing the First Punch

The first NQDC arrangement was confirmed in a knockout ruling by the U.S. Tax Court in 1965, when Sugar Ray Robinson, considered by many experts to be the greatest boxer in history, deferred money he was set to earn from a title fight in 1957. Rather than receiving the purse in the year the fight occurred,

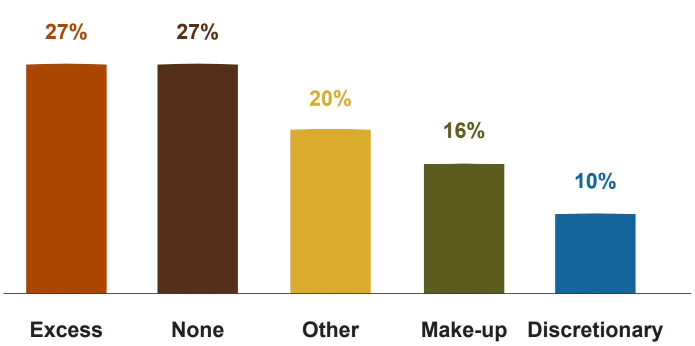
1 In reality, what the participants have is an unsecured IOU from the company and, in the event of bankruptcy, the participants become general creditors. This is the key risk of NQDC plans for participants and the quid pro quo for the benefit. It is also the main driver of limiting eligibility to a "select group," as the HCEs are presumed to be aware of the financial health of the company and savvy enough to act accordingly.

it was paid, and therefore taxed, over four years (40% in 1957 and 20% in the following three years).

An NQDC plan is simply a contractual agreement between an employer (plan sponsor) and an employee (participant) in which the participants agree to defer a portion of their compensation. In turn, the employer agrees to pay the participants the compensation deferred, adjusted for a notional rate of return, at some future defined date or because of a predefined distributable event. Limits on DC plans (e.g., the maximum deferral amount is $18,500 in 2018, or the maximum compensation is $275,000 in 2018) along with longer life expectations make NQDC plans appealing for attracting and retaining highly compensated employees (HCEs).

A participant's election to defer income must be made prior to the time in which the income is earned (i.e., before a tax year, or prior to a long-term incentive period). According to the Newport Group 2017 Non-Qualified Deferred Compensation Survey, 93% of NQDC plans include salary and bonus deferrals, while only 25%-34% allow deferrals of short-term bonuses, commissions, long-term incentives, and director fees. Employers may also contribute to the plan **(Exhibit 1)** on behalf of the employee (e.g., matching contributions, discretionary contributions). While subject to FICA and Medicare taxes in the year

Exhibit 1: Types of Employer Contributions



* Multiple answers were permitted

the money is either deferred or vested, contributions are tax-deferred for the participants, as are any investment returns in the account. Distributions are treated as taxable income in the year they are received.

Although participants in an NQDC plan cannot make changes to their deferral rate during a plan year or alter the distribution options generally, they may be permitted to change their investment allocation. Daily-valued account access is typically achieved by a "deemed" investment menu or a set crediting rate, as defined in the plan document, allowing participants to track earnings performance in their NQDC accounts.

It is important to remember that because NQDC plans are not formally funded, the returns generated by participants' investment elections become an aggregate liability for the plan sponsor on the company's balance sheet. As a result, the selection of the investment menu is one of the key drivers of complexity in managing liabilities.

Consider the three common menu approaches:

DC Mirror Menus: Often, plan sponsors may be tempted just to "mirror" the investment line-up from their DC plan in their NQDC plan. According to the 2016 Plan Sponsor Council of America NQDC Plans Survey, 49.5% of plans have the same investment options for their DC and NQDC plans. But unlike DC plans, the investment menu of an NQDC plan may need to fit the administrative limitations, lower asset values, pattern of payouts, and asset-liability matching goals of the plan sponsor.

Human resources and benefits departments generally prefer mimicking the DC plan investment menu as it simplifies administration of the plan. It may also permit the employer to use a common recordkeeper for both the DC and NQDC plans and provide single sign-on website access for participants.

But there are potential pitfalls with this approach:

- First, not all of the investment vehicles or share classes offered in a qualified DC plan may be available to an NQDC plan, leading to different expenses and returns, and complicating the effort to closely match the assets and liabilities on an ongoing basis.

- Second, since an NQDC plan is not necessarily limited to planning for retirement, different accounts for the same participant within the NQDC plan may have distinct distribution options or separate investment allocations for a spectrum of financial objectives (e.g., saving for kids' college, vacation homes). In these instances, the investment options in the DC plan that have been selected for a long-term time horizon may not fit the needs and objectives of the NQDC plan and its participants.

This option should not be confused with "mirror" plan designs, where the participant's deferrals and matching contributions are tied to those made in the qualified plan.

"Executive" Menus: The general concept is to offer an expanded menu of investment options for the participants—typically executives—in the NQDC plan. This usually takes the form of using some or all of the core investment funds in the DC plan and adding specialty investment options that may not be appropriate in a DC plan. In some cases, plan sponsors choose to offer a completely different investment menu from the DC plan to increase the diversification opportunity for the executives by having different managers for the core options as well as additional specialty options.

A potential benefit of the executive menu is that different asset allocation tools—particularly risk-based model portfolios—can be offered that are more useful to the participants in managing their in-service distributions.

The same asset-liability pitfalls related to the mirror menu apply here but may be exacerbated by the additional options. Another potential issue may arise by offering an expanded universe of investment options to the HCEs in the NQDC plan, while not offering those same options in the DC plan, particularly if the executive menu outperforms the qualified DC plan options. In addition, participants in NQDC plans, who are supposedly more sophisticated investors, may make the same mistakes as DC plan participants when it comes to using the specialty options (i.e., return chasing, market timing, etc.).

Insurance-Based Menu: For tax purposes, some plan sponsors that informally fund the NQDC plan will use corporate-owned life insurance (COLI) as a funding vehicle. COLI allows the employer to receive the death proceeds from an insurance policy income tax-free, assuming proper notices are provided, and the growth in the policy's cash value is not subject to income tax. Wanting the liabilities and assets to match, they will limit participants to a menu of funds included in the insurance-eligible funds offered within the particular COLI products.

While optimal for asset-liability management, the insurance-based menu approach has some challenges:

- First, the universe of investment options tends to be narrower and may exhibit more retail-like pricing. This is particularly true for registered COLI products but not as much with private-placement COLI products (which tend to have a broader universe and institutional pricing but are by no means "open architecture").

- Second, using insurance-eligible funds may complicate the flow of data for administration, reporting, participant communication, account values, liability management, etc., as the insurance carrier may be the only reliable source of information on the investment options. Further, fund-related data can also vary by the carrier of a specific product and may require a separate administrator from the DC plan.

Other Investment Menu Considerations

In addition to the various menu approaches described above, plan sponsors will sometimes consider company stock, illiquid alternatives (hedge funds, private equity, real estate, etc.), and self-directed brokerage accounts (SDBAs) as options for NQDC plans. But these can be problematic for plan sponsors, particularly those informally funding the plan:

Company Stock: If a sponsor informally funds the plan with the intention of hedging liabilities, then company stock is a challenging investment menu option as corporate assets invested in company stock become treasury stock on the balance sheet and cease to move with the market, thus negating the value of the hedge. There have been many attempts to create a synthetic hedge for company stock but they all have limitations. Regardless, company stock is fairly common as an option in NQDC plans, and many companies simply choose not to hedge the resulting liabilities.

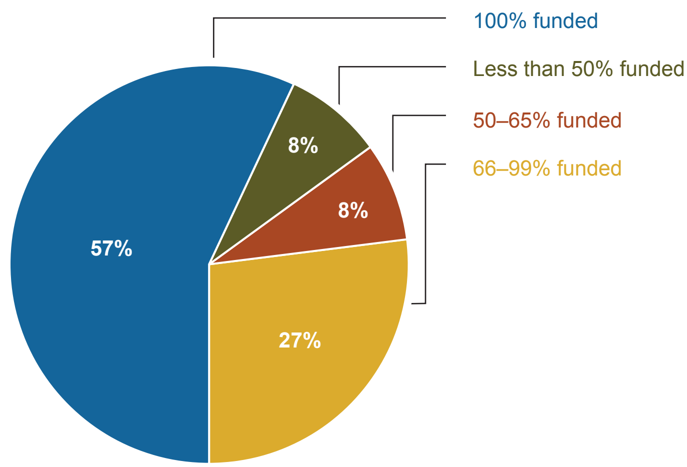
Illiquid Alternatives: With contemporary design for NQDC plans dictating daily valuation and daily transactions, alternatives begin with many of the same problems they present for qualified DC plans. However, given the difference in fiduciary duties and standards (as well as the notional account construct), those issues are typically more easily overcome within NQDC plans. There is, however, a potential financial risk to the company because of the challenges of hedging illiquid alternatives.

SDBA: For unfunded plans, offering SDBAs to participants can be problematic. The company has little insight into what its unfunded liability will look like and how it will behave from quarter-to-quarter and year-to-year. Given that participant accounts are notional and account values/performance is hypothetical, an SDBA also represents a challenge for recordkeepers as far as maintaining participant accounts. For informally funded plans, the challenge is even greater and it would be almost impossible to closely manage assets to liabilities without mirroring each participant transaction. But that creates a potential issue with what is known as "constructive receipt," an accounting concept that basically indicates participants' income was never truly deferred because they maintained control of it, and could create unwanted tax issues for the NQDC plan sponsor and participants.

Marrying the Funding and Liability Management

It is important to remember that because NQDC plans are not formally funded, the investment menu and the funding mechanism are completely divorced. The general goal of the asset-liability management process is to match the total liabilities (the sum of all of the participant accounts) with the total assets (the sum of all the corporate assets). Plan sponsors may seek to hedge the NQDC liabilities to manage cash flow, minimize payout risk, and provide security for the benefit. According to the Plan Sponsor Council of America, 80% of plan sponsors say they informally finance their NQDC plan obligations to some degree, with more than half funding 100% of the liabilities **(Exhibit 2)**. When that is the case, the company must establish a process to manage the assets versus the liabilities to achieve its hedging objectives. This can have important implications when determining the investment menu—a plan sponsor wanting to minimize the mismatch between assets and liabilities will limit the participant investment menu to the exact same investment options available for funding.

Exhibit 2: Percentage of Informally Funded Liabilities



* Multiple answers were permitted

Informally funding an NQDC plan using mutual funds, COLI, or other investments can be inefficient as these methods limit the capital that could otherwise be reinvested back into the company and may also have more limited liquidity.

Simple Hedge: Typically if mutual funds are the primary funding vehicle for an NQDC plan, then the plan will offer the same mutual fund menu to participants so it can more easily match plan assets with its liabilities. But if a plan sponsor invests in mutual funds, any realized earnings, dividends, or interest are taxable to the company. Further, when the plan sponsor sells its taxable investments, the sale may trigger additional taxes.

If a COLI is utilized as the primary funding vehicle, then the plan will typically offer an insurance-based menu.

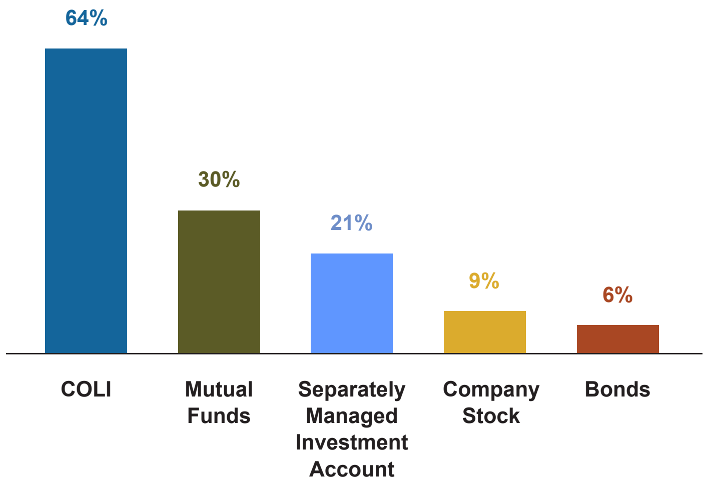
Moderately Complex Hedge: This may include the use of an investment menu dominated by institutional mutual funds and collective trusts. On the funding side, the sponsor cannot invest in retirement plan-only share classes (such as R6) that may be available in qualified DC plans, high-minimum institutional share classes, and/or collective trusts. In this instance the plan sponsor will have to identify the available mutual fund that most closely matches.

Additional complexity may be driven by target date funds (TDFs) in a qualified plan, which are designed for long-term investing but may not be necessary for an NQDC plan. Given that most DC plans offer TDFs and that TDFs tend to be the largest holding in DC plans, it is important to consider what mirroring them in the NQDC would involve.

For the stable value fund, the sponsor must choose to hedge the expected return over time (e.g., short-duration fixed income) or the expected risk (e.g., money market) or a combination. Either way there will be some kind of mismatch associated with stable value options available on the investment menu.

With this approach, there will be some basis risk resulting from the potential differences in any active strategy that cannot be directly matched (including stable value, for which there is no true equivalent), as well as differences in expenses, both for the passive options as well as for active funds that may "match" but involve different share classes.

Exhibit 3: Informal Funding Vehicles*



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Source: Newport Group 2017 Non-Qualified Deferred Compensation Survey

Very Complex: A plan sponsor may use an investment menu of custom white-label investment options and custom TDFs, separate accounts, collective trusts, etc. On the funding side, the plan sponsor may be investing through a group of COLI policies from multiple carriers, each with a different universe of underlying insurance-eligible funds. In this case, asset-liability management becomes a complex correlation exercise that must be adjusted any time there are any changes to the custom options, including both changes to the underlying asset classes/managers as well as the roll-down of the glide path within any TDFs. As an example of micro-level hedging decisions, the sponsor may identify the least expensive S&P 500 Index fund from across all of the various COLI policies and the only holding in that policy will be the index, as it is the closest match to the S&P 500 Index option offered in the NQDC plan.

Not a Duck—But Close

As should be clear, NQDCs can be quite complex to design and differ significantly from DC plans. But NQDC plans can be useful in helping a company with its overall executive compensation strategy, and offer some benefits that can complement a traditional DC plan. By understanding the purpose of the plan, the effect that plan design has on distributions, the actual impact of payouts on the company itself, and the limitations of the NQDC plan recordkeeper, sponsors can generate a streamlined and manageable investment menu and funding strategy.

Author

Jana Steele is a senior vice president and defined contribution consultant in Callan's Fund Sponsor Consulting group. Jana has worked with qualified and nonqualified retirement plans, including plan design, vendor management, vendor searches, fee benchmarking, data security analysis, and compliance support.

The ***DC Observer*** is a quarterly newsletter that offers Callan's observations and opinions on a variety of topics pertaining to the defined contribution industry. For defined contribution inquiries, please contact Jimmy Veneruso at 312.346.3536.

Editor – Stephen R. Trousdale

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Callan

Corporate Headquarters

600 Montgomery Street
Suite 800
San Francisco, CA 94111
800.227.3288
415.974.5060

Regional Offices

Atlanta
800.522.9782

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800.999.3536

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