HIGHLAND CAPITAL BROKERAGE

Attracting, Retaining and Rewarding Highly Valuable Key Employees

Non-qualified Executive Benefit Plans

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The Non-qualified Executive Benefit Plans (NQEB)

We know a company's success relies on its employees. And when it comes to the expertise, experience and seasoned talent of key executives, employers are intent on retaining them for the long term. One of the ways to entice key executives to remain with the company is to offer a comprehensive compensation and benefits package that attracts, retains and rewards them.

Non-qualified Executive Benefits plans such as Non-qualified Deferred Compensation Plans (NQDC), Supplemental Executive Retirement Plans (SERP), and Executive Bonus Plans are three exceptionally powerful incentive programs that have been proven to retain a company's top talent. **Highland Capital Brokerage has a long history in specializing in the design, funding, implementation and ongoing evaluation of such plans.**

The State of Affairs

Many employers offer qualified retirement plans, such as 401(k) plans, to help employees save for retirement. However, these types of plans have strict requirements as to how much an employee can contribute annually, which severely limit a "highly compensated" key employee's ability to save for retirement commensurate with his or her standard of living. For example, the maximum contribution allowable currently is $18,500 annually (at 2018), subject to annual indexing for inflation. For employees over age 50, an additional $6,000 can be contributed to the plan.

As a result, employers can offer supplemental retirement plans, generally referred to as Non-qualified Executive Benefits (NQEB) to kick in where the qualified plan leaves off.

For context, the below chart provides a comparison of features between qualified and non-qualified plans:

Comparison of Qualified & Non-qualified Plan Features

Feature	Tax-qualified plans	NQEB plans
Participation	Must include all eligible employees	Employer selects employees – must be management / highly paid
Vesting	Statutory vesting schedules	Employer can design vesting schedule – no restrictions
Funding	Contributions/deferrals must be deposited into qualified plan trust in timely manner	No assets/funds can be held in employees' names, otherwise those amounts will be taxable income to employees
Creditor access to assets	Amounts in the trust are not subject to claims of creditors of employer or employee	Employer assets that are "earmarked" for NQEB plan are subject to claims of unsecured creditors, even if held by a rabbi trust
Fiduciary	Subject to ERISA fiduciary rules	Not subject to ERISA fiduciary rules
Reporting and disclosure	Depending on the type of plan, may need to file annual report (form 5500) and provide summary plan description (SPD) to employees, funding disclosures and others	One-time notice to the U.S. Department of Labor of plan's existence; no SPD required
Tax deduction for employer	Employer can deduct contributions (within limits) when made, including elective deferrals by employees	Employer cannot deduct contributions (including employees' elective deferrals) until they are paid out of the plan to employees
Contribution amount	Amount that can be credited to a participant's account is limited; benefit limited in defined benefit plan	No limit on amount that can be credited or paid to employees (subject to being "reasonable compensation")
Recognition of taxable income to employee	Employees recognize taxable income when amounts are paid or made available to them	Employees recognize taxable income when amounts are paid or made available to them

Feature	Tax-qualified plans	NQEB plans
Distributions	Depending on type of plan, employees may be able to take out loans, hardship distributions, and may elect when, after retirement, to begin distributions Must begin distributions no later than age 70 ½, if no longer employed	Distributions can only occur upon events defined in contract: separation from service, death, disability, unforeseeable emergency, change in control, fixed date or event
Elective deferrals	Employees may change, begin or stop deferrals to 401(k) plan at any time	Employees must make irrevocable deferral election in the year before the year in which the amount is earned. May stop deferrals due to unforeseeable emergency or disability
Rollovers	Employees may elect to rollover amounts to another qualified plan or IRA, thereby delaying the taxation of those amounts	No rollovers allowed. Once an amount becomes payable, it is taxable to the employee

Non-qualified Deferred Executive Benefit Plan (NQEB)

A NQEB plan is a flexible solution to supplement and complement an existing qualified plan for highly compensated employees. Generally, NQEB plans do not limit the amount of the retirement benefit nor the amount that can be contributed to the plan. As such, these types of plans are extremely attractive to key executives.

Highly Compensated Employees (HCE)

A “highly compensated” employee (HCE) is defined under IRC §414(q)(1)(B) and includes the 5 highest- paid officers or individuals in the company who are among the highest-paid 35% of all employees. The definition also includes employees who were 5% owners of the business at any time during the preceding year or who received compensation in excess of a specific amount during the preceding year ($120,000 in 2018, indexed for inflation).

Take a look at the impact a NQEB plan can have on post-retirement income of a highly compensated employee:

The Difference a NQEB Plan Makes in Amount of Retirement Income for Highly Compensated Key Executives

	Non- HCE	HCE (No NQEB)	HCE (With NQEB)
Annual compensation	$100,000	$300,000	$300,000
401(k) annual deferral[1]	$19,000	$19,000	$19,000
Projected balance in 20 years**	$770,000	$770,000	$770,000
Estimated pre-tax annual payment for 20 years	$58,806	$58,806	$58,806
Estimated annual Social Security benefit at age 67 (based on current law)	$33,296	$38,340	$38,340
NQDC plan annual deferral	$-	$-	**$50,000**
NQDC projected balance in 20 years[2]	$-	$-	**$1,735,963**
Estimated pre-tax annual payment for 20 years	$-	$-	**$132,665**
Total estimated pre-tax annual payment	$92,101	$97,146	$229,811
Post-retirement income replacement ratio	**92.1%**	**32.3%**	**76.6%**

[1] Assumes deferrals increase by 2% per year for 20 years, increasing in $500 increments
[2] Assumes a 5% Net ROR

This example is hypothetical and not predictive of performance of an investment. The assumptions are : 7% rate of return with 3% short term income; 1% long term realized capital gain tax; 3% unrealized capital gains; 45% total income tax; 20% long term capital gain tax; 4% index on salary; employer match of 25% up to 6% of salary; 10 annual retirement payments.

As you can see, without a non-qualified executive benefit plan to accompany an existing qualified plan, highly compensated executives may not retire with enough savings to maintain their standard of living. That is, an executive receives a smaller percentage of retirement income from qualified plans than do lower compensated employees. In other words, the qualified plan rules discriminate against highly compensated executives when it comes to saving in proportion to earnings. This phenomenon is stark when you look at the averages:

Average Final Salary Replacement from Qualified Plans

Highly Compensated Employee	Lower Compensated Employee
30-40% of final average salary	60-70% of final average salary

Advantages of Enhancing Your Current Benefits Package Using a NQEB Plan

Benefits of a NQDC Plan for Employer & Executive	
Employer	**Executive**
Plan can be offered to a select group of highly compensated employees	Plan allows contributions to be made above the limits imposed on qualified plans so executives can save more for retirement
The employer can design the plan as one that includes or does not include employee contributions.	The executive has access to a supplemental retirement savings vehicle
Plan can be tailored to the needs of the employer and to complement an existing benefit plan	Plan allows executives to save more pre-tax compensation
Employer is not required to fund NQEB plan, but a wide range of informal funding vehicles are available	Funds grow tax-deferred
Plan can utilize funding alternatives such as Corporate Owned Life Insurance (COLI) to reduce overall cost of implementing a NQEB plan	Plan reduces the current income tax liability of the executive
When the plan is designed as a NQDC plan, an employer match can be included and can be in the form of cash or stock, or based on performance criteria	Plan may provide the executive more flexible investment allocation options
Plan can include a vesting schedule for employer contributions to serve as an employee incentive to remain with the company	Plan may allow employees to defer compensation into multiple accounts, with different investment options and distribution dates

Types of Non-qualified Executive Benefits Plans (NQEB)

1. The Non-qualified Deferred Compensation Plan (NQDC)

A NQDC plan is an executive compensation plan that offers highly compensated executives an opportunity to defer more compensation on a pre-tax basis to help increase the final salary replacement ratio.

NQDC plans can be designed in a number of ways. Generally:

1. **401(k) Mirror**. In this design the executive defers income and the business matches the deferrals beyond the qualified plan limits, delaying taxation to the executive until distributions are made at retirement, or earlier due to termination. The matches, which can be made in the form of cash or stock, can be subject to a vesting schedule (to create a golden handcuff) and/or can be based on pre-determined performance criteria.
2. **Voluntary Salary Deferral**. This design permits the executive to defer income beyond the qualified plan limits, delaying taxation on the contributions until retirement when distributions are made. In this type of plan the employer may or may not provide a percentage match of the contribution.
3. **Death Benefit Only Salary Continuation Plan**. This design provides income to the beneficiaries after the executive's death that is generated from a life insurance policy on the executive's life

In each of the three plans listed, unlike an employer's contributions or matches to a qualified plan, there is no income tax deduction until distributions are made at the retirement (or termination) of the employee. However, recovery of the contributions made by the employer to the NQDC can be incorporated into the design of the plan.

Moreover, when the plan includes an employer match, the result is higher executive participation and can serve as an incentive for employees to remain with the company. Adding in vesting requirements can go a long way in encouraging employees to remain with the company, especially during challenging times.

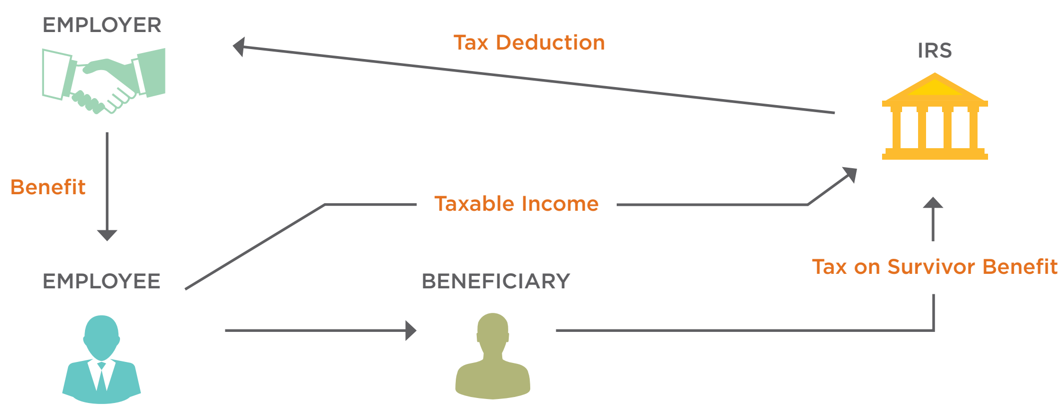
The Tax Advantages of a NQDC Plan
A NQDC plan has many of the same benefits as a 401(k) plan but without the many restrictions. With a NQDC plan, Executives can:

- choose the amount of the deferral that is right for them, up to 100% of base salary and bonus compensation (less FICA and Medicare taxes etc.)
- select the timing of deferrals
- create separate investment buckets with distinct investments

How a NQDC Plan Works

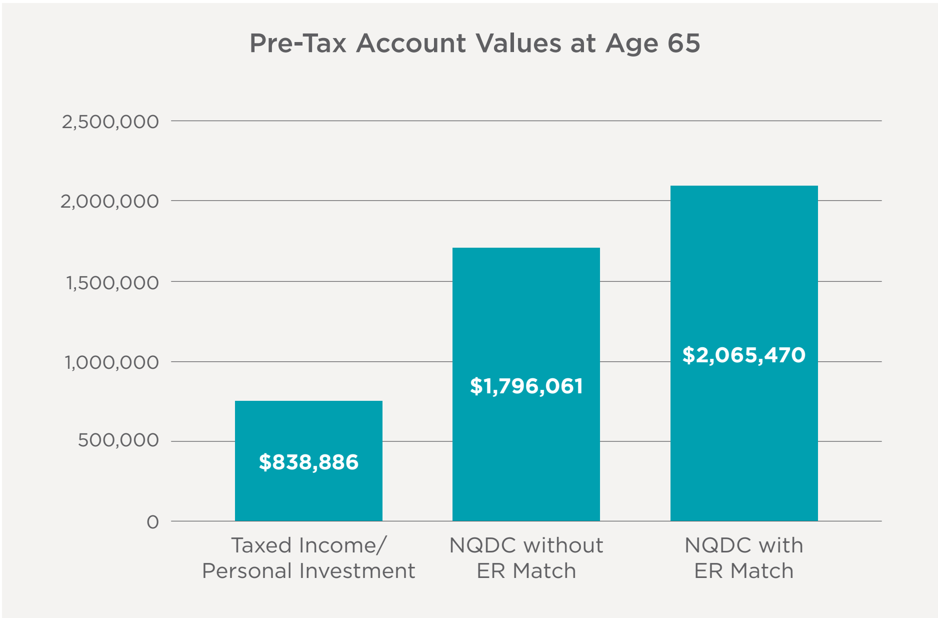
Salary Deferral

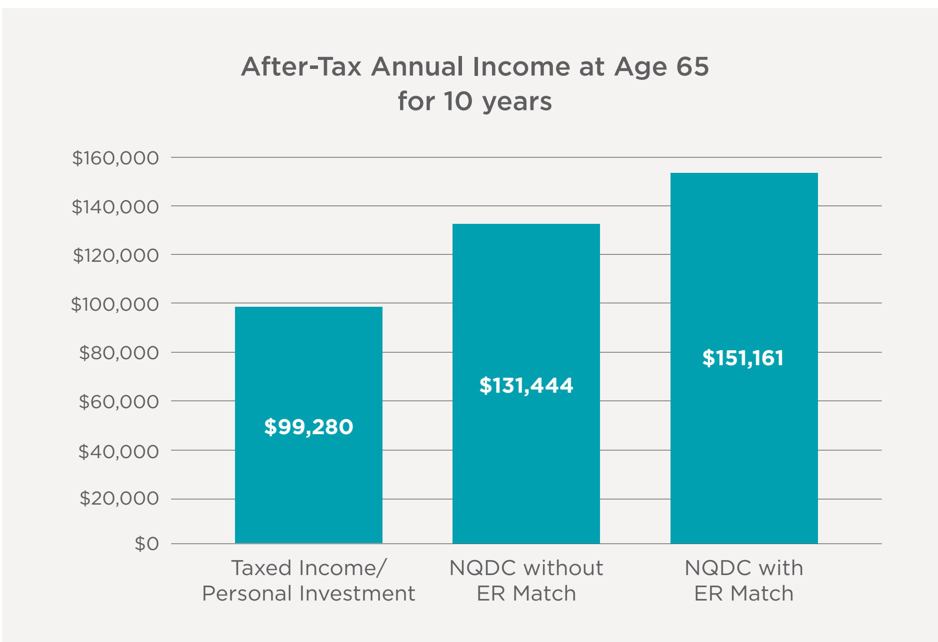
Retirement Benefit



The Power of a NQDC Plan to Fill the Income Gap at Retirement

The following example isolates the NQDC plan (both with an employer match and without one) and compares the account balance to an alternative after-tax investment account. It is assumed the executive is 45 years old, earning $300,000 per year and contributes 10% of income until age 65 to each account. In the match scenario, it is assumed that the employer matches 25% up to 6% of salary.





This example is hypothetical and not predictive of performance of an investment. The assumptions are : 7% rate of return with 3% short term income; 1% long term realized capital gain tax; 3% unrealized capital gains; 45% total income tax; 20% long term capital gain tax; 4% index on salary; employer match of 25% up to 6% of salary; 10 annual retirement payments.

2. The Supplemental Executive Retirement Plan (SERP)

Like a NQDC plan, a SERP plan allows the employer to choose which employees it would like to provide a benefit to. Unlike in a NQDC plan, in a SERP plan, the employee generally does not make contributions to a SERP Plan. The employer is entirely responsible for the funding of the SERP retirement benefit. However, the plan can be designed to include an employee contribution.

HOW A SERP WORKS

The employer and employee enter into an arrangement that states that the employer will pay the employee a stated amount, either as a lump sum amount or in installments over a period of time, upon death, retirement or termination of the plan. The income received by the employee at the time will be taxable at the employee's income tax rate, while the employer receives an income tax deduction at that time for the payment(s). Because a SERP is a NQEB plan, the employer's tax deduction is delayed until such time that the employee receives the benefit.

3. Executive Bonus Plans (EBP) under IRC Section 162

An executive bonus plan (EBP), also referred to as a Section 162 Bonus Arrangement, is a simple and cost-effective way for the employer to provide the employee with supplemental retirement income, as well as survivor benefits. In an EBP, the employer pays a bonus to the executive in the same amount as the premium on a life insurance policy that is owned by the executive.

HOW AN EXECUTIVE BONUS PLAN WORKS

The employer decides who will be part of the plan and the executives then apply for a life insurance policy on their lives, that they each own and for which they name a beneficiary of their choosing. The employer will pay the bonus to each executive in the plan, who in turn is responsible for paying the taxes on the bonus. The employer can increase the amount of the bonus to include the taxes, as well. This is known as a double bonus arrangement.

At retirement, the employee will access the policy's cash values to supplement other retirement income. Alternatively, if a long-term care rider is included in the policy at issue, it is possible to use the policy's death benefit during lifetime to cover the costs of long term care.

The EBP can be designed as a *Restrictive Endorsement Bonus Arrangement (REBA)*, as well. In a REBA, access to the policy's cash values is restricted for a period of time. A REBA may also include a vesting schedule so that each bonus is vested over a schedule. By adding the vesting component to the design, a golden handcuff is included to help entice the employee to remain with the company. It is important, however, to keep the vesting simple.

In a REBA plan, the employee owns the life insurance, as is the case in a straight forward EBP, and can name the beneficiary of the policy. However, the employee also files a restrictive endorsement with the life insurance company. The endorsement restricts the executive from: 1) surrendering the policy cash values 2) taking policy loans and withdrawals 3) changing policy ownership and 4) using the policy as collateral.

Informal Funding of NQEB Plans

We have described how a NQDC Plan can provide a supplemental retirement income plan for your key executives to help attract and retain them by offering a complement to an existing 401(k) or other qualified plan that allows them to contribute to the plan without limitations. One of the reasons the NQDC plan is set up without the restrictions and limitations of a 401(k) plan is because the plan is not "formally" funded and subject to risk, such as the claims of the company's general creditors. That is, a NQDC plan cannot be funded and secured like a 401(k) plan.

With this in mind, there are 3 options for 'informally' funding a NQDC plan:

1. Keep the plan unfunded
2. Purchase equities/mutual funds
3. Purchase tax-deferred Corporate Owned Life Insurance (COLI)

We work closely with you to understand your unique needs and develop a solution to help meet them.

Below is a chart comparing the informal funding options of a NQDC plan:

Comparison of Informal Funding Options for a NQEB Plan

	COLI	Equities/ Mutual Funds	Unfunded
Overview	Employer-owned cash value life insurance policies on the lives of eligible executives with benefits payable to the employer	Employer makes contributions to the Mutual Funds or to purchase equities, and uses withdrawals from the account to fund pre-tax benefits.	The employer simply pays the benefits out of corporate cash flow as they are due
Accounting & Taxes	The increase in the cash surrender value of the policy above the net premiums paid by the employer, flows through to the P&L statement as income. The appreciation in the cash values of the policies is not taxed unless the policy is surrendered	Only realized gains can flow through as income on the P&L statement; unless fair value option is selected Realized gains and reallocation among different investments will trigger taxation (which can be substantial if executives frequently balance and reallocate investments)	P&L expense will be higher since there is no gain on assets to offset benefit expense

	COLI	Equities/ Mutual Funds	Unfunded
Funding	Institutionally-priced COLI is a highly liquid funding vehicle and can be surrendered without any charge. Policies can be issued on a guaranteed basis based on the group size and does not require, generally, medical exams	Liquid investments that may be bought or sold at any time	Employer does not have to set aside funds and deferrals can be invested back into the company
Death Benefit Returns	Provides tax-free death benefit. Some of the tax-free death benefit can be allocated to the executive's beneficiaries when a DBO feature is included in the design of the plan. With a large group of insured-executives, the likelihood of early deaths is greater and can provide significant cashflows to help reduce the overall cost of the NQEB plan	Equities do not provide any death benefit Returns are dependent on investment performance At liquidation, unrealized gains are taxable	There are no death benefits
Notice & Consent under IRC Section 101(j)	Per IRC Section 101(j) When COLI is used, written notice and consent needs to be obtained for all policies owned by the employer on the life of an employee before a policy is issued. A record of the consent must be kept by the employer and the notice and consent forms can be obtained from the insurance carrier. Employers must also maintain annual records to demonstrate that the requirements under 101(j) are being met, including the filing of Form 8925 with the company's annual tax return each year.	Notice & Consent under 101(j) does not apply	Notice & Consent under 101(j) does not apply
Requirements under IRC Section 409A	Requirements for distributions, acceleration and elections of a NQEB plan under Section 409A must be complied with or penalties apply	Requirements for distributions, acceleration and elections of a NQEB plan under Section 409A must be complied with or penalties apply	Requirements for distributions, acceleration and elections of a NQEB plan under Section 409A must be complied with or penalties apply

Plan Implementation and Administration

Generally, a third party administrator (TPA) that specializes in NQEB plans will be needed to provide the proper accounting information for the employer's records and tax returns, and to track the performance of the underlying informal investments in meeting future benefit payments. The TPA fees are minimal and generally are tax deductible to the employer as a business expense. Highland Capital Brokerage can provide a list of TPAs that specialize in this area.

Highland Capital Brokerage has more than 30 years of experience with NQEB plans. Our experience endows us with the expertise to help you consider the full range of plan design and funding options for your NQEB plan. We serve as your partner and specialist from start to finish—designing the plan, weighing the funding options in the context of your needs, to plan implementation, and ongoing evaluation of the plan. Let us help you retain your key executives by filling in the retirement income gap they face.

[1] Executive Benefits—A Survey of Current Trends, Clark Consulting, 2009

This material does not constitute tax, legal, investment or accounting advice and is not intended for use by the taxpayer for the purposes of avoiding any IRS penalty. Comments on taxation are based on current tax law as of August 2018.

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