Nonqualified *Deferred* COMPENSATION

A LEGISLATIVE FACTSHEET

AALU
ASSOCIATION FOR ADVANCED LIFE UNDERWRITING

THE FACTS ON NONQUALIFIED DEFERRED COMPENSATION

Nonqualified deferred compensation is sometimes mistakenly confused with "executive compensation." It goes far beyond the ranks of top management and is integral to the ability of hundreds of thousands of mid-level managers and employees to save for retirement and for employers to recruit and retain high quality employees. This paper highlights the important benefits of deferred compensation arrangements and separates fact from fiction.

WHAT IS NONQUALIFIED DEFERRED COMPENSATION?

A typical nonqualified deferred compensation plan is an arrangement under which a part of an employee's salary is deferred until a future date. Generally, the employee is at risk for the deferred portion of their salary. Individuals typically enter into these arrangements as a means of saving for retirement, in many cases augmenting amounts saved through 401(k) and other qualified plans. Limits on such qualified plans—for example, a maximum annual contribution limit of $15,500 for 401 (k) plans—and a lengthening life expectancy, as well as the failure of qualified plan limits to keep up with inflation, make nonqualified deferred compensation plans particularly important savings tools for employees. Both large and small employers view these plans as valuable tools for retaining and attracting talent.

In setting up a nonqualified deferred compensation agreement, the employer and employee typically will specify the percentage of current salary to be deferred and how hypothetical earnings on the deferred amounts will be computed. In some cases, the agreement will specify a rate of return on the deferred amounts. In other cases, employees maintain an account in which they may make hypothetical investments that will govern the amount ultimately received by the employee.

A nonqualified deferred compensation plan is not eligible for the tax benefits granted to qualified plans. Under a qualified plan, the employer may deduct the deferred compensation currently, as amounts are contributed to the plan, while the employee is able to defer paying taxes until receiving distributions from the plan. By contrast, in a nonqualified plan, the employer's deduction is postponed until the employee receives the compensation and pays income taxes.

Another key difference between nonqualified and qualified plans is that amounts deferred in a nonqualified plan are not protected in the event of the employer's bankruptcy. Assets intended to fund nonqualified deferred compensation must remain subject to the claims of the employer's general creditors. Thus, if the employer becomes insolvent, there are no assurances that the deferred amounts will ever be paid to the employee. In this case, the employee simply becomes another unsecured creditor of a bankrupt company.

EXHAUSTIVE RULES ALREADY ENSURE RESPONSIBLE USE

In 2004, Congress enacted sweeping additional requirements on deferred compensation. The legislation imposed strict rules affecting deferral elections, funding, and distributions and imposed tax and penalties for violations of these rules. These rules were designed to ensure that employees do not have constructive receipt of income that is deferred. Regulations to implement the 2004 changes, which have not yet been finalized, will run to hundreds of pages. Those 2004 changes surely addressed any concerns about nonqualified deferred compensation.

PRESENT-LAW TAX TREATMENT IS PROPER

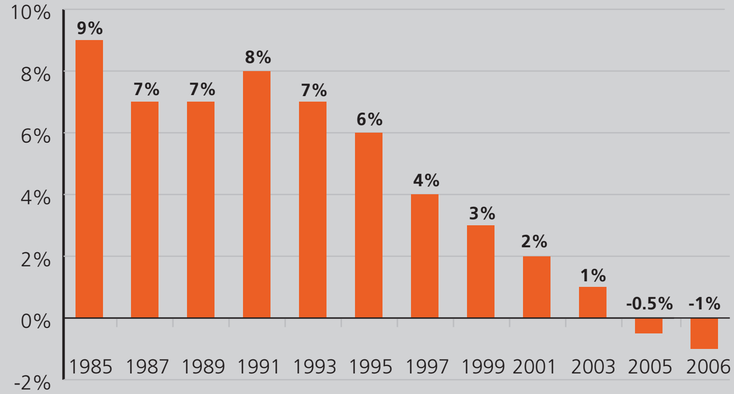
The tax law governing deferred compensation matches the employer deduction with the employee income inclusion. The employee generally is taxed on the compensation at the time of receipt. Likewise, the employer's deduction comes at the time the deferred amounts are paid. Thus, an employer entering into the deferred compensation arrangement is foregoing an immediate deduction for the payment, thereby increasing its current tax liability. The employer is willing to do this in order to attract and retain its best employees. This matching of deductions and income inclusion effectively eliminates any revenue concerns on the part of the federal government.

The doctrine of "constructive receipt" is one of the key principles that guides the present-law treatment. Deferred compensation will be taxed currently if the individual is determined to have constructively received these amounts. An amount is constructively received if the individual is able to draw on it, without restriction, at any time, even if the individual has not actually received the income.

IMPACT ON RETIREMENT SAVINGS, SOCIAL SECURITY

Nonqualified deferred compensation represents a major source of personal savings for many employees. In light of the dramatically low rate of U.S. individual savings – the personal savings rate has dropped from 9% to a negative 1% since 1985 – policymakers should consider ways to make it easier, not more difficult, for employees at all levels to save for retirement.

Personal Savings as % of Disposable Income

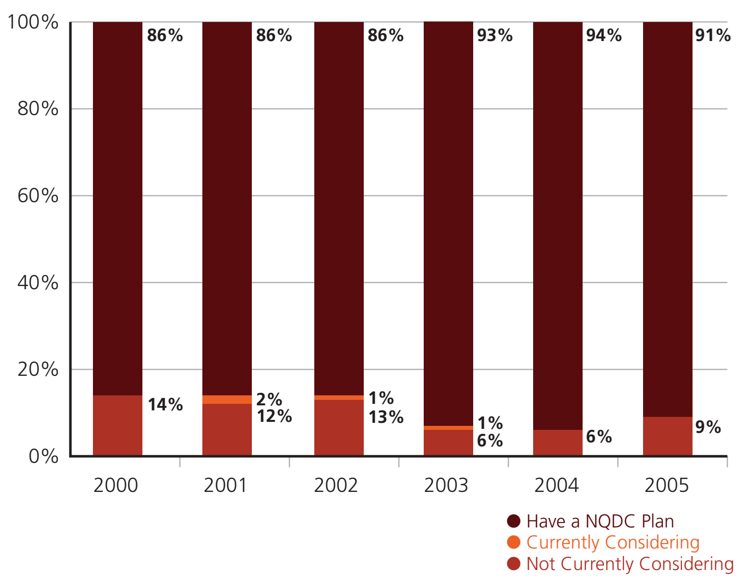


Source: US Department of Commerce, Bureau of Economic Analysis

BROAD REACH OF DEFERRED COMPENSATION PLANS

With longer life expectancies, the need for substantial retirement savings, and restrictive limits on qualified retirement plans—such as the $15,500 maximum annual contribution for 401(k) plans—deferred compensation plans have become important to a wide-range of employees and businesses. According to a recent survey, 91% of Fortune 1000 respondent companies have nonqualified deferred compensation plans.*

PREVALENCE OF DCPs



Smaller businesses also commonly offer nonqualified deferred compensation programs. For large and small businesses alike, deferred compensation can be used as a tool to increase productivity and to retain employees who make important contributions to the businesses' bottom lines.

*Clark Consulting "Executive Benefits – A Survey of Current Trends" 2005

IMPORTANCE TO MID-LEVEL MANAGERS

Of survey respondents with nonqualified deferred compensation plans, 28% allow employees with compensation below $100,000 to participate, and 63% allow employees with compensation below $150,000 to participate.

The following are some examples of plans now in operation:

1. A nationwide retailer based in the Midwest offers its nonqualified deferred compensation plan to 1,120 employees. Of the 962 participants, 68% have annual salaries between $66,000 and $120,000.
2. A nationwide specialty retailer based in the Southwest offers it nonqualified deferred compensation plan to 335 participants, 73% of whom have annual salaries below $120,000.
3. One of the nation's leading homebuilders offers its plan to almost 500 employees. 60% of those employees have annual salaries below $140,000, and 40% have annual salaries below $120,000.

These numbers counter the common belief that individuals making less than $100,000 have little ability to save after they have "maxed out" contributions to 401(k) plans and IRAs. In reality, there are many reasons mid-level managers need to utilize nonqualified plans. A common scenario is a "two-earner" couple whose combined income affords significant additional savings capacity. There also are situations where a worker making less than $100,000 is prevented – by operation of the tax law's nondiscrimination rules – from making his or her full contribution to a qualified plan. At the same time, particularly for small businesses, business leaders might see less merit instituting or maintaining a deferred compensation plan if they themselves were unable to benefit from a deferred compensation plan.

About AALU:

AALU is a nationwide organization of life insurance agents, many of whom are engaged in complex areas of life insurance such as business continuation planning, estate planning, retirement planning, deferred compensation and employee benefit planning. AALU represents approximately 2,000 life and health insurance agents and financial advisors nationwide. The mission of AALU is to promote, preserve and protect advanced life insurance planning for the benefit of its members, their clients, the industry and the general public. AALU's website can be accessed at www.aalu.org

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