Nonqualified Plan Financing: One Size Does Not Fit All

At the height of the pandemic, corporate America was hyper focused on finding strategies for effectively cutting costs. Today, business verticals vary in their stage of recovery and return to prosperity. Yet regardless of where they stand, companies and organizations continue to seek cost optimization solutions for yielding higher profits.

One significant cost optimization opportunity that organizations may be overlooking is the sponsoring of a nonqualified deferred compensation plan. Nonqualified deferred compensation (NQDC) plans are popular because they are an effective tool to attract and retain executive level talent while also supporting retirement readiness goals. Following the trend of qualified retirement plans, NQDC plans typically are defined contribution in style and are market based.

Contributions to the plan create an unfunded liability that can grow at an unpredictable rate and plan participation tends to trend higher in an escalating tax environment. NQDC liabilities can be volatile as a large percent of participant balances are notionally invested in equity securities. Stocks overall have historically outperformed other major asset classes but with much greater volatility, especially over shorter periods.

The decision of how to hedge the liability drives a plan's overall cost. No single method is best for every organization and multiple factors must be taken into consideration. While not a requirement to fund the plan, a majority of plan sponsors set aside assets to informally finance it, generally investing in taxable investments or corporate owned life insurance (COLI). In line with cost optimization, reducing the costs of sponsoring the nonqualified plan should improve profit and loss (P&L) performance.

Financing with Taxable Securities

Companies might select to finance their plan with tax securities if theirs is a new plan and the initial economic impact will not be material. They might also choose this option if they want to use the same administrator as the qualified retirement plan or if they are in a net operating loss (NOL) position. Taxable securities act as a direct hedge to the notional accounts but this method adds to the cost of the plan. Account balances are credited with tax deferred earnings while the plan sponsor recognizes tax for investment earnings, reallocation, dividends, and liquidation at ordinary income tax rates. The reduction in the corporate tax rate from the Tax Cuts and Jobs Act (TCJA) reduced, but did not eliminate, the tax disadvantages of financing with taxable securities. However, the Biden administration's proposed increase to a 28% rate would reverse a portion of the previous tax savings.

Financing with COLI

Recent surveys suggest that just over half of plan sponsors finance their plan liability with COLI[1]. COLI is advantageous for its tax benefits, which include tax deferred accumulation of policy values, tax-free reallocation of investments, tax-free distributions, and tax-free receipt of policy death benefits. COLI also has preferable accounting and P&L treatment compared to taxable securities.

Year-end tax legislation (the Consolidated Appropriations Act (CAA)) included a positive development for the life insurance industry that provided a catalyst for plan sponsors to review their current funding strategy. The insurance interest rate used to calculate the definition of a life insurance contract changed. The net effect of the rate reduction was materially improved performance and greater accumulation of the value in the investment accounts.

Repriced COLI products can reduce the cost of hedging the plan, increasing cash flow, and enhancing earnings. Combined with a higher tax rate, converting from taxable securities to COLI can position plan sponsors to realize savings.

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When it comes to best options for optimizing nonqualified plan financing, there is no one-size-fits-all solution. Although there are a number of effective options, including taxable securities and COLI, each organization's needs are unique and must be evaluated on a case-by-case basis.

Only an in-depth assessment of an organization's structure, finances, and objectives, conducted by an experienced executive benefits professional, can equip the company's decision makers to make optimal choices for their current situation and future goals.

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1 According to the Newport/PLANSPONSOR Executive Benefits Survey, 2020 Edition: "For the last 20+ years there have two primary funding vehicles when it comes to funding NQDC plan liabilities: corporate-owned life insurance (COLI) and mutual funds. COLI has remained the number one choice at 63% and has remained in this range for the last several surveys."

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