



Nonqualified Plan Accounting

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RCG
Retirement Capital Group

About This Report



Nonqualified deferred compensation plans impact the balance sheet and income statement of the sponsoring company. Since the plan is a nonqualified plan, the participant account balances are liabilities to the company and any amounts set aside to pay future balances are the company's assets. Income, expenses and associated taxes of the plan must also be recorded by the company.

This report will cover the financial accounting for nonqualified plans using the most prevalent assets to fund the plan, corporate owned life insurance (COLI) and mutual funds.

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Nonqualified Plan Accounting



The Plan

With nonqualified deferred compensation, the participant is not taxed on the amounts deferred until he or she receives the money.

- ◆ Income deferral → Employee dollars
 - ◆ Supplemental Executive Retirement Plan (SERP) → Employer Dollars
- The distinction between the two is usually determined by who makes the contribution, employee or employer.

Nonqualified Plan Accounting



Accounting for Benefits

- APB 12 versus FAS 87 versus FAS 106?
- FAS 109
- Is it an individual arrangement or a plan?
- What difference does it make?

Voluntary Nonqualified Deferred Compensation



- ❑ Nonqualified deferred compensation
- ❑ The participant is not taxed on the amounts deferred until he or she receives the money.
- ❑ The company sponsoring such a plan cannot take the corresponding compensation expense deduction, but rather books a deferred tax credit equal to the amounts deferred until the money is paid to the participant, at which time the deduction is taken.
- ❑ The company also records the deferral as a liability on its balance sheet.

Voluntary Nonqualified Deferred Compensation



Asset/Liability Separation

NQDC

- ❑ **Participant elects:**
 - ❖ Deferral amount
 - ❖ Allocation of hypothetical investments
 - ❖ Time and form of payout
 - ❖ Reallocation of account balance

Hypothetical Investment

- ❑ **Choices available in NQDC:**
 - ❖ Bond Fund
 - ❖ International Fund
 - ❖ Small Cap Growth
 - ❖ Mid-Cap Growth
 - ❖ Large Cap Growth

Separation Wall

Rabbi Trust

Trust Company receives cash and is directed by the employer to invest the cash in a funding vehicle. The employer compares the investment results of the NQDC with the Rabbi Trust and reallocates the assets of the Rabbi Trust to hedge the NQDC.

Funding Vehicle

- ❑ **Trustee directs asset allocation:**
 - ❖ Bond Fund
 - ❖ International Fund
 - ❖ Small Cap Growth
 - ❖ Mid-Cap Growth
 - ❖ Large Cap Growth

Voluntary Nonqualified Deferred Compensation



“Unfunded”

- ❑ “Unfunded” means money deferred by participant goes into the company’s general account and cannot be set aside to “guarantee” the plan’s future obligations.
- ❑ Should a company sponsoring such a plan become insolvent, the amounts deferred are considered part of the company’s assets and therefore subject to the “claims of creditors” (in 401(k), this is not the case).

Voluntary Nonqualified Deferred Compensation



“Unfunded” (continued)

- ❑ This “unfunded” feature is what gives the NQDC plan its tax-deferred status.
- ❑ The “general creditor risk” is why only those who are “highly compensated” may participate.
- ❑ The Department of Labor (DOL) believes that those who are “highly compensated” are capable of understanding the risk.

Voluntary Nonqualified Deferred Compensation



Informal Funding

- Formal funding is required with qualified plans – money is set aside in investments outside company’s general creditors (i.e., 401(k)).
- “Informal Funding” is where the company invests deferrals to help match the assets to its liability.
- Informally funded assets are general assets of the company (even if held in a Rabbi Trust)*.

*IRS Letter Ruling 8113107

Voluntary Nonqualified Deferred Compensation



Informal Funding *(continued)*

- ❑ Company can invest in any asset, but most common choices are mutual funds or Corporate Owned Life Insurance (COLI).
- ❑ COLI products are popular because of the tax advantages they provide to the corporation.
- ❑ Any investment gains, dividends or interest earned within COLI insurance contracts held until maturity are tax-free to the company whereas mutual funds are taxable.

Voluntary Nonqualified Deferred Compensation



Liability

- The liability that the company must record is equal to the balance due to the plan participants at the balance sheet date.
- Participant account balances are calculated by administrator using the “phantom tracking” method.
- Amounts are not actually invested on behalf of the participant, but the account balance reflects the amount that would be earned if the funds were invested as elected.

Voluntary Nonqualified Deferred Compensation



Liability (continued)

- ❑ The liability balance is affected by:
 1. Participant deferrals
 2. Company Contribution
 3. Amounts credited or debited to participant accounts
 4. Participant distributions and withdrawals

Voluntary Nonqualified Deferred Compensation



Liability (continued)

Participant Deferrals – Amounts are withheld from participants by the company based on elections made by the participant.

- ◆ Since the company cannot currently deduct the amounts deferred, a deferred tax asset is established.
- ◆ When amounts are withheld, the following entries should be made:

DR: Compensation Expense	CR: Deferred Compensation Liability
DR: Deferred Tax Asset	CR: Income Tax Expense

Voluntary Nonqualified Deferred Compensation



Liability (continued)

- ❑ **Company Contribution** – Company contributions are expensed as they vest. The company cannot deduct vested amounts until they are distributed, therefore deferred taxes are affected.

- ◆ The following entry records vested company contributions:

DR: Compensation Expense	CR: Deferred Compensation Liability
DR: Deferred Tax Asset	CR: Income Tax Expense

Voluntary Nonqualified Deferred Compensation



Liability (continued)

- ❑ **Amounts credited or debited to participant accounts** – Participant account balances are calculated by administrator based on the participant deferrals, participant investment options and the fund returns for the period.
- ❑ The change in the liability due to the change in the fund values for the period is recorded by the company as expense or income depending on the fund values.
- ❑ The amount recorded represents what the participants would have earned had their deferrals actually been invested as they directed.

Voluntary Nonqualified Deferred Compensation



Liability (continued)

- ◆ The following entry would be made based on the participant's earnings:

DR: Compensation Expense	CR: Deferred Compensation Liability
DR: Deferred Tax Asset	CR: Income Tax Expense

Voluntary Nonqualified Deferred Compensation



Liability (continued)

- ❑ In an increasing market, the participant balances and thus the liability increase.
- ❑ In a declining market, the participant balances and thus the liability decrease.
 - ◆ In a declining market, the following entry would be made:

DR: Deferred Compensation Liability	CR: Compensation Expense
DR: Income Tax Expense	CR: Deferred Tax Asset

Voluntary Nonqualified Deferred Compensation



Liability (continued)

- ❑ **Participant distributions and withdrawals** – Participant distribution may be scheduled or unscheduled and result in a debit to the deferred compensation liability.
- ❑ The distribution also triggers a tax deduction by the company.
 - ◆ Assuming trust assets are used to fund the distribution, the following entry would be made to record a scheduled distribution or withdrawal:

DR: Deferred Compensation Liability	CR: Asset
DR: Income Taxes Payable	CR: Deferred Income Tax Asset

Note: The company has several options from which to choose for funding the distributions including corporate cash, offsetting deferrals or withdrawing from the life insurance policies.

Voluntary Nonqualified Deferred Compensation



❑ **Assets** - The company's asset is affected by:

1. The company deposits
2. Investment earnings/(losses)
3. Tax (on mutual funds) or insurance expense (with COLI)
4. Benefit payments (withdrawals)
5. Death benefit proceeds (with COLI)

Voluntary Nonqualified Deferred Compensation



Accounting for COLI

Background – FAS 85-4

- ◆ Accounting for COLI is governed by FTB 85-4
- ◆ Tax implications are governed by FAS 109
 - IRC § 101
 - No deferred tax expense under FAS 109

Voluntary Nonqualified Deferred Compensation



Accounting for COLI (continued)

- Company usually makes premium payment equal to participants deferrals plus any company contribution.
- After premium payment is made and insurance expenses are affected, the following entry should be record.

DR: Life Insurance Asset (Asset Account)	CR: Cash
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Voluntary Nonqualified Deferred Compensation



Accounting for COLI (continued)

- The investment earnings/(losses) associated with the life insurance policies have no tax impact.
- The entry is dependent on the values of the underlying funds.

Increasing Market

DR: Life Insurance Asset	CR: Other income (expense) non-taxable
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Decreasing Market

DR: Other income (expense) non-taxable	CR: Life Insurance Asset
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Voluntary Nonqualified Deferred Compensation



Accounting for COLI (continued)

- ❑ **Insurance Expenses** - In an increasing market, the participants' balances increase and thus the company's liability increases.
- ❑ **Life Insurance Asset** – The expenses associated with the life insurance policies are not tax deductible.
 - ◆ The following entry records life insurance related expenses:

DR: Other income/life insurance (expense) non-taxable	CR: Asset Account/Life Insurance Asset
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Voluntary Nonqualified Deferred Compensation



Accounting for COLI (continued)

- ❑ **Benefit Payments (withdrawal)** – Benefit payments decrease the deferred compensation liability.
 - ◆ The following entry records benefit payments made by the company:

DR: Deferred Compensation Liability	CR: Cash
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Voluntary Nonqualified Deferred Compensation



Accounting for COLI (continued)

- ❑ **Death Benefit Proceeds** – When death benefit proceeds are received by the company, income should be recorded equal to the death proceeds in excess of the cash surrender value of the policy immediately preceding the death.
 - ◆ The following entry records benefit payments made by the company:

DR: Cash	CR: Life Insurance Asset (CSV of COLI) CR: Other Income (expense) non-taxable
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Voluntary Nonqualified Deferred Compensation



- ❑ **Income Statement** – The entries discussed in both the asset and liability section, have income statement implications.

- ❑ The income statement of the company will be affected by:
 1. The compensation deferred*
 2. Investment returns credited or debited to participant accounts
 3. Investment earnings or losses associated with life insurance policies
 4. Expenses associated with life insurance policies
 5. Participant forfeitures
 6. Death benefits

*The compensation expense associated with the deferral is not an incremental expense of the plan. It would be incurred regardless of the existence of the deferral plan.

Voluntary Nonqualified Deferred Compensation



☐ Income Statement (continued)

1. **The compensation deferred** is a tax deductible expense to the company when the compensation is paid to the participant. Until then, for book purposes, the expense is recognized and tax affected.
2. **Investment returns credited or debited to participant accounts** – an increasing market would result in expense to the company. The amount is subject to tax. The income statement impact is the after tax amount.
3. **Investment earnings or losses associated with life insurance policies** – in an increasing market, the cash value of the policies would increase and the company would record income. In a decreasing market, the cash value of the policies would decrease and the company would record expense. Changes in cash value of life insurance policies are not taxable; therefore there is no tax impact as a result of the change in the cash surrender value.

Voluntary Nonqualified Deferred Compensation



Comparison of FAS 85-4 to mutual fund treatment FAS 115

□ FAS 115

- ◆ Addresses accounting for investments in equity securities that have readily determinable fair values and for all investments in debt securities.
- ◆ The investments covered are to be classified in three categories and accounted for as follows:
 1. Held-to-maturity
 2. Trading
 3. Available for sale

Voluntary Nonqualified Deferred Compensation



Comparison of FAS 85-4 to mutual fund treatment FAS 115 (continued)

❑ Examples – Should companies use trading versus available for sale?

	Held to Maturity Securities*	Trading Securities	Available for Sale Securities	Life Insurance
FASB Rules	Stmt. #115	Stmt. #115	Stmt. #115	FASB Technical Bulletin 85-4
Definition	Debt securities (e.g., bonds) where the holder has the positive intent and ability to hold securities to maturity	Securities bought & held principally for purpose of active trading in the short term for profit	Investments not classified as either Held to Maturity or Trading	Life insurance policies owned by the entity
Balance Sheet Treatment	Carried at amortized cost (i.e., no mark-to-market)	Mark-to-market – included at FMV – net of taxes	Mark-to-market – included at FMV – net of taxes	Cash surrender value
P&L Inclusion	Realized gains (interest) plus amortization of acquisition discount or premium	Realized gains/losses (dividends, sales) and unrealized holding gains & losses included in current earnings	Only realized gains/losses included in current earnings. Unrealized holding gains & losses booked to a special shareholder equity account	Change in cash surrender value booked as income or expense

*This method is generally considered inappropriate to use for mutual funds financing a nonqualified plan liability.

Voluntary Nonqualified Deferred Compensation



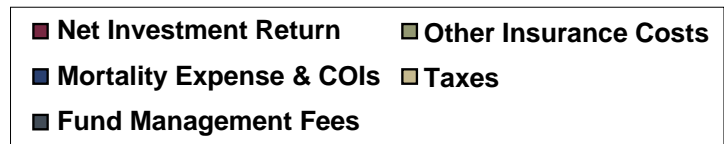
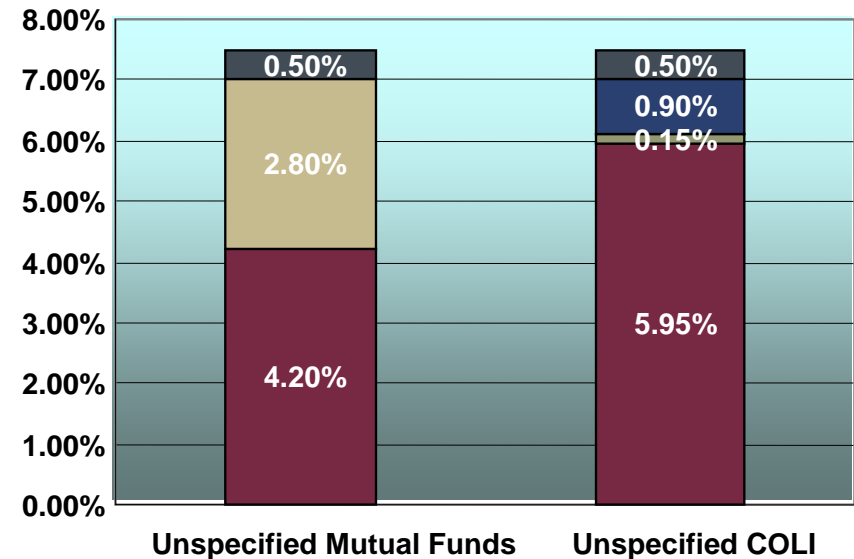
COLI versus Mutual Funds

- A simple analysis of mutual funds to COLI is to evaluate the cost of the insurance charges to the cost of taxes the corporation will pay on the fund performance.

7% Net Return Cost Breakdown

40% Tax Rate		
	Unspecified Mutual Funds	Unspecified COLI
Net Investment Return	4.20%	5.95%
Other Insurance Costs	0.00%	0.15%
Mortality Expense & COIs	0.00%	0.90%
Taxes	2.80%	0.00%
Fund Management Fees	0.50%	0.50%

7.0% Net Return and 40% Tax Rate



Benefits



Benefits Comparison

Year	Benefits (Cash Flow)				Benefit (P&L)			Trust Deposit
	(1) Executive Deferral	(2) Benefit Payment	(3) Tax Savings	(4) Cash Flow	(5) Deferred Comp Expense	(6) Deferred Tax Credit	(7) P&L Impact =(5) + (6)	(8) Trust Deposit
2006	100,000	0	(40,000)	60,000	(107,000)	42,800	(64,200)	(100,000)
2007	100,000	0	(40,000)	60,000	(114,490)	45,796	(68,694)	(100,000)
2008	100,000	0	(40,000)	60,000	(122,504)	49,002	(73,503)	(100,000)
2009	100,000	0	(40,000)	60,000	(131,080)	52,432	(78,648)	(100,000)
2010	100,000	0	(40,000)	60,000	(140,255)	56,102	(84,153)	(100,000)
2011	100,000	0	(40,000)	60,000	(150,073)	60,029	(90,044)	(100,000)
2012	100,000	0	(40,000)	60,000	(160,578)	64,231	(96,347)	(100,000)
2013	0	0	0	0	(64,819)	25,927	(38,891)	0
2014	0	0	0	0	(69,356)	27,742	(41,614)	0
2015	0	0	0	0	(74,211)	29,684	(44,527)	0
Cumulative								
Year 10	700,000	0	(280,000)	420,000	(1,134,366)	453,746	(680,619)	(700,000)
Year 20	700,000	0	(280,000)	420,000	(2,231,469)	892,588	(1,338,881)	(700,000)
Year 30	700,000	(2,289,750)	635,900	(953,850)	(3,294,312)	1,317,725	(1,976,587)	(700,000)
Year 40	700,000	(3,434,626)	1,093,850	(1,640,776)	(3,434,626)	1,373,850	(2,060,775)	(700,000)
Life of Plan	700,000	(3,434,626)	1,093,850	(1,640,776)	(3,434,626)	1,373,850	(2,060,775)	(700,000)
NPV Rate 5.00%			NPV 983,783	NPV (199,779)				NPV (607,569)

Benefits



Non-Tax Managed Assets (Mutual Funds, Classified as “Trading”)

Non-Tax Managed Assets

Year	(1)	(2)	(3)	(4)	(5)	(6)	(7)	(8)	(9)	(10)	(11)
	Benefits P&L	Trust Deposit	Withdrawals	Investment Gains	Current Tax	Deferred Tax Expense	P&L Impact =(4)+(5)+(6)	Cash Flow	P&L Impact =(1)+(7)	Compensation Expense Savings	Net P&L Impact =(9)+(10)
2006	(64,200)	(100,000)	1,489	7,000	(1,489)	(1,019)	4,491	(40,000)	(59,709)	60,000	291
2007	(68,694)	(100,000)	3,912	14,393	(3,912)	(1,246)	9,235	(40,000)	(59,459)	60,000	541
2008	(73,502)	(100,000)	6,630	22,122	(6,630)	(1,298)	14,194	(40,000)	(59,309)	60,000	691
2009	(78,648)	(100,000)	9,469	30,200	(9,469)	(1,355)	19,376	(40,000)	(59,272)	60,000	728
2010	(84,153)	(100,000)	12,434	38,644	(12,434)	(1,417)	24,793	(40,000)	(59,360)	60,000	640
2011	(90,044)	(100,000)	15,534	47,471	(15,534)	(1,481)	30,456	(40,000)	(59,588)	60,000	412
2012	(96,347)	(100,000)	18,775	56,699	(18,775)	(1,549)	36,376	(40,000)	(59,971)	60,000	29
2013	(38,891)	0	20,674	59,346	(20,674)	(599)	38,073	0	(818)	0	(818)
2014	(41,614)	0	21,793	62,038	(21,793)	(446)	39,799	(0)	(1,815)	0	(1,815)
2015	(44,527)	0	22,777	64,851	(22,777)	(471)	41,603	0	(2,924)	0	(2,924)
Cumulative											
Year 10	(680,620)	(700,000)	133,488	402,764	(133,488)	(10,883)	258,394	(280,000)	(422,225)	420,000	(2,225)
Year 20	(1,338,883)	(700,000)	426,577	1,237,302	(426,577)	(16,962)	793,762	(280,000)	(545,120)	420,000	(125,120)
Year 30	(1,976,589)	(700,000)	2,057,479	1,924,729	(683,629)	(6,370)	1,234,730	(280,000)	(741,859)	420,000	(321,859)
Year 40	(2,060,777)	(700,000)	2,693,215	1,993,215	(714,561)	0	1,278,653	(362,122)	(782,123)	420,000	(362,123)
Life of Plan	(2,060,777)	(700,000)	2,693,215	1,993,215	(714,561)	0	1,278,653	(362,122)	(782,123)	420,000	(362,123)
NPV Rate 5.00%		NPV (692,164)			NPV (441,473)			NPV (299,600)			P&L Impact (362,123)
					Internal Rate of Return			4.43%			

Benefits



Tax Managed Assets (COLI)

Tax Managed Assets

Year	(1)	(2)	(3)	(4)	(5)	(6)	(7)	(8)	(9)	(10)	(11)
	Benefits P&L	Trust Deposit	Withdrawals	Investment Gains	Current Tax	Deferred Tax Expense	P&L Impact	Cash Flow	P&L Impact	Compensation Expense Savings	Net P&L Impact
2006	(64,200)	(100,000)	0	107,695	0	0	7,695	(40,000)	(56,505)	60,000	3,495
2007	(68,694)	(100,000)	0	109,169	0	0	9,169	(40,000)	(59,525)	60,000	475
2008	(73,502)	(100,000)	0	113,721	0	0	13,721	(40,000)	(59,781)	60,000	219
2009	(78,648)	(100,000)	0	118,334	0	0	18,334	(40,000)	(60,315)	60,000	(315)
2010	(84,153)	(100,000)	0	127,178	0	0	27,178	(40,000)	(56,975)	60,000	3,025
2011	(90,044)	(100,000)	0	127,787	0	0	27,787	(40,000)	(62,257)	60,000	(2,257)
2012	(96,347)	(100,000)	0	137,787	0	0	37,787	(40,000)	(58,560)	60,000	1,440
2013	(38,891)	0	0	41,692	0	0	41,692	0	2,801	0	2,801
2014	(41,614)	0	0	51,723	0	0	51,723	0	10,109	0	10,109
2015	(44,527)	0	0	55,427	0	0	55,427	0	10,900	0	10,900
Cumulative											
Year 10	(680,620)	(700,000)	0	990,511	0	0	290,511	(280,000)	(390,108)	420,000	29,892
Year 20	(1,338,883)	(700,000)	0	1,778,274	0	0	1,078,274	(280,000)	(260,608)	420,000	159,392
Year 30	(1,976,589)	(700,000)	0	3,194,689	0	0	2,494,689	(1,653,850)	518,100	420,000	938,100
Year 40	(2,060,777)	(700,000)	0	5,686,965	0	0	4,986,965	3,346,189	2,926,188	420,000	3,346,188
Life of Plan	(2,060,777)	(700,000)	0	5,686,965	0	0	4,986,965	3,346,189	2,926,188	420,000	3,346,188
NPV Rate 5.00%		NPV (692,164)			NPV 0			NPV 223,643			P&L Impact 3,346,188
							Internal Rate of Return	6.74%			

Benefits



Comparison Mutual Funds to COLI

Comparison Tax Managed Funds to COLI

Year	(1) Net P&L Mutual Funds	(2) Net P&L COLI	(3) Difference
2006	291	3,495	3,204
2007	541	475	(66)
2008	691	219	(472)
2009	728	(315)	(1,042)
2010	640	3,025	2,385
2011	412	(2,257)	(2,669)
2012	29	1,440	1,411
2013	(818)	2,801	3,619
2014	(1,815)	10,109	11,924
2015	(2,924)	10,900	13,824
Cumulative			
Year 10	(2,225)	29,892	32,117
Year 20	(125,120)	159,392	284,512
Year 30	(321,859)	938,100	1,259,958
Year 40	(362,123)	3,346,188	3,708,311
Life of Plan	(362,123)	3,346,188	3,708,311
Internal Rate of Return	4.43%	6.74%	2.31%

Benefits



COLI versus Improved COLI

COLI, What a Difference a Product Makes

Year	(1) Net P&L COLI	(2) Net P&L Improved COLI	(3) Difference
2006	3,495	7,422	3,928
2007	475	4,054	3,580
2008	219	4,182	3,963
2009	(315)	3,995	4,309
2010	3,025	7,059	4,034
2011	(2,257)	2,549	4,806
2012	1,440	6,296	4,856
2013	2,801	3,291	490
2014	10,109	10,839	730
2015	10,900	13,047	2,147
Cumulative			
Year 10	29,892	62,734	32,842
Year 20	159,392	226,139	66,747
Year 30	938,100	1,059,684	121,584
Year 40	3,346,188	3,562,647	216,459
Life of Plan	3,346,188	3,562,647	216,459
Internal Rate of Return	6.74%	6.86%	0.12%

Voluntary Nonqualified Deferred Compensation



FAS 106 and Retiree Medical Costs

- ❑ Use of VEBA funding to offset FAS 106 expense
- ❑ Life insurance as VEBA asset
 - ◆ Impact to tax deductions, balance sheet

Voluntary Nonqualified Deferred Compensation



Nonqualified Plans and Company Stock

- FAS 123R
- Company stock in nonqualified plans

Voluntary Nonqualified Deferred Compensation



Where to go for more information:

- Go to FASB's website <http://www.fasb.org/>
- Free downloads of...
 - Statements – e.g., FAS87
 - Interpretations – e.g., FIN44
 - Concept Statements – e.g., Concepts No. 6
 - Titles of all EITF Issues (but not the issues themselves)
- Go to SEC's website for free download of SAB99 on materiality



William L. MacDonald
Chairman, President & Chief Executive Officer

Retirement Capital Group, Inc.
12340 El Camino Real, Suite 400
San Diego, CA 92130
Toll-Free: 866-RCG-4TRS (724-4877)
Phone: 858-677-5900
Fax: 858-677-5915
E-mail: wmacdonald@retirementcapital.com
Website: www.retirementcapital.com

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