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**RetirementDNA**

Mapping Retirement & Executive Benefits For Biotech and Life Sciences Leaders

RETIREMENT PLANS ■ EXECUTIVE DEFERRED COMPENSATION ■ COMPENSATION CONSULTING

**Finding, Winning & Keeping The Best &  
Brightest With A Deferred Compensation Plan**

***A Primer on Non-Qualified Deferred Compensation Plans  
For BIOCOM Members***

September 14, 2006

# RetirementDNA

Mapping Retirement & Executive Benefits  
For Biotech and Life Sciences Leaders

RETIREMENT PLANS ■ EXECUTIVE DEFERRED COMPENSATION ■ COMPENSATION CONSULTING

## Retirement & Executive Benefits Services To Match Your Corporate Lifecycle

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### Spotlight On Science

#### Joe Panetta

Chief Executive Officer  
BIOCOM

Leading the premiere biotech and  
life sciences association representing  
450 member companies in  
San Diego and Southern California.



### Discovery Abstracts

Understanding Non-Qualified  
Deferred Compensation (NQDC)

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# About Retirement DNA

Find. Win. Keep.

## Services

- Company Sponsored Retirement Programs
- Executive Benefits and Deferred Compensation
- Compensation Consulting

## What We'll Cover Today

- ' Why Even Consider A Deferred Compensation Plan
- ' How Non-Qualified Deferred Compensation (NQDC) Plans Work
- ' How NQDC Plans Are “Informally Funded”
- ' How Do Executives Know They'll Receive Their Money: Benefit Security Issues
- ' Designing A Plan For Your Company
- ' Section 409A: The Compliance Clock Is Ticking

## Why Consider A Non-Qualified Deferred Compensation Plan

“Your people [employees] are not your best assets. Your best people are your best assets. Everyone else is cannon fodder”

- Dick Marcinko

The Rogue Warrior

Legendary Navy SEAL Commander

## Why Consider A Non-Qualified Deferred Compensation Plan

- ' Your best and most highly compensated people need to save money for retirement, college and other financial needs
- ' The 401(k) plan is usually inadequate as a retirement and tax savings strategy for highly compensated executives
- ' \$15,000 deferral amount in 2006 may only replace a small amount of retirement income for your high earners
- ' The 401(k) plan could be as insignificant as Social Security to a high earning executive
- ' The result is a substantial “income replacement gap” for high earners
- ' When properly designed, NQDC can be a powerful “Find, Win, Keep” tool to attract the best and brightest

## How NQDC Plans Work Basics

### Qualified vs. Non-Qualified plans

- ' Retirement plans deemed to be “qualified” under ERISA include the 401(k) plan
- ' Qualified plans have contribution limits - \$15,000 in 2006 (\$20,000 for age 50+)
- ' Non-discriminatory guidelines as well as a host of other ERISA compliance issues
- ' Note: qualified plans are really reverse discrimination for high earners because they limit their savings ability!

How to address savings and income replacement gap  
problem created by ERISA for high earners?

## How NQDC Plans Work Basics

### Sponsor a NQDC plan

- ' Non-qualified plans are **not** subject to the filing, funding or fiduciary responsibilities under ERISA
- ' Provides executives with a “non-qualified” savings plan
- ' Allows executives to defer a portion of salary, bonus and other compensation in excess of the 401(k) limits; IRC allows unlimited funding of NQDC plans
- ' The allowable deferral amount – X% of salary and Y% of bonus - is set by the company and is part of the plan design process
- ' Best Practice: 80% - 90% of salary and 100% of other comp

## How NQDC Plans Work Eligibility

But which executives can you allow to participate?

- ' Plan must be for a “select group of highly compensated employees”
- ' Often referred to as “top hat” plans
- ' Rule of thumb: employees who earn in excess of \$100,000 annually; commission-based sales employees are also eligible
- ' Growing trend is to include middle management as eligible participants
- ' NQDC plans are intentionally “selective” and discriminatory

## How NQDC Plans Work Tax Issues

- ' The participant in a NQDC plan is not taxed on the amounts deferred until the money is received by them
- ' The company sponsoring a NQDC plan cannot take a compensation expense deduction at the time of the deferral by the executive
- ' The company instead books a deferred tax credit equal to the amount deferred and takes a deduction when the deferral amount is paid to the executive
- ' The company also records the deferral as a liability on its balance sheet
- ' The executive, of course, has an asset, equal to the company's liability

## How NQDC Plans Work Assets & Liabilities

- ' Asset / liability separation between executive's account and company's assets is required as plans must be "unfunded"
- ' Executive elects:
  - \_ Deferral amount
  - \_ Allocation of hypothetical investments (menu selection provided by the employer)
  - \_ Time and form of payout
  - \_ Reallocation of account balance
- ' Employer:
  - \_ Establishes Rabbi Trust to receive executive deferral amounts and directs Trust to invest the money into a "funding" vehicle that models closely / correlates strongly to the hypothetical investments provided to the executives
  - \_ The "funding" vehicle selected by the employer ideally has investment options similar to executive's investment choices; Trust assets will be reallocated when executives reallocate to maintain asset / liability relation

## How NQDC Plans Work Distributions

- ' The executive's ability to manage their "distribution options" is a major attraction of NQDC plans; 409A rules allow for excellent strategies
  - \_ Each amount deferred can be allocated to multiple distribution "buckets" each with its own payout schedule
  - \_ Participant can take short-term, in-service distributions (as early as three years from the year of deferral)
  - \_ Ability to re-defer any distributions for a minimum of five years as long as you elect to re-defer one year before the original distribution is scheduled
  - \_ Retirement benefits can be paid lump sum or over 5 – 20 years
- ' Taxes are reconciled when distributions are taken: executive pays taxes and company takes deduction
- ' Distribution "buckets" – a closer look

## Distribution “Buckets”

- 45 year old CFO; \$250,000 base salary; \$100,000 bonus
- Defers 20% of base and 100% of bonus – total deferral of \$150,000
- Goals: college costs for eight years starting in four years; purchase second home in 10 years; retire in 15 years
- Distribution “bucket” allocation:

	<u>College 1</u>	<u>College 2</u>	<u>Second Home</u>	<u>Retirement</u>
Allocation	15%	15%	25%	45%
Amount	\$22,500	\$22,500	\$37,500	\$67,500
Paid Out	2010	2012	2016	2021
Years	4	4	1	20

## “Informally” Funding NQDC Plans

But I thought you said NQDC plans could not be funded?

- ' We did! Let's clarify between “unfunded” and “informally funded”
- ' “Unfunded” means that all money deferred by a participant becomes a general account asset of the company and cannot be set aside to “guarantee” the plan's future obligations
- ' If the company goes bankrupt or insolvent, the amounts deferred by plan participants are subject to the “claims of the creditors” as company assets
- ' Contrast this with 401(k) assets – as a “qualified” plan, assets in the plan have ERISA protection and cannot be used by company creditors

## “Informally” Funding NQDC Plans

- ' The “unfunded” aspect of NQDC plans is the reason for its tax-deferred status (risk of forfeiture by executive and lack of constructive receipt) for participants
- ' The exposure of plan assets to general creditors is why only highly compensated employees may participate
- ' The Department of Labor has determined that highly compensated employees must be intelligent and therefore can understand the trade-off between tax-deferral and asset risk on deferrals
- ' We’ll be discussing “benefit security” a bit later

## “Informally” Funding NQDC Plans

- ' Remember, formal funding is required with qualified plans – the money is invested and out of reach of general company creditors
- ' Informal funding refers to the company investing participant deferrals (company asset) to try and match the liability to its executives; an asset / liability management strategy
- ' Even when a company invests and informally funds the NQDC plan, these assets are still subject to creditor claims – even if held in a Rabbi Trust
- ' Best Practice: 90% of Fortune 500 companies informally fund their NQDC plans; more than ever, Board members want to see future obligations covered

## “Informally” Funding NQDC Plans Funding Vehicles

- ' Any asset can be used by company, but most common choices are mutual funds or COLI (corporate owned life insurance)
- ' Prevalence: 70% of F500 with NQDC plans fund with COLI
- ' COLI products have high prevalence due to the tax advantages that they deliver
- ' COLI: investment gains, dividends and interest are tax-free if held to maturity
- ' Mutual funds: taxable to the corporation
- ' COLI products cost more than mutual funds, but are still less expensive than the tax bite
- ' 7% net investment return: COLI would deliver 1.75% higher “net net” return

## **“Informally” Funding NQDC Plans Rabbi Trust**

- ' Most companies informally funding also use a Rabbi Trust – an irrevocable trust to hold the assets
- ' Rabbi Trust protects participants from a broken promise by the company
- ' Rabbi Trust does not protect against bankruptcy
- ' Important protection for NQDC participants

## Executive Confidence Benefit Security Issues

- ' Executives like tax-deferral on income they don't need today to would like to set aside for a specific goal
- ' Choosing to defer money also means choosing to trust the company's promise and ability to pay the money in the future
- ' The company's promise has to remain an "unsecured" promise with the executive's money subject to "general creditors"
- ' The "promise" is the cog in the wheel ...or what makes the wheel fall off

## Executive Confidence Benefit Security Issues

- ' Two other rules of the road in order to not sink a hole in the tax protection
  - \_ **Constructive Receipt** – must comply with rules under IRC Section 409A governing deferral elections and distribution payouts
  - \_ **Economic Benefit** – participant cannot receive any incidental economic benefit while the money is deferred
- ' 409A Deferral Rules
  - \_ Salary deferral elections need to be made in the calendar year prior to earning the salary
  - \_ Performance based bonus compensation deferral election can be made up to six months prior to the end of the performance period

## Executive Confidence Benefit Security Issues

- ' Rabbi Trust – irrevocable trust that protects participants from most contingencies, short of bankruptcy
- ' The 3 C's - Change of control, change of heart and change in financial condition

Best Practices can add two additional safeguards

- ' Fiduciary Clause – fiduciary responsibility for interpreting the plan is placed in friendly or third-party hands rather than an “admin committee” which could change after a change in control or change of heart by management
- ' Moglia Rabbi Trust – the “Moglia language” should be used which states that the assets are “subject to the claims of the unsecured general creditors.” The unsecured general creditor line may be shorter than the secured creditors; Bank of America N.A. v. Moglia is the legal precedent

## Designing A Plan Considerations

- ' Some key questions
  - \_ Who is it for and what is the purpose? Multiple purposes?
  - \_ Employee deferral or employer contributions? Or both?
- ' Common purposes for NQDC plan are:
  - \_ Finding and winning key employees
  - \_ Retaining key employees
  - \_ Rewarding key employees
  - \_ Incentive for key employees
- ' NQDC plans can serve all four, but it is helpful to rank your company's priorities

## Designing A Plan: Considerations

<b>Retain Key Employee</b>	<ul style="list-style-type: none"><li>' Tight vesting on company match or contribution</li><li>' Loss of benefit if joining competitor</li><li>' Excess interest credit if they stay until retirement</li></ul>
<b>Recruit Key Employee</b>	<ul style="list-style-type: none"><li>' High level of deferrals; defer signing bonus</li><li>' “Teeth” on the vesting</li><li>' Company contribution to achieve objectives</li><li>' Short-term distribution and flexibility</li></ul>
<b>Incentive For Key Employee</b>	<ul style="list-style-type: none"><li>' Company match based on individual, unit or company performance</li></ul>
<b>Reward Key Employee</b>	<ul style="list-style-type: none"><li>' Great deal of flexibility</li><li>' High deferral limits</li><li>' Many investment options</li></ul>

## Designing A Plan: Considerations

- ' A company may have multiple different NQDC plans
- ' Deferral only program for middle management
- ' SERP design for senior management or just the CEO and a smaller group
- ' A single plan can also have multiple classes of participants with different restrictions
- ' The key is to go through a comprehensive process for designing and/or reviewing an existing plan
- ' DeferredCompAudit is our process
- ' Guarantee that if a plan has not been reviewed in the last two years, we'll find savings or opportunity for improvement or all consulting fees are reimbursed

## 409A Update The Clock Is Ticking

- ' Section 409A created by the American Jobs Creation Act; generally effective on January 1, 2005
- ' September 2005 – IRS issued proposed regulations for Section 409A
- ' Compliance with 409A required by December 31, 2006
- ' Companies should be well on their way toward plan compliance by 12/31/06
- ' If you have not started yet, it's not too late – but start asap!
- ' Plan documents must be adopted and amended by 12/31/06

## 409A Update The Clock Is Ticking

- ' 409A applies to any arrangement that defers compensation
  - \_ Excludes tax-qualified plans, welfare plans, certain “stock rights” plans, some severance plans and “short-term deferrals”
- ' Dictates when deferral elections must be made
- ' Restricts flexibility on distributions (no haircut provisions and benefit acceleration provisions)
- ' Restricts some funding options such as offshore trusts
- ' Requires informational reporting of deferrals on IRS W-2 statement and 1099

## 409A Update The Clock Is Ticking

- ' Applies to amounts deferred after 12/31/04
- ' Deferred comp earned and vested before 1/1/05 may be maintained under the plan document in effect on 10/3/2004
- ' Companies may need to keep and administer two plans – old money and 409A money
- ' Cost / benefit analysis should be done for the maintenance of two plans

## 409A Update: The Clock Is Ticking

- ' SERP plan designs that are linked to a qualified plan need review as it relates to their distribution
- ' Discounted stock options and SARs
  - \_ A discounted “stock right” may be replaced with a non-discounted stock right through 12/31/06
  - \_ Non-discounted stock right is not subject to 409A
  - \_ The amount of the “discount” may be preserved in the form of a credit to a participant’s deferred comp account
- ' Distribution payment elections (time and form of payment) may be made through 12/31/06 without triggering an impermissible subsequent deferral or acceleration

## 409A Update The Clock Is Ticking

- ' Overall, 409A is reasonable and better than expected
- ' With proper discussion, some excellent planning opportunities are available to companies and participants
- ' The key will be whether or not a company's existing plan administrator can handle the flexibility that participants will want
- ' Creative plan design greatly enhances the value to executives, but plan admin should not be a creativity censor

## Summary

- ' Great employees are a must and they must be paid well
- ' High earning employees need to save for their goals and tax-deferral is a powerful incentive to save
- ' NQDC plans allow for great companies to find, win and keep great people through a selective benefit program
- ' DeferredCompAudit process drives great plan design
- ' With proper funding, the plan can be cost neutral to shareholders
- ' Existing plans need to be in compliance with 409A by 12/31/06
- ' 409A allows for a new level of creativity that benefits companies and participants

# Additional Resources

[www.biocom.org](http://www.biocom.org)

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## **Deferred Compensation Plan Design to Maximize Benefit Security & Retirement Income**

**October 12, 2006 11:00-12:00**

- \_Strategies for Maximizing Benefit Security
- \_“MOST” Deferral & Withdrawal Strategy
- \_ISOP Alternative

## **Carving Out Executives for Other Key Benefits**

**November 9, 2006 11:00-12:00**

- \_ Executive Long Term Care Insurance
- \_ Executive Disability Insurance
- \_ Deferred Compensation

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