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the shareholder-friendly deferred compensation plan

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QUICK LOOK

- According to a recent study, traditional nonqualified deferred compensation plans are found at more than 90 percent of Fortune 1,000 companies.
- The value proposition inherent to NQDC is eliminating the limit on the maximum amount that can be deferred by the employee and mimicking, to the extent feasible, the 401(k) plan environment for participants.
- There are problematical aspects of NQDC plans in the eyes of many shareholders. From a practitioner's standpoint, the biggest concern seems to be situations in which NQDC plans cease to be retirement savings vehicles and morph into another form of compensation.

Starting in 2007, corporate proxy statements will include full disclosure of the internal mechanics of nonqualified deferred compensation arrangements (NQDC). Given the intense controversy generated earlier this year when Pfizer *voluntarily* disclosed CEO Hank McKinnell's supplemental pension, should companies be concerned how such plans are likely to be perceived by shareholders? Is there such an animal as a "disclosure-friendly" deferred compensation plan?

Absolutely. This article provides an overview of best practices for structuring and reporting nonqualified deferred compensation plans, including how to avoid potentially problematical plan provisions.

What is Deferred Compensation and Why Does It Exist?

Let's begin with a common understanding of the rationale of traditional NQDC plans, which a recent survey by Clark Consulting found are in place at more than 90 percent of the Fortune 1,000 companies.

NQDC plans are more easily understood when compared to the most popular and

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important defined contribution plan, the 401(k) plan. Participation in a 401(k) plan offers numerous advantages to the plan sponsor and the participant. The company receives a current tax deduction for monies contributed to the plan, while the participant postpones payment of taxes on any funds that are deferred. Additionally, 401(k) account balances grow on a tax-deferred basis and by law are beyond the reach of corporate creditors.

The maximum amount that an individual employee can contribute to a 401(k) plan in 2007 is $15,500, and then only if the plan meets specific nondiscrimination testing requirements. The problem is that $15,500 of annual deferral opportunities not only is inadequate for most executives' retirement-planning needs, but many executives end up being precluded from deferring the full amount because of the nondiscrimination standard.

The value proposition inherent to NQDC is eliminating the limit on the maximum amount that can be deferred by the employee and mimicking, to the extent feasible, the 401(k) plan environment for participants. There are trade-offs to the benefit. For example, the corporation does not receive a current tax deduction at the time of employee deferrals. Also, the participant effectively receives an "IOU" from the corporation, stating that the deferrals (plus corresponding gains) will be returned at some future date. The participant is not taxed currently on the funds deferred, and the NQDC balance grows on a tax-deferred basis. However, and importantly, the participant's NQDC balance is *not* shielded from corporate creditors.

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The principal attributes of a modern "Best Practice" NQDC plan are as follows:

Participant Attributes

- Defer compensation on a pretax basis through automatic payroll deductions.
- Reduce current federal income tax rates.
- Accumulate future assets on a tax-deferred basis to supplement retirement income.
- Invest in variable measurement funds that mimic the performance of equity and fixed-income investments (like a 401(k) plan).
- Permit distributions at a future date prior to retirement for payment of college tuition, second home, stock exercise, etc.

Corporate Attributes

- Low-cost executive benefit
- Recruiting vehicle to provide "make whole" contributions for executive recruiting (e.g., bonus foregone in changing jobs)
- Retention vehicle when company contributions are made with vesting schedules
- Flexibility to selectively choose plan participants (unlike broad-based plan requirements)
- Neutral to favorable impact on corporate earnings when an informally financed plan experiences positive returns.

As noted earlier, if not for legislative limits on the amounts that can be deferred into a qualified plan, nonqualified deferred compensation plans would not exist. Instead, executives would simply defer more of their compensation into their 401(k).

Why the concern?

Although the concept of deferral seems benign, there are problematical aspects of NQDC plans in the eyes of many shareholders. From a practitioner's standpoint, the biggest concern seems to be situations in which NQDC plans cease to be retirement savings vehicles and morph into another form of compensation.

The confusion is understandable given that "nonqualified deferred compensation" is a generic label for a tremendous variety of plans. While all such NQDC plans are based on delaying the receipt of income to a future date, that's where the similarity ends. Most NQDC plans are elective savings programs; some place a heavy emphasis on corporate contributions. Some NQDC plans involve fixed crediting rates; others

offer multiple investment choices that resemble a 401(k) plan.

Depending on the specific structure of an NQDC plan, disclosure in the proxy may skew shareholder and investor perceptions of the company's overall executive compensation philosophy. The NQDC plan attributes that are most likely to draw the attention of shareholders when fully disclosed in the proxy statement are as follows:

- Above-market, fixed-interest crediting rates that are not linked to company performance
- Company contributions that exceed amounts necessary to make up for qualified plan limitations (i.e., 401(k) matching, profit share matches, etc.)
- Adverse accounting and tax treatment of nonqualified deferred compensation
- Rabbi trust.

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Above-market interest-crediting rates

It may be conjecture, but arrangements that provide preferential, guaranteed interest rates will be unpopular with the investment community. The investor's argument is simple: "If I cannot get a guaranteed, above-market rate of return from the corporation, why should the executives?" It's a good question.

Shareholders should not be disgruntled if the corporation invests in an asset that mirrors the after-tax cost of the participant's crediting rate *and* accounts for the corporation's cost of borrowing. In such a scenario, the benefit may be disclosure-friendly and practically cost-neutral. To get credit, a corporation should communicate this benefits-financing strategy in the narrative portion of the proxy. From a practical standpoint, plan sponsors will have difficulty finding assets that can provide after-tax fixed returns higher than 7.5 percent in today's market environment. Therefore, such financing strategies will not directly resolve the problems inherent to most above-market plans.

If the board has the flexibility to change the plan's crediting rate, a viable solution exists by changing the fixed crediting rate to one that varies based on the performance of variable investments. The participants would not be given a guaranteed interest-crediting rate. Instead, they would have the opportunity to create an investment portfolio that meets their respective investment-risk tolerance and objectives. This "Best Practice" design allows the corporation to effectively hedge the liability by mirroring the participant's investment choices and removes the concern of a runaway liability. If the corporation is not a normative taxpayer, this financing strategy may be accomplished through the purchase of institutionally priced mutual funds. If the corporation is a taxpayer, it may necessitate the purchase of tax-advantaged assets to mimic the after-tax return of the participant. In either case, the NQDC benefit coupled with this financing strategy will disclose better than a fixed-rate plan.

Although participants will not be pleased with losing their high crediting rates, they should not dismiss the value of the program. As Albert Einstein once said, "The most powerful force in the universe is compound interest." Einstein's statement remains true in both the 401(k) and the nonqualified deferred compensation plan.

Company contributions in excess of qualified plan formulas

Most qualified retirement savings programs utilize company matching formulas that are based on base salary. Nonqualified plans often change the definition of compensation to include incentive and other types of compensation. Company contributions that go beyond restoring benefits that would have been received if not for government limitations will be deemed additional compensation under the new executive pay disclosure rules.

It is suggested that every corporation analyze its matching provisions. Dollar-for-dollar matches, even if they are designed as retention vehicles, are additional forms of compensation. Matches that restore benefits that are lost due to

government limitations or matches that restore lost benefits that are attributable to participation in the deferred compensation plan will make sense to investors when disclosed. In all cases, make certain that your narrative discussion adequately addresses the purpose of each component of additional compensation.

It is possible that the NQDC program will result in more shareholder-friendly disclosure if adverse accounting and tax effects are mitigated.

Accounting and tax treatment of nonqualified deferred compensation

The regulations suggest that the Compensation Discussion & Analysis ("CDA") discuss "the impact of accounting and tax treatments of a particular form of compensation." As discussed earlier, a company must delay recognition of a compensation tax deduction when a participant defers income. In lieu of an immediate tax deduction, corporations book a deferred tax asset that grows (or declines) with the participant account balance. The corporation also books a liability for the NQDC balance and effectively receives the cash for the compensation deferred to the corporation.

With the above in mind, it may be prudent to perform an analysis of the income statement, cash flow and balance-sheet accounting implications of the NQDC program. Also, consider a review of after-tax financing strategies to improve the financial statement and proxy effects of the deferral program(s). Assets are readily available to hedge against all but the most generous guaranteed fixed-interest rates.

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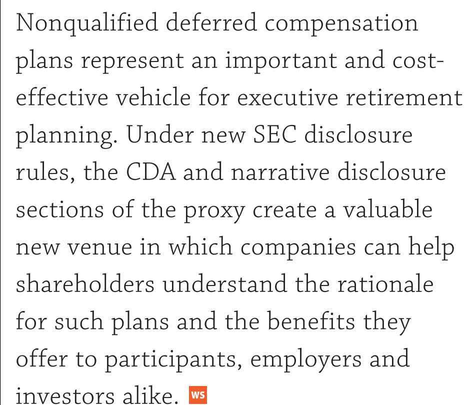
Rabbi trust

A Rabbi trust is an irrevocable trust set up by the employer to help ensure payment of nonqualified benefits obligations such as deferred compensation. It is the most common security device for nonqualified deferred compensation plans. Generally, monies placed into the Rabbi trust cannot be accessed by the employer, but are within the reach of creditors of the company in the event of corporate insolvency or bankruptcy. Hence, the Rabbi trust remains on a corporation's balance sheet.

From a participant's perspective, the trust helps protects participants against events such as a corporate change-in-control or a company's change-in-heart, but does not protect participants against corporate insolvency or bankruptcy. Assets placed into the Rabbi trust are not taxable to the participant until paid or received. The trust's investment income is taxable to the corporation.

Although the actual cost of the Rabbi trust is *de minimus*, shareholders may have conceptual problems with trust contributions that reduce a corporation's working capital. The narrative disclosure is the appropriate forum to address such concerns. Absent legislative limits on contributions, the executive would have an irrevocable, *bankruptcy-proof* trust. To the extent possible, the Rabbi trust attempts to mimic the qualified plan environment.

Summary



Nonqualified deferred compensation plans represent an important and cost-effective vehicle for executive retirement planning. Under new SEC disclosure rules, the CDA and narrative disclosure sections of the proxy create a valuable new venue in which companies can help shareholders understand the rationale for such plans and the benefits they offer to participants, employers and investors alike. WS

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