GOING BEYOND THE 401(K)

Understanding the benefits of incentive plans

Jan. 31, 2019
Objectives

• By the end of this webcast, participants will be able to
  – Recognize and describe deferred compensation plans other than 401(k) plans
    • Qualified Plans
    • Nonqualified Plans
  – Identify plans may benefit various clients
Goals for incentive and retirement compensation

• Attract, retain and reward talent
  – Establish longer-term goals
  – Incentivize specific performance
  – Certain owner benefits

• Protect employees and their families with longer-term income

• Allow an orderly transition of employees at retirement age
## Broad categories of plans

<table>
<thead>
<tr>
<th>General terms</th>
<th>Qualified plans</th>
<th>Nonqualified plans</th>
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</thead>
<tbody>
<tr>
<td>Eligibility</td>
<td>Broad-based plans that cover both highly compensated and nonhighly compensated employees; Discrimination rules apply; Can cover employees and partners, not directors</td>
<td>Top employees only; No discrimination rules</td>
</tr>
<tr>
<td>Employee protection</td>
<td>Held in trust, safe from bankruptcy, limited distribution timing</td>
<td>Not held in trust</td>
</tr>
<tr>
<td>Employer deduction</td>
<td>Contributions are deductible when made to the trust</td>
<td>Deductible only as distributed and included in taxable compensation</td>
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<tr>
<td>Employee income</td>
<td>Taxable when distributed; can rollover tax deferred to IRAs and other qualified plans</td>
<td>Taxable when distributed</td>
</tr>
<tr>
<td>Design flexibility</td>
<td>Limited flexibility</td>
<td>Flexible within section 409A rules</td>
</tr>
<tr>
<td>Examples</td>
<td>401(k) plans&lt;br&gt;Elective contributions&lt;br&gt;Matching contributions&lt;br&gt;Profit sharing plans&lt;br&gt;Defined benefit plans</td>
<td>Long-term incentive plan&lt;br&gt;Supplemental executive retirement plan&lt;br&gt;Stock appreciation rights&lt;br&gt;Employee elective deferrals</td>
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Overview

• SEPs
  – Held in IRAs
    • Very few administrative requirements
    • No Form 5500 filings
  – Rigid contribution structure, cover almost all employee
  – Employer-only contributions
    • Limits much like profit sharing plans
  – May have SEP WITH a 401(k) plan – 401(k) elective contributions and small match, SEP for additional employer contributions

• Can cover employees and partners, not directors (directors can set up their own plans, as contractors)

• Ideal profile: Smaller companies with less administrative support in-house; Willing to make employer contributions for broad employee base to support contributions for highly compensated employees
Qualified retirement plans

• Profit sharing plans
  – Built on the same platform as the 401(k) plan
  – Additional employer contributions using one of several formulas
    • Not required to be tied to profits
    • Can be discretionary – Board decides percentage or amount each year
    • Contributions be focused, in some cases, but cannot be “discriminatory” in favor of the highly compensated group
Qualified retirement plans (cont.)

• Profit sharing contribution limits
  – Compensation considered for percentage of compensation contributions - limited to Section 401(a)(17) limit - $280,000 for 2019
  – Maximum contribution
    • Lesser of
      • 100 percent of compensation
      • $56,000 per employee (less any 401(k) and matching contributions)
Formulas

• Percent of salary
• Percent of profits (as defined)
• Discretionary amount – allocated based on individual compensation/total participant compensation x contribution amount
• Age-weighted formulas
• Percent of compensation for nonhighly compensated and narrow group of highly compensated
  – Matching contribution + additional contribution can support higher contribution for small group of highly compensated employees (HCE)
• Ideal profile: Companies with electives and matching that want another “safe” form of long-term savings; Family owned, closely held, few highly compensated employees, etc.
Cash balance defined benefit plans

• Qualified retirement plans
  − Designed to mimic defined contribution plans to assist employees in understanding and valuing the plan
  − Balances do not change based on market value – the employer funds a promised benefit
  − “Service credit” for each year of service
  − “Interest credit” for each year – generally with a minimum interest credit

• Small, top-heavy companies may find these plans useful, especially to allow older owners to catch up on retirement savings

• Maximum deductible contributions can be quite high

• Benefits must be “nondiscriminatory,” but can be focused to support a benefit for a narrow group of HCEs and a broader group of nonhighly compensated employees
Cash balance defined benefit plans (cont.)

• Generally employer-only contributions

• Maximum benefit
  – 100 percent of the participant's average compensation for his or her highest three consecutive calendar years, or
  – $225,000 for 2019 ($220,000 for 2018)

• Maximum benefit not attained until plan is in existence for 10 years. Plan must generally remain in existence for at least four years.

• Ideal profile: Smaller or closely held company with high compensation and only a few nonhighly compensated employees
Partnership qualified plan points

• Partners cannot establish their own separate SEPs or qualified plans based on partnership income
• Partners can only make qualified plan contributions out of net income from self employment (SECA income)
• Partnership contributions for partners generally allocated to individual partners, reported as guaranteed payments and are then deductible on individual Forms 1040
• However, a broad-based defined benefit plan covering partners and employees can be treated
  – As a partnership expense deductible by the partner (and thus not subject to SECA), or
  – As allocated to each partner
Employee stock ownership plans

• Primarily invests in employer common stock
  – May be built onto 401(k) or separate
  – Ownership of share held by retirement trust, not employees

• Special tax advantages to ESOPs

• Unique ability to borrow funds to purchase employer stock
  – Leveraged model – employer contributes cash to ESOP, ESOP makes loan payment, shares are released to employee accounts over time
  – Unleveraged model – employer contributes shares/cash over time
Employee stock ownership plans (cont.)

• Ideal profile
  – Size, industry not necessarily indicative
  – Ownership transfer desired
  – Strong financial performance
  – Supportive culture
## Qualified plan pros and cons

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<tr>
<th>Pros</th>
<th>Cons</th>
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<tbody>
<tr>
<td>Early deduction</td>
<td>Significant administrative requirements</td>
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<tr>
<td>Employer contributions never subject to FICA (elective contributions are subject to FICA, partnership contributions subject to SECA)</td>
<td>Limits on contributions, especially to HCEs</td>
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<tr>
<td>Employee loans available from trust</td>
<td>Required to cover cross section of nonhighly compensated employees</td>
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<tr>
<td>Held in safe trust</td>
<td>Form 5500 filing (and required audit, for larger plans)</td>
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<tr>
<td>Rolloverable to allow further deferral</td>
<td>Errors affect the plan – correctible but correction can be costly</td>
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<td>10 percent early distribution penalty (compared to 20 percent penalty for nonqualified plan failures)</td>
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NONQUALIFIED DEFERRED COMPENSATION PLANS
Nonqualified deferred compensation plans

- Participants not taxed until distribution, even if plan vests earlier (other than tax exempt entities)

- Typical plan structures
  - Elective contribution plans (defer salary or bonus)
  - Restricted stock unit plans/phantom stock plans
  - Supplemental Executive Retirement Plans (SERPs) - Defined benefit plan arrangements paying on employee retirement or separation
  - Excess benefit plans – paired with qualified plans

- Pay as lump sum or over time, based on design or employee choices

- Can cover employees, partners and contractors (directors, usually)

- Plans are technically “unfunded” – participants are unsecured creditors of company in bankruptcy
Section 409A basic design rules

• Meet section 409A rules or 409A exemption rules
• Typical exemptions
  – Short term deferral plans (unvested, required to fully distribute soon after vesting event – 2.5 month rule)
  – Stock options or stock appreciation rights granted at Fair Market Value (FMV) on employer shares
    • Employees can be allowed to decide when to exercise
  – Involuntary separation plans
Section 409A requirements

- Written plan document
- Elections to defer generally must be made in year before amount is otherwise earned
  - Elect in December 2018 to defer compensation earned in 2019. Elect performance bonus deferral no later than six months before payment would otherwise occur.
- Distribution timing, event and method must be stated up front
- Only certain distribution events are permitted
  - Death, disability, 409A change in control, 409A separation from service, stated date or unforeseen hardship
- Very little employer or employee discretion to accelerate or decelerate payments (but “subsequent election” may allow a five year delay in payment)
Common plan designs

• Elective contribution plans, sometimes with match
  - Employee can be allowed to choose distribution events and distribution type (Lump sum, installments)

• Restricted stock unit or phantom plans/Long term incentive plans
  - Generally paying stock (or cash based on stock value) of company after vesting period

• Deferred bonus plans – award some bonus in cash, some over several years (may be “short term deferral plans or vest over time and pay at a future date or permitted event)
  - Aids in retention

• SARs (may be exempt or not)

• Discounted stock option plans – meeting section 409A, not exemption rules

• SERPs – retirement plans for top employees – often paid over several years after retirement
### Nonqualified deferred compensation pros and cons

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<tr>
<td>Successful deferral if properly administered</td>
<td>Not “funded” – not safe in bankruptcy</td>
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<tr>
<td>Fairly flexible designs (within section 409A constraints)</td>
<td>On books as an expense but no tax deduction until distribution</td>
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<td>Can discriminate, can have different designs or formulas for different people or groups</td>
<td>FICA/SECA applies to the employer and employee contributions</td>
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<td>Helps with retention and provides significant incentives/rewards for success</td>
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Contact information

Anne Bushman

 anne.bushman@rsmus.com
📞 202.370.8213

Karen Field

 karen.field@rsmus.com
📞 202.370.8194

Brent Hulbert

 brent.hulbert@rsmus.com
📞 515.237.7412

Eric Carroll

 eric.carroll@rsmus.com
📞 212.372.1281
THANK YOU FOR YOUR TIME AND ATTENTION