Moving from a DB Executive Retirement Plan to a DC Executive Retirement Plan

An analysis of the tax, accounting, regulatory and design factors unique to nonqualified plans.

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Part One – Overview

The Current Environment for Retirement Benefits

The general trend in qualified, company-sponsored retirement plans is to freeze, or even terminate, defined benefit (DB) pension plans and instead utilize defined contribution (DC) plans. Examples of DC plans are profit sharing, money purchase, and 401(k)s. These plans are often designed as flat-dollar amount, flat percentage of pay, integrated with Social Security, age- or service-based or some combination. While there are many reasons cited for the changes, most fall into one of these categories:

- **Volatile cost** – New funding rules introduced by the Pension Protection Act are overly complicated to many plan sponsors. These rules have various thresholds and cliffs that add to the volatility in required contributions. In addition, the pattern in recent years of declining plan assets, coupled with falling interest rates, has made these plans appear expensive.

- **Flexibility** – Many companies seek the flexibility to contribute less in lean years and more in good years. The funding rules tend to produce results that are counter to that goal.

- **Insufficient credit** – Why sponsor a DB pension plan if your employee population doesn’t fully appreciate it?

As companies rethink their qualified plans, similar decisions on nonqualified plans are often delayed or even ignored entirely. When companies switch from a philosophy of having the DB plan as the core plan to freezing the DB plan and having the DC plan as a core plan, nonqualified DB plans are often frozen at the same time. But, many of those same companies are not offering nonqualified DC plans to their key employees. Occasionally nonqualified DB plans are left in place even when the qualified DB plans are frozen. Companies that have previously extended their retirement philosophy above the qualified plan limits are now clearly differentiating between qualified plan benefits and nonqualified plan benefits.

Why the change in philosophy? Is it cost, optics, or something else? Or are companies simply putting off the decision?

Over the course of several articles, we will explore these questions and examine the key differences in qualified and nonqualified retirement plans. Our outline:

- **Part One**: Examining the current environment surrounding retirement plans
- **Part Two**: An in-depth discussion of the legal implications of converting plans, namely the impact of IRC Section 409A; also SEC and tax implications
- **Part Three**: An in-depth discussion of the accounting implications of converting plans
- **Part Four**: Design considerations for defined contribution plans, including: vesting, contribution formulas and contribution levels

For simplicity we use the following naming conventions throughout all parts. A DB SERP is a defined benefit nonqualified executive retirement plan and a DC SERP is a defined contribution nonqualified executive retirement plan.
Retirement Plan Statistics

In the 2010 Aon Benefit and Talent Survey, 40% of respondents indicated that they froze or terminated their DB SERP within the last year. Only 30% of the companies that froze their DB SERP implemented a new DC SERP. This is much lower than the percentage for qualified plans, raising the question of why.

Cost

While ERISA and the Internal Revenue Code require the funding of qualified retirement plans, there is no such requirement for nonqualified plans. In fact, nonqualified plans cannot be formally funded or the benefits will immediately be subject to income taxation.

This makes the corporate cash flow requirements with respect to a qualified DB plan different from a DB SERP. In the qualified setting, generally, a sponsor is required to contribute the value of participant accruals for that year plus a percentage of the unfunded liability (the amount by which plan benefit obligations exceed plan assets) on an annual basis.

In a DB SERP many companies choose to not prefund their obligations. This results in cash flow requirements only when a participant elects to begin receiving his or her benefit. A “promise to pay” plan presents its own issues, namely the plan liability increases over time with no corresponding asset set aside to pay these benefits. It becomes purely a liability on the books of the company.

Alternatively, many companies do set assets aside to informally finance their DB SERP. Whether using mutual funds, alternative investments or corporate owned life insurance, these assets usually fluctuate with market performance and may bear no relationship to the plan’s liability.

A Different Set of Rules

Perhaps a more important factor in the divide between corporate action on qualified pension plans and DB SERPs is the fact that DB SERPs operate with a different set of rules and regulations than qualified plans. Among these are Code Section 409A added by the American Jobs Creation Act (in 2004), revised proxy disclosure rules added by the SEC in 2006, and while not a rule, the general optics of maintaining a special plan just for executives. Typical concerns include:

- What is the impact of terminating the DB SERP under 409A?
- What are the implications for the next proxy period when we have to disclose the prior year’s compensation?
- What is an appropriate retirement benefit for our executive team?

Conclusion

Many companies have successfully dealt with the transition from a qualified DB retirement plan to a qualified DC retirement plan. Whether due to financial materiality or confusion over the nonqualified plan rules, far fewer have successfully dealt with the transition for their nonqualified retirement plans. However, certain factors may now start to push companies towards action.

It is our belief that many companies are struggling with the question of what to do with their existing DB SERP. Other companies, those without a qualified pension plan, may be struggling with the proper design...
for a nonqualified DC plan. While these articles are written primarily to address the thorny issues surrounding the move from a DB SERP to a DC SERP, we will be touching on the basic building blocks for a DC plan.

There are delicate issues that must be dealt with to successfully implement a DC SERP. First and foremost, companies must understand the complex rules that govern only nonqualified plans. Second, companies must evaluate the competing factors that can shape compensation and benefit issues. And finally, companies must design programs that align with overall corporate philosophies on reward, retention and retirement.
Part Two – Impact of Taxation and Proxy Reporting

Introduction

In our August article, we examined why companies have addressed qualified defined benefit (DB) retirement plan issues, often without addressing nonqualified plans or only partially addressing them. More specifically, companies have frozen their qualified DB plans and replaced them on a go-forward basis with enhanced defined contribution (DC) plans. If nonqualified DB plans have been addressed at all, often they are frozen with no DC replacement.

One of the reasons for this difference in activity could be confusion about the issues that are unique to nonqualified plans. In this article, we explore one of these issues, namely the effect of IRC §409A as it relates to moving from a nonqualified DB plan to a nonqualified DC plan. How companies handle the move from one to the other will define how §409A comes into play.

In addition we briefly discuss:

- SEC or disclosure differences in DC and DB nonqualified executive retirement plans
- Differences in the treatment of FICA taxes

This is the second in a four-article series that explores the unique issues present when companies move from nonqualified DB plans to DC plans. The articles are:

- Part One: Examining the current environment surrounding retirement plans
- Part Two: An in-depth discussion of the legal implications of converting plans, namely the impact of IRC Section 409A; also SEC and tax implications
- Part Three: An in-depth discussion of the accounting implications of converting plans
- Part Four: Design considerations for defined contribution plans, including: vesting, contribution formulas and contribution levels

For simplicity, we use the following naming conventions throughout: A DB SERP is a defined benefit nonqualified executive retirement plan, and a DC SERP is a defined contribution nonqualified executive retirement plan.
Disposition of the Existing DB SERP

There are three courses of action for the disposition of an existing DB SERP. Companies can freeze the plan, terminate the plan, or convert the plan.

Freezing a Plan

Freezing a DB SERP does not present any issues under §409A. However, the ability to freeze a plan depends on the plan document, although most plans do give the employer/sponsor the ability to freeze the plan.

Unfortunately, freezing does not eliminate the company’s existing obligations under the plan, and therefore, any problems or issues with it remain with the company. For example, if the company is moving away from a DB SERP because of an inability to hedge the liability with an asset, that issue will still be present, albeit in a frozen form. Additionally, the company will still incur a financial accounting expense under ASC 715 (formerly known as FAS 87).

Employee Perspective

By having two plans and two forms of benefits, participants may find it more difficult to manage their retirement planning.

Terminating a Plan

Under §409A, companies can terminate a plan and pay out all plan benefits, subject to satisfying certain conditions. For example, companies have to leave the plan in place for 12 months after the decision to terminate, then all benefits must be paid between the 13th and 24th month.

Termination and settlement cannot “occur proximate to a downturn in the financial health” of the company, which is understood to mean there is a reasonable expectation that if not paid out immediately, the benefits may never be paid.

Furthermore, all plans of the same type (non-account balance plans, in this case) must be similarly terminated. And, the company may not establish a new non-account balance plan for 3 years after the plan is terminated.

Employee Perspective

Any distributions from a terminated plan are fully and immediately taxable to plan participants, a point which should be carefully considered. If the company offers a voluntary nonqualified deferred compensation plan, the timing of the plan termination and distribution should be considered so that participants may voluntarily defer salary and/or bonus to offset the tax effects of the DB SERP distributions.
Converting a Plan

Perhaps the most complicated option is to convert the DB SERP plan, which under §409A includes balance distribution options, to a DC SERP. Many DB SERPs offer annuity distribution options, as the distribution options often mirror those available in the pension plan. It is highly unlikely that a company would want to continue with an annuity payment option; if that is the case, participants who have elected annuity payouts must change their elections.

Changes to either the time or form of payment are known as subsequent deferral elections and are subject to a minimum 5-year delay in the commencement of distributions. In addition, participants must make secondary elections 1 year before the original distribution date for the election to be valid.

If a company decides to allow annuity payouts, the company has to either self-insure longevity risk or buy an annuity to informally finance the benefit.

Converting a DB SERP to a DC SERP is a §409A category change for aggregation purposes. While §409A does not prohibit a category change, the key is that the form and timing of the distribution remain unchanged.

Employee Perspective

In the event that a company discontinues annuity payment options, giving participants another distribution form and delaying the distribution 5 years may not be overly popular, as participants may have done their retirement planning around an expected distribution stream.

One practice we often suggest in conversions is to include an acknowledgement or release in communications to participants. This acknowledgement states that the participant agrees that the new DC SERP accurately reflects the value of the benefit under the DB SERP. Customized individual communications and modeling tools may help with the employee relations element of this change.

Separate From the Plan

Employers need to be particularly careful of one other element. It is relatively common that top executives are given employment agreements that guarantee them a particular level of SERP benefit. For those individuals, it may be a violation of the terms of a contract to freeze or terminate a SERP.
Establishing the New DC Plan

A thorough discussion of §409A is beyond the scope of this article. However, at a high level:

- Distribution elections are made when accounts are established. Any changes to these distribution elections (if changes are allowed by the plan) delay the distribution start date by at least 5 years.
- For publicly traded companies, any distributions to key employees (as defined in IRC §416(i)) on account of their separation from service must be delayed at least 6 months after separation of service.
- Distributions are allowed only at certain §409A specified and defined points. Examples include change in control, hardship (more restrictive than the 401(k) definition), specified date, and termination.

As the new plan is rolled out, it is important to communicate differences and educate participants through multiple forms of communication. The combination of printed/mailed materials, webcasts, and especially one-on-one meetings can effectively promote understanding of the benefit and position the company’s rationale for the changes.

Proxy Disclosure

For DB SERPs, the amount included in the Summary Compensation Table column “Change in Pension Value and Nonqualified Deferred Compensation Earnings” is the change in the individual’s SERP liability, which is largely driven by discount rates. To some extent the amounts are out of the company’s control on a year-to-year basis. The change is not included in determining inclusion in the Summary Compensation Table as a named executive officer.

For DC SERPs, the amount included in the Summary Compensation Table is the company contribution to the individual’s account. Often this is included in the “All Other Compensation” column. Only above-market earnings (i.e., a high fixed-rate plan) are included in the “Change in Pension Value…” column. These amounts are included in determining inclusion in the Summary Compensation Table as a named executive officer.

Companies must disclose compensation for the principal executive officer (PEO), principal financial officer (PFO) as well as the three most highly compensated officers. A change from a DB SERP to a DC SERP is, in effect, a change to the method of calculating compensation for disclosure purposes, and therefore may change the identities of those individuals other than the PEO and PFO that are disclosed in the proxy.

FICA Taxation

For both DB and DC SERPs, company-provided benefits are subject to FICA. The difference between the two plan types is when the benefits are subjected to FICA.

In a DC SERP, benefits are subject to FICA as they vest. For example, if vesting is based on years of service, once an employee reaches the fully vested point, all company contributions would be subject to FICA taxation when contributed. Once the plan is designed, there is no flexibility in the timing of FICA taxation.
In a DB SERP, it is possible to time the exposure of the plan benefit to FICA based on the retirement date. The benefit is subject to FICA when it is known and determinable, which is essentially once the retirement date is known. Some companies may have chosen to use an early inclusion technique that accelerates, and possibly reduces, payment of FICA taxes. Typically the present value of the plan benefit is subject to FICA in a lump sum.

If the plan benefit is subject to FICA at a time when the executive’s FICA wages have exceeded the Social Security wage base for the year, the plan benefit is only subject to the withholding for the Medicare portion of Social Security, currently 2.35% on wages in excess of $200,000. Otherwise, it is subject to full FICA taxation, currently 7.65% until the sum of wages and this amount exceeds the wage base ($118,500 for 2015).

**Conclusion**

While freezing a DB SERP may not fully achieve the company’s goals and objectives, terminating the DB SERP or converting to a DC SERP have significant §409A implications. Tax penalties for §409A violations are quite severe, and the participants bear those penalties.

However, with careful planning and communication, companies can successfully transition out of their DB SERP arrangements, remain in full §409A compliance, and continue to provide their executive groups with valuable benefits.
Part Three – Accounting Implications

Introduction

In our first article we examined why companies have addressed qualified defined benefit (DB) retirement plan issues, often without addressing nonqualified plans or only partially addressing them. In our second article we explored one of these issues; namely the effect of IRC §409A as it relates to moving from a nonqualified DB plan to a nonqualified defined contribution (DC) plan. In this article we explore the accounting implications that may present themselves as a result of changes to a nonqualified DB SERP.

This is the third in a four article series that explores the unique issues present when companies move from a nonqualified DB to DC plans. The articles are:

- **Part One**: Examining the current environment surrounding retirement plans
- **Part Two**: An in-depth discussion of the legal implications of converting plans, namely the impact of IRC Section 409A; also SEC and tax implications
- **Part Three**: An in-depth discussion of the accounting implications of converting plans
- **Part Four**: Design considerations for defined contribution plans, including: vesting, contribution formulas and contribution levels

For simplicity we use the following naming conventions throughout all parts. A DB SERP is a defined benefit nonqualified executive retirement plan and a DC SERP is a defined contribution nonqualified executive retirement plan.

Current Accounting Environment

There are several factors influencing the accounting world which may affect the ways in which DB plans appear on a company's financial statements. The Financial Accounting Standards Board (FASB), the US governing body that establishes Generally Accepted Accounting Principles (GAAP), has been working with the International Accounting Standards Board (IASB) to establish a roadmap to convergence of the two sets of standards in order to improve reporting for all users of financial statements and to reduce reporting costs of multinational companies. One consequence of this convergence may be the elimination of delayed recognition of gains and losses that is currently allowed under US GAAP in DB accounting. If this does occur, the income statement effects associated with DB plans may become more volatile. In addition, companies may need to review their hedging strategies to adapt to this change in accounting. While this hasn't happened yet, it is certainly something that is being considered.

In addition to the convergence plan, FASB has recently completed its Accounting Standards Codification project (Codification™), which changed the organizational structure of US GAAP. Codification was not intended to change existing GAAP. However, in reorganizing all the information, certain less formal guidance (for example Staff Q&As) that had never been formally approved by the full Board was formally made a part of GAAP. As a result, some items that were subtle or absent in GAAP have appeared or become obvious under Codification. For example, one interpretation is that nonqualified DC plans do not fall under the rules for DC accounting. We will discuss this in more detail later in this article.
Disposition of the Existing DB SERP

Many nonqualified plans are not material enough to warrant separate disclosure in financial statements. Instead, many plans are folded into pension disclosures. When DB SERP obligations are material, the financial statement impact and required disclosures often attract unwanted attention. For companies struggling to deal with the increasing volatility in the cost of their DB SERP, or for those that are looking to move away from DB arrangements in general (including on the qualified plan side) several options are available to them depending on their goals and objectives. Companies can freeze the plan, terminate the plan, or convert the plan.

Freezing the Plan

To mitigate the costs associated with the DB SERP going forward, companies can close the plan to new entrants through a "soft freeze". Existing participants will continue to accrue benefits with years of service and salary increases, but no new entrants would be permitted. This option does not change the accounting for the plan nor will it remove the existing liability, but it will contain the future growth of the liability to only those individuals remaining in the plan.

Alternatively, companies can take this one step further and not only close the plan to new entrants, but also freeze the plan for future accruals (e.g. future salary increases and future service). Removing future accruals from the plan will result in a curtailment under GAAP, which would typically reduce the Projected Benefit Obligation (PBO). However, as discount rates have fallen fairly precipitously since the adoption of most DB SERPs, the majority of companies have unrecognized losses (the lower the discount rate, the higher the PBO). This cumulative unrecognized loss frequently exceeds the reduction in PBO due to the curtailment. As result, the curtailment simply reduces the losses present rather than resulting in a gain. A curtailment may also require recognition of prior service costs.

Terminating the Plan

To remove the liability completely from the books, companies can terminate the DB SERP. The company would settle the obligation by calculating the present value of the vested benefit for each participant and paying out these amounts (subject to §409A restrictions). To the extent the assumptions used for calculating the payouts differ from the assumptions used for calculating the liability (for example, a different discount rate), a gain or loss could result. From an accounting perspective, this would constitute both a curtailment and a settlement of the plan. All unrecognized items that were previously being smoothed through Accumulated Other Comprehensive Income would immediately be recognized.

Converting the Plan

The third alternative is for the company to convert the existing DB SERP into a DC SERP. Determining the appropriate accounting may require some discussion with your auditors as the answer is not as clear as the other options.

The typical accounting for DC SERPs involves booking the aggregate account balances as the liability. The simplest way to treat a conversion from a DB SERP to a DC SERP would be to recognize all previously unrecognized amounts carried in Accumulated Other Comprehensive Income and record the aggregate account balances as a liability going forward. Initial account balances in the new DC SERP are often the actuarial equivalent of each participant’s accrued benefit in the old DB SERP. Essentially this amounts to a settlement of the DB SERP with a new DC SERP. While the determination of liabilities may
result in a reduction of the total liability the settlement will result in immediate recognition of unrecognized losses to such an extent that most companies would recognize a loss.

However, there may be another way to look at this transaction. Codification may suggest that DC accounting is appropriate only when the obligation is fully satisfied at the time a contribution is made. In a nonqualified environment, employer obligations are not fully satisfied at the time the contribution is made. Because a benefit obligation exists, DC accounting may not be appropriate. If the plan is not considered a DC plan for accounting purposes, the only other option is DB accounting. Instead of being treated as a settlement of a DB SERP with a DC SERP, the conversion may instead be a plan amendment for accounting purposes. Any change in PBO from the plan amendment would flow through Other Comprehensive Income (OCI) and be amortized as prior service cost (usually over the average future service of plan participants). This may be desirable to companies that are looking to preserve the delayed recognition aspect of DB accounting.

The entire plan conversion process may be an appropriate time for the company to consider the methods that it uses to account for its retirement plans. For example, many companies that sponsor nonqualified account balance plans invest assets to hedge a plan’s obligations (often through an insurance product or rabbi trust). In this case, it may be very appropriate to immediately recognize gains or losses incurred by the plan. As described above, converting from a DB SERP into a DC SERP can leave the company with some important decisions to make concerning the accounting treatment of gains and losses. Companies can continue with delayed recognition, or they may want to consider a change to immediate recognition.

Summary

Companies have several options available to them for how to handle their DB SERP to minimize the liability of the plan including freezing the plan, terminating it, or converting it to a DC SERP. Each of these options has specific accounting implications for companies to consider before moving forward and no two companies have exactly the same situation or the same goals. For assistance related to your company’s specific situation, contact your Aon Hewitt consultant or one of the authors.
Part Four – Future Design Considerations

Introduction

In our first three articles, we examined why companies may be hesitant to make the transition from a nonqualified defined benefit plan to a nonqualified defined contribution plan. We also described the unique issues inherent in nonqualified plans that complicate the decision to do so—including IRC §409A, SEC/disclosure, tax, and accounting implications. As discussed, there are advantages and pitfalls to making this move. As companies make the important decisions about how to handle their existing plans, they must also look ahead and determine what form their new plans will take. In this article, we explore the plan design spectrum available in a nonqualified defined contribution environment.

This is the fourth article in a four-part series, which includes:

- **Part One:** Examining the current environment surrounding retirement plans
- **Part Two:** An in-depth discussion of the legal implications of converting plans, namely the impact of IRC Section 409A; also SEC and tax implications
- **Part Three:** An in-depth discussion of the accounting implications of converting plans
- **Part Four:** Design considerations for defined contribution plans, including: vesting, contribution formulas and contribution levels

For simplicity, we use the following naming conventions throughout the series: a defined benefit nonqualified executive retirement plan is referred to as a DB SERP, and a defined contribution nonqualified executive retirement plan is a DC SERP.

Design Considerations

While it would be ideal to provide one standard DC SERP design that works well for all companies, the nature of nonqualified plan design does not lend itself to a definitive set of parameters. Much like the decision of what to do with an existing DB SERP, designing the new DC SERP is a complex undertaking. Companies, with the right guidance, must identify a plan design that most suits their specific objectives, needs and preferences.

In some cases, companies may find that they simply want to extend the logic from their qualified plans over to their nonqualified plans; while in other cases, the circumstances surrounding the qualified and nonqualified plans might be significantly different and warrant a new plan design. In our experience most companies end up designing a plan that falls into one of the following four general categories:

- Tax Restoration Plan
- Retention Plan
- Performance Plan
- Holdback Plan
To identify the appropriate plan design category, companies must ask themselves one key question: what is the DC SERP trying to accomplish? From there, they can move on to other questions to help refine the plan design features. These include:

- Eligibility – Who will be eligible for the program? (e.g., top hat employees, c-level executives, anyone affected by qualified plan limits)
- Benefit Level – What contribution formula and limits will the plan have? (e.g., uniform percentage of salary, tiered percentages, a formula offset by other benefits)
- “Handcuffs” – How will benefits vest? (e.g., service based, class-year, performance based)
- Distributions – What payout options will the plan offer? (e.g., lump sum, installments, life annuity variations, payout at a certain age, payout at retirement)
- §409A has the biggest impact on distribution elections. Converting from a DB SERP to a DC SERP is a category change for aggregation purposes, and it is important that the form and timing of distributions remain unchanged. Any changes to distribution elections or the form and timing of payment delays the distribution start date by 5 years. A new plan combined with a frozen or terminated plan offers more flexible payout options.

It is important to note that the answers to the questions above must support the primary objective that the DC SERP is trying to accomplish.

This article provides a high-level description of each of the four plan categories, as well as the circumstances in which each plan would be most appropriate. It is important to note, however, that these options are not mutually exclusive. Some companies may choose certain components from more than one category to design the most appropriate plan for their needs. However, for purposes of this discussion, we will only focus on the four broad categories noted above.

**Tax Restoration Plan**

**Ideal for:**
Companies who like their qualified plan design but are unhappy with its tax limits for highly compensated employees.

**Overview:**
Qualified plans are important savings and retirement vehicles, but are limited in their ability to provide value to highly compensated employees. These plans only consider compensation up to a certain amount and also limit total annual contributions, indexed for inflation. For 2012, the maximum compensation for qualified plan purposes is $250,000 and the maximum elective deferral is $17,000. These limits put highly compensated employees at a distinct disadvantage when it comes to saving through employer-sponsored plans.

For companies who want to restore benefit equity to these executives but are satisfied with all facets of the qualified plan design, a Tax Restoration Plan may be the most appropriate nonqualified plan structure. In essence, this option retains all (allowable) features of the qualified plan, without the contribution and income restrictions.
The nonqualified Tax Restoration Plan will look and feel exactly like the 401(k) plan, except for the eligibility criteria and the absence of formal funding. For the plan to be considered “nonqualified,” ERISA restricts eligibility to a select group of management or highly compensated employees, whereas a 401(k) is open to all employees. Also, unlike 401(k) plans, nonqualified plans cannot be formally funded if they are designed to allow the employee to defer income taxes.

Because the primary objective of this type of plan is to restore lost benefits due to qualified plan limits, eligibility is the feature that drives the design of this plan. Fundamentally, anyone harmed by qualified plan limits is eligible to participate. Other features, such as benefit levels and vesting, should mirror the qualified plan. The timing of payouts, however, cannot mirror the qualified plan according to §409A.

Retention Plan

Ideal for:
Companies who want to reduce turnover and retain key employees.

Overview:

Some companies find that executive turnover is one of their biggest issues. One way to reduce this turnover is to implement a compensation plan designed to ensure that executives will lose a significant amount of money if they choose to terminate employment. A Retention Plan, also known as a Service Vesting Plan, achieves this objective by keeping benefits unvested until an executive meets certain service terms. Vesting terms can be cliff, graded, or class-year.

With cliff vesting, the executive must satisfy some combination of service and age to receive any benefit. Examples include 5 years of service, attaining age 60, and attaining age 55 with ten years of service. With graded vesting, the executive earns an increasing percentage of the benefit over the vesting period. An example is 20% after two years, 30% after three years, 40% after four years, etc. With class-year vesting, every award the company makes requires a certain number of years of service before it is available to the executive. For example, if the company makes annual contributions to the plan, the executive must wait three years from the date of each contribution to receive that particular award.

Retention Plans provide greater incentive for executives to remain at the company so as not to lose a significant and valuable benefit. To achieve this, vesting and benefit levels are the features that should carry the most weight when designing the plan. After determining eligibility (i.e., who the company feels strongly about retaining), the company must identify benefit levels that will be meaningful enough to keep these executives around. A benefit level that is not significant provides no incentive for employees to stay. It is important to note, as well, that providing different levels of benefits to different executives, i.e., “discrimination,” is allowed in nonqualified plans, and often makes sense in this type of plan.

After identifying the appropriate benefit levels, the company can determine what type of vesting—cliff, graded, or class-year—will be the most meaningful for retaining executives for the desired time period.

As noted, the key to a Retention Plan is vesting, and careful consideration must be given to this feature. Vesting benefits too late can be just as ineffective as vesting benefits too early. In addition, the condition of how vesting occurs should be considered. Is vesting based on age or years of service, or is it applied to each award given? Vest benefits too early and the executives have no further “hooks” to ensure their continued employment; vest benefits too late and the eventual reward can seem unrealistic.
Performance Plan

Ideal for:
Companies who want to reward employees for attaining pre-determined performance objectives.

Overview:
Much like the Retention Plan, a Performance Plan uses vesting as the primary criteria for structuring the plan design. The difference is that, with a Performance Plan, the vesting is not based on years of service, but instead requires executives to meet certain performance criteria selected by the company. These criteria may be company-wide (revenue targets, NOI targets, etc.), team-wide (department budget, sales numbers, etc.), or individual (productivity metrics, personal growth, etc.).

Similar to the Retention Plan, the company makes regular contributions to executive accounts, but executives only vest in these benefits to the extent that they achieve the pre-determined goals and metrics. For example, meeting 60% of the NOI target might result in 60% vesting in the benefit. Alternatively, a leverage feature could pay only 40% of the benefit for meeting 60% of the target NOI, but 140% of the benefit for reaching 120% of the target NOI.

Determination of the performance vesting criteria should be the number one objective. Because this is a reward-based plan, eligibility comes down to identifying those employees for whom performance is a key factor in the overall success of the business. Benefit levels can also reflect performance. In other words, high performance can affect both the amount of the benefit and whether the benefit is paid at all.

Holdback Plan

Ideal for:
Companies who base compensation on performance, but where the validity of such performance takes some time to confirm.

Overview:
DC SERPs are uniquely positioned to hold long-term incentive compensation when the company designs the plan with a Holdback provision. A Holdback Plan is essentially designed to restrict payment in any shape or form until it is confirmed that the compensation upon which any benefit is based was actually earned.

Why would a company want to delay payment of earned compensation? Companies where certain executives have both the incentive and opportunity to inflate financial results would benefit from a Holdback provision. Another prime candidate is a company in a volatile line of work (e.g., investment banking, where traders can be rewarded for big risks, only to have the tables turn upon a big market crash). Delaying payment for a specified amount of time gives these companies the opportunity to validate the performance and the resulting compensation.

Additionally, companies subject to current or future legislation, such as §954 of the Dodd Frank Act, can utilize a Holdback provision to hold compensation as required under the regulations. Administering a Holdback provision is easier than using a Clawback provision to recover compensation already paid.
Although the Dodd-Frank rules require deferral of incentive compensation for certain executives of large financial institutions, some companies are considering such provisions even when they are not required to do so.

While a Holdback Plan may seem somewhat similar to a Retention Plan in that benefits are not earned until a specific amount of time passes, they differ in that in a Retention Plan, executives lose their benefits if and when they leave the company. With a Holdback, executives who voluntarily terminate employment can still receive their benefit as long as the compensation is valid.

The key component of a Holdback Plan is the deferral period. This period should relate to the amount of time needed to validate the compensation or the amount of time required to hold compensation under specific regulations. Vesting can be immediate. In other words, an executive could vest immediately in a benefit but have to wait three years for the compensation to be validated. Eligibility in a Holdback Plan generally includes employees in a position to manipulate numbers that affect their personal compensation.

Other Plan Design Considerations – Starting Point for Plan Benefits

Regardless of the plan design category a company selects, it is important to remember that a determination must be made as to what will happen to existing benefits in the DB plan. As discussed in previous articles, freezing a DB plan for future accruals or paying out DB benefits upon plan termination would typically result in recognition of prior service costs and/or unrecognized losses that were previously smoothed through Accumulated Other Comprehensive Income. Yet, it enables a company to essentially start with a clean slate when designing the new plan, and eliminates any issues with transferring existing balances.

Converting a DB SERP to a DC SERP presents more intricate choices. Conversion to a DB SERP may enable a company to continue with delayed recognition, or prompt a change to immediate recognition of gains and losses. It will also generate §409A issues which must be addressed. Often, initial account balances in the new DC SERP are the actuarial equivalent of each participant’s accrued benefit in the old DB SERP. For existing contributions that are not vested, the company must also determine to what extent the beginning balance in the new plan is vested.

Conclusion

Whether converting a DB SERP to a DC SERP or designing a new DC SERP altogether, it is essential to first determine the company’s and the plan’s overall objectives in order to craft the most effective and value-driven benefit. While there is no “in the box” answer as to what form the DC SERP should take going forward, most plans fall into one of four major categories: Tax Restoration, Retention, Performance, and Holdback. Each category addresses one or more of the primary goals that, in our experience, most companies are aiming to achieve when designing a DC SERP. After identifying the appropriate plan design category, companies can then explore more specific criteria such as vesting, payout, contributions, etc. to fine tune their plan designs and provide a meaningful benefit that is most in line with their overall objectives.
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