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Financing Nonqualified Benefit Plans

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Most employers chose to finance nonqualified plans because of a desire to hedge market driven changes in the obligation or to provide benefit security. The authors believe that such employers should explore the advantages of using a combination of mutual funds and corporate owned life insurance (COLI) to finance nonqualified executive benefits, rather than just one exclusively. This article provides a brief overview of the advantages and disadvantages of both mutual funds and COLI, and then discusses how to coordinate the two types of investments in terms of cash flows. Finally, the article discusses hedging strategies in the context of both account balance plans with market risk and traditional defined benefit plans. It does not address hedging strategies for share based liability awards such as restricted stock units.

FINANCING NONQUALIFIED PLANS

Unlike assets that fund qualified pension and 401(k) plans, assets that finance nonqualified plans are available to general creditors of the employer. In other words, nonqualified benefit obligations are unsecured promises to pay.

While there are no requirements to finance nonqualified plans, many employers choose to set aside assets to finance these obligations. They do so for a variety of reasons, including:

- Managing cash flow—providing a source of funds to pay benefits.

- Hedging the benefit expense—protecting themselves against severe market fluctuations in the benefit obligation.

- Additional benefit security—providing security against the risks of change of control or change of heart.

A Rabbi Trust[1] combined with some sort of asset can provide limited benefit security against the risks that a change in control or a change of heart disrupt benefit payments. A Rabbi Trust does not protect executives from the risk of corporate bankruptcy.

Numerous surveys confirm that the most popular investments for financing nonqualified plans are mutual funds and COLI.[2] Often the choice of investments is heavily influenced by the selected plan administrator.

MUTUAL FUNDS

Many nonqualified plans are administered by qualified plan vendors who use mutual funds because they are not familiar with, or not prepared to administer, other types of assets. Other times employers may use mutual funds to finance nonqualified plans because of their relative simplicity. While financial decision makers may have a working knowledge of COLI, they are often still more familiar with mutual funds, and point to the insurance expenses charged by COLI and the endless array of fund choices available in mutual funds. Accounting advisors point out that the employer can choose how to account for all future gains and losses in mutual funds. This flexibility in accounting can be especially important when financing both account balance plans and traditional defined benefits plans. Tax advisors point out that investment losses on mutual funds create tax benefits in the form of offsetting capital losses against capital gains.

On the downside, mutual fund investment income is taxable. Hedging transactions may create taxable gains. Although dividends received by corporations are eligible for the 70% dividends received deduction,[3] capital gains are generally taxed at the 35% statutory rate[4] for federal income tax purposes. Even when a tax strategy succeeds in deferring the actual payment of taxes, Generally Accepted Accounting Principles (GAAP) require the accrual of these future taxes.[5]

COLI

Competing for nonqualified plan administration services are insurance brokers, whose focus is on the placement of corporate owned life insurance, or COLI, to finance nonqualified plan benefits. COLI implies the modern generation of insurance products specifically designed and priced for the corporate market. Compared to mutual funds, they offer

a more limited universe of fund choices but still offer a diverse selection of high quality funds in insurance sub-accounts inside an insurance wrapper. Employers use COLI to finance nonqualified plans because of its tax advantages. With proper notice[6] to (and written consent by) insured employees, employers receive death proceeds income tax-free. Growth in policy cash values due to investment gains is not subject to income tax. Withdrawals[7] to the extent of basis and policy loan proceeds[8] are generally income tax-free except for policies classified as Modified Endowment Contracts (MEC).[9] Reallocating COLI cash value among available separate accounts is not a taxable event.

On the downside, COLI carries insurance loads that would not otherwise be incurred. Proper selection, implementation, and management of COLI requires specialized knowledge.

Because of conflicting priorities or objectives, the choice between mutual funds and COLI is not always clear.

IDEAL FINANCING VEHICLE

The ideal financing vehicle provides a perfect hedge against the market related changes in the benefit obligation, both on a pre-tax and after-tax basis. The contribution is deductible so that the asset value equals the liability and does not require any funds outside of the deferrals of otherwise deductible income. Investment income is tax free, so the employer does not incur tax expense in addition to, or as an erosion of, the direct investment. Therefore, the financing vehicle is easy to understand and involves little cost. Unfortunately, no such financing vehicle exists. Most employers choose some combination of mutual funds and COLI—appreciating the advantages and tolerating the disadvantages of their chosen strategy.

PRE-TAX FINANCING TO IMPROVE BENEFIT SECURITY

Even though there is no requirement to finance nonqualified plans at all, most employers choose to set aside some combination of mutual funds and/or COLI cash value that approximates the full benefit obligation. The question of pre-tax financing or after-tax financing is also one that must be addressed. While taxpaying employers are required to record a deferred tax asset[10] to reflect the future tax savings associated with paying nonqualified benefits, nonqualified plan participants are often less than comfortable relying on the future tax savings to finance benefit obligations. Future net operating losses (NOL)[11] can reduce or eliminate otherwise available tax benefits from paying nonqualified

benefits. A company with large NOL carry forwards may also struggle with finding sufficient cash to pay nonqualified benefits. Concerns about benefit security motivate most companies to hold some combination of mutual funds and COLI cash value equal to the pre-tax benefit obligation (and not rely on future tax savings to provide benefit security).

ALLOCATING FINANCING CONTRIBUTIONS

Since participants in nonqualified plans have no claim to specific assets, these plans should be financed on an aggregate basis (looking at the total liability versus total asset rather than individual balances) in order to improve the flexibility of the financing. During the early years of a nonqualified plan, the emphasis is on setting aside the funds to finance the arrangement. Companies that choose to invest in both mutual funds and COLI must decide how to allocate funding contributions between mutual funds and COLI premiums.

Generally, COLI is used for the more permanent element of the liability, while mutual funds may be used for the marginal or less predictable component. This division of assets is most effective because COLI performs best when the mortality element is minimized by reducing the death benefit to the lowest level required by federal tax law. This optimum COLI structure requires a level premium for five to seven consecutive years and the minimum death benefit. When less than the planned premium amount is paid, or fewer than five premiums are paid, cash values reduce and insurance charges increase. As a result, COLI policy performance is less than optimal and probably less than expected. Conversely, when funding needs increase, an additional block[12] of COLI may be required.

Estimating the company's desire and ability to maintain this consistent level of premium for five to seven years is as important as it is difficult. The estimate is important because the appeal of COLI depends not only on its tax advantages but its efficient structure. The estimate is difficult when premiums depend on unknown factors, such as future levels of elective deferrals or corporate profits.

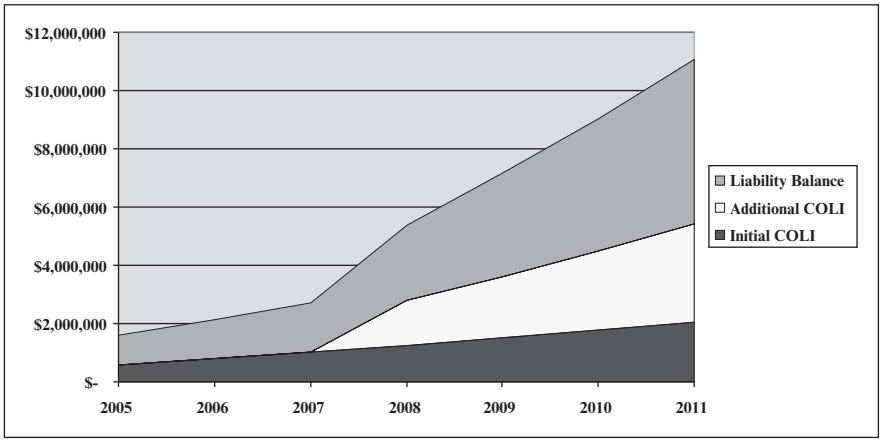
Liquidity needs also affect premiums, especially short term liquidity needs. An efficient COLI program minimizes distributions from the COLI policies. For instance, a large lump-sum payout of a deferred compensation balance five years after a plan is implemented should not be financed with COLI. Over the longer term, asset values should be evaluated against the changing liability to measure the need for additional funding or the need for cash to finance benefit payments. This balancing of assets and liabilities is particularly important in evaluating COLI cash flows. For example, paying a premium and then making a

withdrawal (or vice versa) within the same quarter makes little sense: the premium paid and then withdrawn (or the withdrawal later paid) incurs an unnecessary premium load that erodes policy performance. Although non-MEC COLI contracts allow tax-free withdrawals of basis and policy loans, such distributions reduce COLI performance. Such distributions are appropriate in trimming COLI cash value to a level appropriate for the benefit obligation, but any planned distributions from the COLI should be factored into a pre-purchase evaluation of the COLI performance. In determining this appropriate level of financing, many Chief Financial Officers believe that total plan financing should not significantly exceed the pre-tax amount of the benefit obligation.

When the unexpected happens, and actual premiums are less than the planned (optimal) premium, several remedies are available to correct the structural imbalance between cash values and death benefits in the policies. An in-depth analysis of options is recommended and a conservative estimate of a sustainable premium level may be the best approach.

While overly optimistic estimates of sustainable premium levels reduce the efficiency of a COLI program, overly conservative estimates reduce the overall efficiency of the financing strategy. The tax advantages of properly structured COLI are often compelling, and a rapidly growing benefit obligation can quickly exhaust the premium capacity of a block of COLI. If the investment mix is allowed to change such that mutual funds become a larger part of the portfolio, then the tax-favored attributes of COLI become relatively diminished. At some point, an additional block of COLI may need to be considered to maximize the company's ability to capture the associated tax savings. Of course, each

Exhibit 1. Maximizing Tax Savings



new block of COLI generally requires new notice[13] to, and written consent by, the insured executives. Also, the availability of additional COLI relies on current tax law.[14]

Once a company settles on a sustainable premium level, any financing in excess of the premium should be invested in mutual funds.

SOURCES OF CASH TO PAY BENEFITS

In a healthy and growing business environment, plan liabilities may be expected to grow indefinitely. In that case, projected cash flow outlays for benefit payments should be measured against inflows from deferrals or other contributions to set the proper funding level. However, in some instances a poor business climate or a company-specific issue may lead to a plan sponsor with declining liabilities.

In this instance, the emphasis changes from setting aside the funds to finance the arrangement to identifying the sources of cash to pay benefits. Companies that choose to invest in both mutual funds and COLI must decide whether to pay benefits out of working capital, sell mutual fund shares, or take distributions from COLI.

When the benefit obligation exceeds the plan financing and the company wants to increase the level of financing relative to the benefit obligation), the company should pay benefits out of working capital. When plan financing is already sufficient, the company should consider the redemption of mutual fund shares or distributions from the COLI policies.

In general, a well-managed, high-performing COLI program will perform best if it is left intact. Distributions from COLI policies may marginally reduce policy performance and any future replacement of cash value withdrawn will generally incur a premium load (depending on the policy design). Redemption of mutual fund shares is generally the better option.

Of course the strategy works in reverse if a COLI program has lost its effectiveness. This can happen when the company no longer needs the tax advantages of COLI because NOL carry forwards,[15]capital loss carry forwards, or alternative minimum tax credits[16] have eliminated tax on investment income. The impact on the tax advantages of COLI depends on the "value" of the NOLs and the opportunity cost of using those NOLs. A company choosing to reduce its COLI holdings should withdraw its tax basis as necessary and then consider tax-free policy loans as appropriate.

When the need for cash is temporary, such as when benefit payments are followed by additional deferrals, a policy loan may be appropriate. Although policy loans usually incur a negative interest

spread, the effect of this spread may be lower than future premium loads or any taxes on redemption of mutual fund shares. A recent example involved a company with a large deferred compensation liability hedged with COLI. The CEO's separation from service triggered a $100 million lump-sum distribution that left the liability over-hedged. The company estimated that five years of future deferrals would bring the liability back to the projected COLI cash value. They chose a policy loan instead of a withdrawal to equalize the short term imbalance because the cumulative effect of the loan spread was less than new premium loads. Had the horizon been 10 years, a withdrawal would have been more cost effective. The choice between withdrawals and loans should be considered on a case by case basis.

HEDGING STRATEGIES FOR ACCOUNT BALANCE PLANS

Many account balance nonqualified plans allow participants to decide on the allocation of their notional accounts across a menu of fund choices. Because the changes in fair value of the benefit obligation generally flow through net income and the sponsoring company has little control over this market risk, most companies choose to hedge these market related changes in fair value. Companies can use a combination of mutual funds and COLI to create an effective hedge.

Creating an effective accounting hedge requires understanding the transaction being hedged and defining hedge effectiveness. The transaction being hedged is the market related change in the fair value of the benefit obligation. Because this is a deductible temporary difference for tax accounting purposes, the company must accrue expected tax savings associated with paying the accrued benefit obligation. When the market rises and the value of the benefit obligation increases, the company records both a benefit expense (immediate recognition) and deferred tax benefit (reduction in tax expense). For example, market gains cause a $100,000 benefit expense and a $40,000 deferred tax benefit (reflecting a 40% tax rate). Net income decreases by $60,000. Conversely, when the market falls and the value of the benefit obligation decreases, the company records both benefit savings (immediate recognition) and deferred tax expense. For example, market losses cause $100,000 in benefit savings and a $40,000 deferred tax expense. Net income increases by $60,000. Defining hedge effectiveness may be as simple as deciding whether to hedge the $100,000 change in pre-tax income or the $60,000 change in after-tax income.

Another aspect of understanding the transaction being hedged is that different notional investments within the benefit obligation have different levels of volatility. On one end of the volatility spectrum, money market funds have zero volatility other than the rate of future interest. On the other end of the spectrum, international funds usually have the highest volatility of the funds available to participants. In hedging the market related change in the fair value of the benefit obligation, hedging the balances in the international fund is more important than hedging money market balances, for example. Company stock may exhibit the highest volatility, but hedging such balances (i.e., restricted stock units) is beyond the scope of this article.

Having discussed the importance of understanding the transaction being hedged and defining hedge effectiveness, we'll switch to the hedging vehicles themselves. Although both mutual funds and COLI can be used to hedge the benefit expense attributable to market related changes in the fair value of the obligation, the two behave very differently in terms of managing ne't income.

Mutual funds with elective accounting under the Fair Value Option[17] are an effective hedge for account balance plans with market risk, because market related changes in fair value flow through the income statement,[18] just as market related changes in the obligation do. Also, market related changes in the fair value drive the related tax expense, whether current or deferred. $100 invested in an international fund asset effectively hedges $100 in the international fund benefit obligation, both on a pre-tax and after-tax basis. The downside to this hedge efficiency is that trades that realize taxable gains require cash outlays for the taxes. While the income statement is effectively hedged, there is a real cost to this approach in the timing difference between tax savings on the liability (deferred) and taxes due on realized investment gains (immediate).

COLI is also an effective hedge for account balance plans with market risk, because market related changes in cash surrender value flow through the income statement, just as market related changes in the obligation do. Unlike mutual funds, market related changes in cash surrender value do not affect tax expense. $100 invested in the COLI cash value international fund effectively hedges $100 in the benefit obligation international fund on pre-tax basis (except for unavoidable insurance charges), but creates tax leverage on an after-tax basis.

There are various ways to structure an effective COLI hedge. To illustrate one method, consider our earlier example. Market gains cause a $100,000 benefit expense and a $40,000 deferred tax benefit. COLI reflects a $90,000 gain, which includes insurance charges. As a result, net income increases by $30,000. Conversely, when the market falls and

the value of the benefit obligation decreases, the company records both benefit savings (immediate recognition) and deferred tax expense. For example, market losses cause $100,000 in benefit savings and a $40,000 deferred tax expense. COLI reflects a $110,000 loss, which includes insurance charges. As a result, net income decreases by $50,000. Matching COLI cash value to pre-tax benefit obligations leverages the effect of income tax accounting for the future tax savings from paying the nonqualified benefit.

Companies that wish to minimize the volatility of net income should consider limiting the COLI hedge to the after-tax benefit obligation. Consider a variation on the last scenario in which the COLI is 60% of the pre-tax benefit obligation. Market gains cause the same $100,000 benefit expense and the same $40,000 deferred tax benefit. COLI reflects a $54,000 gain, which includes insurance charges. Net income decreases by $6,000. Conversely, when the market falls and the value of the benefit obligation decreases, the company records both benefit savings (immediate recognition) and deferred tax expense. For example, market losses cause $100,000 in benefit savings and a $40,000 deferred tax expense. COLI reflects a $66,000 loss, which includes insurance charges. Net income decreases by $6,000. Matching COLI cash value to after-tax benefit obligations minimizes the effect of income tax accounting on net income.

Companies can combine the after-tax COLI hedge with a strategy that recognizes the relative volatility of the various funds. Because the tax advantages of COLI are most effective with the highest investment returns, companies should consider using COLI to hedge the liability in funds with highest expected returns. These are also usually the funds with highest volatility. General account COLI or mutual funds can

Exhibit 2. Annual Earnings Results for 8 Years Based on Change in S&P 500 NAV's over 8 Periods

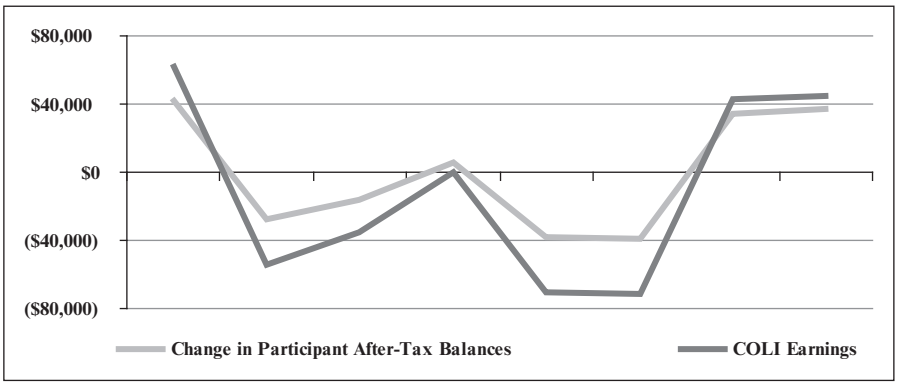
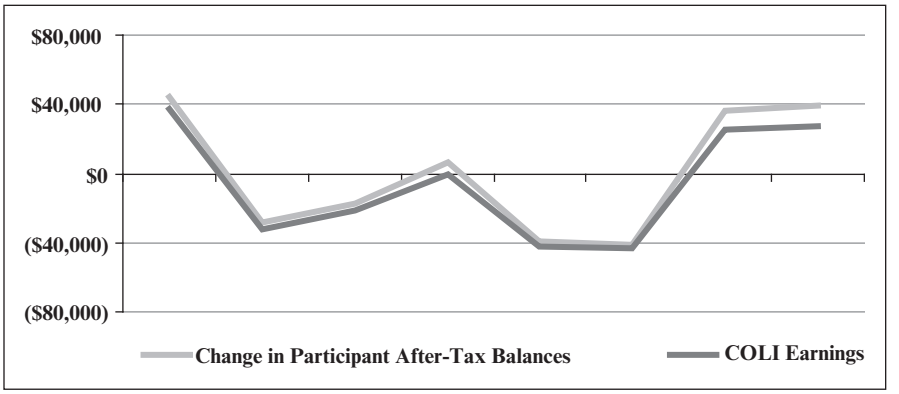


Exhibit 3. Annual Earnings Results for 8 Years Based on Change in S&P 500 NAV's over 8 Periods



hedge the remaining funds in the benefit obligation dollar for dollar. General account COLI is insurance in which the cash value of the policy is invested in the insurance company's general account, earning a stable rate of return. General account COLI or mutual funds can also finance the portion of the benefit obligation equal to the deferred tax asset. This is not an accounting hedge because the after-tax Separate account COLI hedge already addresses the accounting effect of both the benefit obligation and the related deferred tax asset. The General account COLI or mutual funds can be managed independently of the benefit obligation.

FINANCING STRATEGIES FOR DEFINED BENEFIT PLANS

Traditional defined benefit nonqualified plans, known as Supplemental Executive Retirement Plans (SERPs), present different financing issues. Accounting for defined benefit plans allows companies to delay expense recognition of changes in the obligation due to changes in assumptions and due to experience that differs from assumptions. These changes are actuarial gains and losses[19] which accumulate in an owner's equity account labeled Accumulated Other Comprehensive Income.[20] A major source of actuarial gains and losses is changes in the discount rate[21] used in the present value calculations. Because of the relatively low volatility of SERP expense, some companies choose not to finance SERPs at all.

Those companies that do choose to finance may be more focused on issues such as benefit security, asset/liability matching, and cash flow management. These companies usually avoid financing arrangements that create volatility in net income. Because COLI gains and losses flow directly

through net income, COLI cash value in this context should be as predictable as possible. Such predictability includes the use of general account products, variable products invested in high quality limited duration fixed income portfolios, and stable value arrangements. Mutual funds can also be used if they are designated as available for sale,[22] which causes all market related changes in fair value to flow through Other Comprehensive Income[23] (instead of net income) until the shares are sold.

Successful implementation of these financing strategies depends upon the facts and circumstances unique to every employer and is beyond the scope of this article.

SUMMARY

There are numerous ways to manage assets and hedging strategies. Because both mutual funds and COLI have advantages and disadvantages, some companies are beginning to consider that a combination of the two is the best approach. The mutual fund component can provide the flexibility in funding and liquidity, while the COLI can provide the tax advantaged accumulation. Using the combination of mutual funds and COLI as a hedge to manage the effect on net income requires a solid understanding of the transaction being hedged and the company's financial objectives.

NOTES

1. Rev. Proc. 92-64, 1992-2 C.B. 422, provides model trust language that is to be used by Rabbi Trusts or other trusteed nonqualified deferred compensation arrangements.
2. *See* Clark Consulting's 2005 Executive Benefits Survey for example.
3. Internal Revenue Code (IRC) § 243.
4. I.R.C. § 1201 explains that corporate capital gains are taxed as regular income, except that the marginal federal tax rate cannot exceed 35%.
5. Codification paragraph 740-10-25-23 describes gains that are taxable after they are recognized financial income as taxable temporary differences. The glossary in Codification section 740-10-20 defines a deferred tax liability as the deferred tax consequences attributable to such taxable temporary differences. Likewise, the deferred tax expense includes the annual change in the deferred tax liability.
6. I.R.C. § 101(j) restricts insured individuals under COLI policies issued after August 17, 2006, to the top 35% of payroll and requires both notice and written consent of the insureds as conditions of preserving the tax-free nature of death proceeds to employers.
7. *See* Treasury Regulation § 1.72-11 for *general* rule that withdrawals and partial surrenders are not taxable to the extent of cumulative premiums paid, but see later note on Modified Endowment Contracts.
8. I.R.C. § 72(e)(5) states that a policy loan is not a distribution for purposes of taxation under § 72, but see later note on Modified Endowment Contracts.

9. *See* I.R.C. § 7702A for a definition of MEC. I.R.C. § 72(e)(10) requires LIFO taxation of both withdrawals and loans. I.R.C. § 72(v) imposes a 10% penalty on any gain on MEC to a corporation. The effect is that MEC receive favorable taxation only on death proceeds.
10. Codification paragraph 740-10-25-23 describes expenses that are deductible after they are recognized financial income as deductible temporary differences. The glossary in Codification section 740-10-20 defines a deferred tax asset as the deferred tax consequences attributable to such deductible temporary differences. Likewise, the deferred tax benefit includes the annual change in the deferred tax asset.
11. I.R.C. § 172.
12. A "block" of COLI is usually a group of policies issued by the same insurance company on the same issue date.
13. *See* earlier endnote on I.R.C. § 101(j).
14. *See* the Department of the Treasury's "General Explanations of the Administration's Fiscal Year 2011 Revenue Proposals," commonly known as the Greenbook, for an example of a potential tax law change that would discourage future purchases of COLI. The proposal would have expanded the I.R.C. § 264(f) disallowance of otherwise deductible interest expense associated with COLI.
15. I.R.C. § 172.
16. I.R.C. § 56(g)(2).
17. Codification § 825-10-25.
18. Codification paragraph 825-10-35-4.
19. Codification § 715-30-20 (Glossary).
20. Codification paragraph 715-30-35-27.
21. Codificaiton paragraphs 715-30-35-43 through 45.
22. Codification paragraph 320-10-25-1 (b).
23. Codification paragraph 320-10-35-1 (b).