BUSINESS PLANNING

Nonqualified Deferred Compensation

"I want to provide extra benefits to my key people, but qualified plan nondiscrimination rules are just too restrictive."

The Scenario

Allison Maynard and Logan Smith met early in their careers as real estate agents. Initially fierce competitors in their local market, they got to know and respect each other when their sons were on the same travel baseball team. They eventually teamed up, founded GreenAcre Group, Inc., and brought in a total of ten additional agents over the next decade. One of these agents—Jordan Thomas—was a rising superstar. Clients trusted him and enjoyed working with him. He was good at reading people and navigating the emotions attached to home buying, but he also excelled in the business and financial side of the job. His strong knowledge of the local area and the market was a true asset, and in the past year he brought in $30 million in sales.

Allison and Logan know GreenAcre is a stable, profitable business, and as they move closer to retirement, they want to make sure it stays that way. A key component to their strategy is keeping Jordan with the company. His commissions provide him with an excellent income. GreenAcre offers a qualified retirement plan for all employees and Jordan qualifies for the maximum allocation under IRS nondiscrimination rules.

Allison and Logan know that other real estate companies would like to lure Jordan away from GreenAcre. They want to make certain that they provide him with competitive benefits that will encourage him to stay in place. However, with the restrictive regulatory environment surrounding qualified retirement plans, the cost of plan administration, and caps on contributions and benefits, they are not quite sure how to accomplish this. And of course, they don't want to offer additional benefits to all employees, just Jordan. They meet with their advisor to discuss their options.

CHARACTERS AND CONCERNS

Allison Maynard – One of the co-founders of GreenAcre Group. At 55, she places the greatest importance on keeping the business stable and successful as she closes in on retirement.

Logan Smith – The other co-founder of GreenAcre Group. He is 57 years old and, like Allison, has no immediate plans to retire, but has begun thinking about the idea.

Jordan Thomas – At 40, he is the company's top broker, and was named top broker in the entire area the previous year. He likes working for GreenAcre, but other real estate companies consistently approach him. So far, he has resisted other offers.

A Planning Strategy

Their advisor, Chad Bogard, suggests that they set up a nonqualified deferred compensation arrangement with Jordan to provide additional retirement income and death benefits. Because the plan is not a qualified plan, they can select the employees they wish to benefit without worrying about nondiscrimination rules or mandated maximums on contributions or benefits. In fact, they can customize the arrangement to benefit only Jordan, and do so with minimal paperwork or administrative costs.

They set up a plan in which the company promises to make payouts to Jordan beginning at a specified retirement age. This future income does not reduce Jordan's current compensation. For Jordan to avoid current taxation on the deferred income (allowing this amount plus any earnings to grow on a pre-tax basis), he must have only an unsecured promise to receive these benefits in the future—in other words, the company may not set aside reserves to pay the benefits.

While Allison and Logan feel that the income tax deferral is an important part of the benefit, they are uncomfortable not having any funding in place to cover these future payments. They purchase a life insurance policy on Jordan's life to informally fund the arrangement (after giving notice and getting Jordan's consent). If Jordan dies after payments have begun, the death benefit will be paid to his named beneficiary.

MORAL OF THE STORY

Qualified retirement plans are not the only option when it comes to providing owners or key employees with additional benefits. Nonqualified deferred compensation arrangements are an effective way to reward and retain valuable, highly compensated employees on a selective basis.