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Navigating the Executive Benefits Landscape
with The Todd Organization

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Financing Executive Retirement Plans: Strategies, Timing, and Other Considerations

When and how should a company finance its non-qualified, executive retirement plans? In order to minimize costs and even increase shareholder value, it often makes sense for companies to finance plan liabilities as soon as possible.

One thing is certain: companies should study the best way to address these liabilities in order to maximize shareholder value and to be better able to retain and attract the quality executives participating in plans.

Factors that should be examined when deciding when and how to undertake plan financings include:

- Whether or not the plans have been previously financed and, if financed, the type of assets used
- Tax ramifications of different assets
- Asset-liability management concerns
- Acquisition likelihood
- Executives' participation levels and expectations from plans

Background

Non-qualified retirement plans typically supplement a company's qualified retirement plans – pensions and/or 401(k)s. They enable executives to receive a higher amount of retirement income and better plan for the future.

Often, because of strict limitations on qualified retirement plan contributions, executives will only be able to save enough money to replace 35 percent or less of their annual compensation with qualified retirement plans. In contrast, many other employees could save enough to replace 70 percent of their compensation from qualified plans alone. Non-qualified plans thus often serve as a bridge to help executives receive a higher percentage of their annual compensation in retirement income.

Non-qualified plans, however, cannot be "formally" funded even if they are contractually promised. According to the IRS, if non-qualified benefits were to be set aside in a secure trust, the participant would be in constructive receipt of the money and would be subject to current taxation, essentially negating any advantages of participating in a non-qualified plan.

Timing of Plan Contributions

Companies often choose to informally fund their non-qualified retirement plans in order to better retain and attract key executives, while also improving shareholder value.

Some companies have taken a deliberate approach of setting aside a pre-determined amount of assets to meet plan obligations – and have done so since a plan's inception. Others have partially financed a plan. Some, however, have not provided any financing, choosing in effect to "self-fund" plans in the future.

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Companies which are behind on financing plans will often look to make catch-up contributions to address liabilities and obtain the benefits of compounding. In particular, if a company has a large number of executives who are approaching retirement in five years participating in plans, such catch-up contributions may be particularly advisable. A period of higher than expected profitability is also a good time to make catch-up contributions.

Financing Alternatives

Companies' financing options include the following:

- **Self-Funding.** By choosing to not set aside assets for a plan and self-fund, a company is making a choice to pay benefits as they become due. This is analogous to how the Social Security system now works, with future management in effect paying current management's benefits. There is the absence of investment gains and compounding that is an essential feature for generating sufficient retirement plan assets and avoiding major shortfalls.
- **Conventional Retirement Assets: Mutual Funds, Stocks and Bonds.** Some companies will institute mirror plans to their qualified 401(k)s, using bonds, individual stocks and/or mutual funds for financing. Taxes, though, must be paid annually on dividends and capital gains.
- **Corporate-owned life insurance or COLI.** COLI is also quite popular. With COLI, the assets typically grow on a tax-deferred basis. Companies can also take a multi-faceted approach, employing several different asset classes.

A number of companies will use COLI in combination with conventional retirement assets to finance non-qualified retirement plans.

Protecting Executives' Retirement Assets

Regardless of the asset class or amount of funding, one feature that is usually advisable in any plan is a rabbi trust. These trusts stipulate that executives will receive promised funds in the event the company is taken over or management tries in the future to renege on the benefits. The added assurance this provides leads executives to more fully participate in plans.

In fact, a company which is "self-funding" its plan, and in effect has no assets set aside for the non-qualified retirement plan, could be sending a signal to executives that the plan is not likely to pay benefits, especially if it is acquired. This could drive many talented executives from the company, leading to much higher costs for executive recruiting, new executives, and lost business opportunities for the company.

Summary

With many key executives now approaching retirement, non-qualified plan financing strategies are more important than ever for many businesses. Through careful assessment of financing alternatives, companies can often structure plans that are cost effective and beneficial to shareholders, as they address future liabilities and ensure investment compounding while also meeting executives' retirement obligations.

The Todd Organization has numerous experts available to help companies address non-qualified retirement financing matters. For more information about these programs, please contact your Todd consultant.

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