Edited

PBS What is a NonQualified Plan? Josh Owen Edited Transcript

Patti Brennan: Hi, everybody. Welcome to "The Patti Brennan Show." Whether you have $20 or 20 million, this show is for those of you who want to protect, grow, and use your assets to live your very best lives. I'm really excited about our show today.

Joining us is Josh Owen. Josh is Regional Vice President at Principal. His expertise is in this area called nonqualified plans. Josh, thank you for joining us today.

Josh Owen: Pleasure to be here.

Patti: Let's get out of the lingo. What is a nonqualified plan?

Josh: Simply stated, it's any retirement plan that's not qualified by ERISA, that pesky organizational body that puts the rules, restrictions, and limitations on qualified plans like 401(k) plans.

Patti: It's a retirement plan that doesn't have all the rules and regulations that are associated with 401(k)s that have so many limitations, right?

Josh: Correct.

Patti: I guess my first question for you is why doesn't everybody have a nonqualified plan?

Josh: [laughs] Well, the upside of being nonqualified is that you do get that flexibility without limitations. The downside is it doesn't come with the government protections that qualified plans have. If my employer goes bankrupt, I'm still guaranteed my 401(k) dollars. That's not necessarily the case with nonqualified plans. Certainly, there's considerations with the upside.

Patti: Let's talk about that a little bit, because that is a question that always does come up. Whenever somebody comes in, they've got a nonqualified plan option available, we encourage them to do it. We must tell them that, if the company goes through difficulty and goes under, this could be subject to the claims of their creditors, right?

Josh: You're exactly right. That's the primary reason we encourage people to max out their qualified plans, fully protected, government-protected opportunities first and then view and utilize the nonqualified plans how they're intended to be utilized, which is a supplemental plan sitting on top of the qualified plans available to you.

They're just offered for the top-income folks on the pyramid there. These are the individuals where even if you can max out the 401(k), it's probably not enough to get you where you need to be for retirement readiness. There's a shortfall. This is really intended to be that supplemental plan, addressing that shortfall for those individuals.

Patti: You work for Principal, right?

Josh: Right.

Patti: Let's say that a company has their nonqualified plan with Principal, even though Principal is the custodian, it's still could be rated. It still could be forfeited.

Josh: Yeah. Taking it a step back, there's two sides of a coin with a nonqualified plan. To the participants, looks and feels exactly like a 401(k), taxed exactly like a 401(k), but as we talked about -- I'm sure we'll expand on -- much more flexible than a 401(k).

On the plan sponsor side, it's different. These are still going to be corporate assets on the balance sheet of the company until they're paid out to the individuals. In 401(k) plans, those assets are off-balance sheet in a risk of trust that's fully protected.

Because it's technically a corporate asset, should that worst-case situation arises, it's just like any other corporate asset, that bankruptcy judge is going to determine what happens with those dollars. Now, there are plenty of things that you can do to minimize and mitigate that risk, and as you can imagine, I spend a lot of my time consulting on those strategies.

Patti: In other words -- in English -- we could defer 10 percent of our income into a nonqualified plan. It's sitting on my company's balance sheet, and if my company goes under, they could take the money that I would have gotten in as a salary. Is that correct?

Josh: That's correct, now.

Patti: Now, I don't know if you know this, I'm going to hit your blind side. How often has that happened, historically?

Josh: I've been with Principal for 18 years, and we've seen it happen 17 times to our clients. We've got a little over 3,000 clients, so it's infrequent. It's infrequent because you can always terminate a plan at will and just pay people out a year later.

If the company can see into its financial future a year or a couple of years in advance, they can take the appropriate action. It never gets to that situation. It's just companies that either fail to take proper action or are blindsided by a bankruptcy situation that really comes into play.

There are still some planning strategies where, if the program is fully funded, if it is set inside of a trust, these are things that could increase the likelihood that in that worst-case scenario, again, very rare to begin with, but even in that worst-case scenario, that the dollars would still flow back to the end-user participants.

Patti: One of the things that you and I talked about was the fact that, because this is a 401(k)-lookalike plan, there can be matching contributions.

I could be wrong about this, Josh, but I thought that when push comes to shove in those 17 cases, for example, the bankruptcy judge is going to decide, "OK, how much of this is actually going to be subject to the claims of the creditors?" At least historically, those judges tend to leave the employee contributions intact. In other words, that doesn't count.

Josh: You're exactly right, it is what we typically see, but we can't put it in writing as this is guaranteed to what happened because it is up to each bankruptcy judge. If this podcast isn't being recorded, I can go on record and say that yeah, that is the case.

If it's structured properly, funded in a trust, we've never seen a situation where participants did not get back the dollars associated with their own deferrals. The question would be if there had been made any company contributions, do they get all of it? None of it? Pennies on the dollar.

Patti: That's helpful. That is helpful to define what the actual risk really is. It's there. You must be aware of it. Things happen, but it may not be as disastrous or what have you. That, to me, would be confiscatory.

Josh: Right. I would say these are probably not plans that would make sense for the very reasons we're talking about for a startup company or a company in a risky industry. These are typically going to be stable organizations around for a period with strong cash flows that do have a group of top individuals, they are looking to place a supplemental benefit on with fairly low risk.

Patti: When we were talking about this, you said this is typically to solve one of two problems. Can you elaborate on that a little bit?

Josh: Certainly. Usually, a nonqualified plan gets established because there's either a retention problem at a company or there's a retirement problem at a company, and it can be both. Retirement problem, again, I mentioned that this is the higher-income earners for an organization.

You've got one of two situations occurring. Both folks are maxing out the 401(k), but at high-income levels, they need to defer more pre-tax. Or, in a lot of cases, companies struggle in their 401(k) non-discrimination tests, and people that are considered highly compensated under the IRS rules might get some of that money refunded back to them.

There are artificial limitations that we can try to overcome using a nonqualified plan. From a participant perspective, it's great that not only can you defer an unlimited amount, there is no dollar amount limit, but there's also no early withdrawal penalties on the back end. Tremendously flexible as far as how an individual can structure their own benefit.

Patti: When they make that election, you say you're going to put that extra 10 percent over and above the 401(k) in, you also must make an election in terms of when you're going to receive it back, right?

Josh: 100 percent right. I'll use myself as an example. I've got three children here in the area, and I'm starting to think about college planning. I've got five different accounts that I've set up for myself and my nonqualified plan. I've got one for each child that's scheduled to pay out when they turn 18 in four installments.

I've got the bulk of my nonqualified dollars in a retirement account that's going to pay out over a full decade when I leave Principal. Then some small dollars in a secondary retirement account payable in a lump sum because, when I retire, I want to go travel the world, I want to go on a cruise.

Each year, I get to decide the amount of compensation to defer. Again, there's no dollar amount limit, and then how I allocate those dollars amongst these goals that I've established.

Patti: That's so interesting because I would imagine that, from a structure perspective, it's difficult for most employees to figure that stuff out.

I'm just curious, Does Principal have a system where people can keep track of them and say, "It's going to go into this bucket, it's going to go into that bucket"? Is that from your perspective or Principal's, or your custodian?

Josh: No. Principal has the technology through the website and the mobile app to visualize all these accounts you've set up, customize the investment portfolio to mirror it to the time horizon of each of these future distributions and these goals. Clearly, everything I've already said and will continue to say, these are more complicated than a 401(k).

Oftentimes, a good financial advisor or consultant in the mix to have one-on-one sit down how this can fit into these high-net-worth individuals' personal financial plans so they can extract as much value as possible. That's key to the success.

Patti: It's interesting, and I'm going to say this, [we work with a lot of clients who have nonqualified plans, and I don't know that I've ever seen where the plan allowed for that bucketing and kept track of it, which I think is fantastic. That technological advantage that you might have is really appealing to me.] 1

Josh: Been in the industry 18 years. 18 years ago, it did not look like that, but that is a modern nonqualified plan today. It's intended to look and feel familiar to the individuals that utilize it, meaning as much like a 401(k) plan as possible, but taking full advantage of that lack of ERISA oversight and flexibility.

Patti: I'm dating myself, Josh, but it used to be when I first started as a CFP, nonqualified plans were all insurance-driven. [I love the fact that it has moved forward to be that 401(k) lookalike, so you can structure the portfolio accordingly.] 2

Josh: Correct. Insurance is still involved to some extent, depending on the circumstance. I mentioned that these are corporate assets on the balance sheet. Some plan sponsors do utilize insurance products to avoid corporate taxation. This is where separation exists.

The participants themselves inherently get the same tax treatment as a 401(k), and our technology provides them with the same day-to-day experience as a 401(k). Plan sponsors don't automatically get that, and that's where certain financial instruments might help them in avoiding some repercussions.

Patti: One of the things that you said initially was this is really for larger companies. It's not necessarily for small companies. There's a reason for that, isn't there?

Josh: There is. I mentioned this is exempt from ERISA. We're utilizing a specific exemption, which is called a top-hat exemption, which just means these plans cannot be offered to anybody and everybody you want. It must be restricted to a select group of key employees. Maximum is 10 percent of your employee population.

Most of our plan sponsors, it's more like three to five percent of the population. If you've only got 20, 30, 40 employees, it probably doesn't make sense to go through the effort and the expense of sponsoring a plan for one or two people. Although there are exceptions to the rule, usually more than 100 employees is where we see activity.

Patti: What's involved in setting them up? Are they expensive? What's that all about?

Josh: Not expensive, not time consuming. Nonqualified plans don't have 5,500 reporting requirements. There's no audits. It's 90 days up and down. Think of it like a micro version of a 401(k) installation. Just a lot of less oversight from a fiduciary perspective.

Earlier, I did mention that there's retirement issues and then the retention problem that we are solving as well. This is where, oftentimes, plan sponsors after a 401(k) plan have been around for a while, company contributions are fully vested. You can't retain people through vesting schedules and qualified plans.

Nonqualified plans have no restrictions on vesting schedules. We'll commonly see plans designed where vesting is based not on someone's date of hire, but instead the date of the contribution. If I got money that hit my account today, it might vest five years from today, money next year, five years from next year.

It gives its owners or CEOs the ability to motivate people financially speaking for the duration of a project, stay bonuses or even recruitment bonuses. It's very flexible, completely discretionary company contributions with whatever restrictions or vesting schedules they want to apply to those dollars.

Decreasing the turnover rates of your most key employees drives the value of the business up. That's one of the key outcomes that our business owners are typically looking for.

Patti: That's fantastic. That is fantastic. There are many things that I thought were interesting about what you do - you've got three kinds of people who may be listening to this podcast today that you tend to work with. I thought that was fascinating because, honestly, we've got all three who listen to this podcast. Why don't you elaborate?

Josh: I think that's great. I'm partner with financial advisors and consultants that work in the benefit space, whether that's 401(k) retirement benefits or other benefits, where they have direct access to C-level individuals and business owners.

I'm that subject matter expert partnering with the advisors that might be listening and then working directly with that business owner, CEO, CHRO, solving these problems we're talking about, fixing testing issues in a 401(k) much less expensively than the alternative approaches, retaining key talent, all those things.

Then, ultimately, once the plan is designed, it's all for naught if the end users don't understand it or appreciate it. Ultimately, part of my job is to help clearly communicate the benefits of the program so that everybody -- the plan sponsor and the participants -- get as much value as possible.

Patti: That is fantastic. Let's say that we've got one of the employees who's listening to this podcast, and they say, "Yeah, I want one of those. I want one of those." Pros and cons from their perspective. I'm also interested...I'm going to ask you two questions, Josh. Sorry, hitting you all at once.

That 10-percent rule, I learned something today, I didn't realize that was part of this. Is that because those same companies also have a 401(k), and that's why there's that limitation, or is that limitation just period, end of discussion?

Josh: I'll be careful with the limitations. In the world of nonqual, there's a lot of gray. It's a guideline. The official definition for a top-at plan is for a select group of key employees in management. Period. It's not clear. We've never seen any company ever get questioned, as long as two things.

The only people they make eligible for the plan are considered highly compensated. We use the same definition that the 401(k) plans use. It's offered to less than 10 percent of the population. It's not an official safe harbor, but those are the guidelines that we go by as well.

Patti: That's very interesting. That is such an interesting idea and wonderful because of the structure that you can set up in terms of solving what's important to that person, and it helps the business as well. It's a win-win situation, totally.

I just wish that it was available for everybody. It's just one of those things. That's something that I need to explore a little bit further.

Josh: It's certainly becoming much more mainstream. 18 years ago, this was typically 5,000-employee companies or larger. Each year since then, it's been coming down market, normalizing as a benefit as people jump from larger companies to smaller, they had a plan, they expect a plan.

It certainly is, especially with the continued limitations that exist outside of nonqualified plans will continue to be an important part of the overall dialog.

Patti: One last thing, and that is you said something in our conversation that said most of the time the business owner is not involved. They are not one of the people that are participating in the plan. Why is that, Josh?

Josh: Getting into the weeds a little bit, but we already referenced that these plans, the assets are corporate assets on the balance sheet. If I own 100 percent of the business, I can participate in this plan. I can defer $100,000 of my salary, and my W-2 went down by 100,000, but now the company that I own looks like it's $100,000 more profitable.

If it's a pass-through entity, I've done nothing from a tax perspective, net of that transaction. We do see owners of C corporations participating to take advantage of that tax arbitrage between personal and corporate rates, but otherwise, not really.

Patti: Just to define the pass-through, what's a pass-through? Can you define it for our listeners?

Josh: Sure. C corporations are true corporations that pay a corporate tax rate. The federal tax rate right now is 21 percent. Other organizations like S corps, LLCs, partnerships, those the revenue is passed through at the personal tax rate to the owners of those businesses.

Patti: Excellent. Josh Owen, I could talk to you all day about this. My mind's going a mile a minute thinking, "Wow, this is such a great concept." I got to go to Congress and say, "Come on, you got to lift this ceiling here.

"You know why? If we have a retirement crisis -- which we do -- why wouldn't we want to be able to offer this to more people, to more employees? They're all important for crying out loud."

Josh: Could not agree more.

Patti: Thank you so much for joining us today, and thanks to all of you for joining us. I hope this has been as helpful for you as it has been for me. If you have any questions on this or any subject, go to our website at www.keyfinancialinc.com.

Most of all, thank you so much for giving us your time and your attention. We really appreciate it. Let us know if there's a subject that you want to hear about, learn about, etc. In the meantime, I hope you have a wonderful day. Take care.