Funding *nonqualified* deferred compensation plans

Employers can choose to informally fund their nonqualified deferred compensation (NQDC) plan. Learn about the potential benefits for both plan sponsors and participants.

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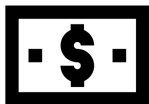
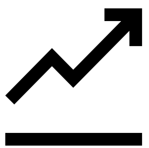
NQDC plans can be informally funded or not funded at all. Plan sponsors offering an unfunded plan promise to pay benefits when due, but from the company's general assets at that time. When funding informally, plan sponsors set money aside in a rabbi trust, giving participants more confidence that money will be available to pay their benefits. Funds in a rabbi trust can be invested a few different ways to help reduce out-of-pocket expenses.

Common investments for informally funded plans



Cash or cash equivalents

Provide liquidity



Mutual funds and other taxable investments

Hedge against growing benefit liability

Corporate-owned life insurance (COLI)

- Accumulate tax-deferred cash value
- Use cash value to pay benefits

Understanding the differences

Informally funded NQDC plans can offer both plan sponsors and participants advantages over unfunded plans. But these advantages require greater commitment on the employer's part by setting aside money throughout the life of the plan.

The funding method ...	Unfunded	Informally funded
Offers participants more comfort and helps increase the security of plan assets	No—Participants must trust the plan sponsor to make good on commitments when benefits are due	Yes—Rabbi trusts help protect plan assets from any plan sponsor change of control or change of heart (but not from the claims of creditors)
Helps to hedge some investment risk	No—Payments are made from the plan sponsor's general assets without considering the benefit liability's investment allocation	Yes—The plan sponsor can invest and replicate the investment allocation of the benefit liability so that assets move in tandem with the liability
Offers tax advantages	No—Assets aren't invested to receive tax advantages	Potentially—Plans funded with COLI have access to the tax-deferred cash value and receive tax-free death benefits
Reduces out-of-pocket cost to plan sponsor	No—The plan sponsor must pay 100% of benefits from company assets	Yes—The investment growth of funding assets can help lessen the out-of-pocket benefit costs to the employer

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Matching plan assets and liabilities

Informally funding an NQDC plan may allow the plan sponsor to hedge some of its risk by aligning the plan's assets and liabilities. Participant benefits are a liability—likely an increasing one—to the company; informal funding creates an asset to help offset the benefits owed. Investing the money or buying COLI can help grow the asset in line with the liability.

Assets (the funding is a company asset)	
Current assets	
Cash	$5,000
Receivables	$2,000
Inventories	$12,000
Total current assets	**$19,000**
Property and equipment (cost)	
Fixtures and equipment	$12,000
Truck and car	$8,000
Less accumulated depreciation	–$2,000
Total property and equipment	**$18,000**
Total assets	***$37,000***

Liabilities and owner equity (benefits owed are a company liability)	
Current liabilities	
Accounts payable	$3,000
Accrued liabilities	$4,000
Debt due within the year	$4,000
Total current liabilities	**$11,000**
Long-term debt	$7,000
Total liabilities	**$18,000**
Owners equity	$13,000
Current earnings	$6,000
Total equity	**$19,000**
Total liabilities and owner equity	***$37,000***

For illustrative purposes only. Individual circumstances may vary and may not be reflective of your situation.

Informally funding can help manage plan costs and create value to the plan sponsor.

Some key terms to know when discussing NQDC plans

- **Rabbi trust**
  This is a trust for employers to set aside assets for future NQDC benefit payments. It helps protect participants against any employer change of control or change of heart, but the assets are still subject to the employer's general creditors.

- **COLI**
  These are life insurance policies on the lives of plan participants, purchased by plan sponsors to fund benefit payments. The employer or rabbi trust is the owner and beneficiary of the policy. The cash value grows tax deferred and can be used to pay plan benefits, and death benefits are tax free to the beneficiary.

- **Tax arbitrage**
  This strategy uses COLI to generate tax advantages of plan assets. Plan benefits—liabilities to the employer—grow tax deferred. By using COLI, the cash value also grows tax deferred, aligning the tax treatment of the asset with the liability. And if the participant were to pass away, the COLI death benefit is tax free, eliminating taxation of the asset.

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Please contact your **John Hancock representative** to learn more about NQDC plan funding options and how we can help you establish a plan for your clients.

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