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# Benefits Perspectives

Current Issues in Employee Benefits

FALL 2002

• Tools for Successful Asset Allocation in a Defined Contribution Plan

• Nonqualified "401(k) Mirror" Plans: Gazing Beyond the Looking Glass

## Ten Questions to Ask About Your Disability Plan

by Daniel D. Skwire

With healthcare costs rising and the stock markets in turmoil, it seems that employer-sponsored medical and pension plans are on everyone's mind lately. Disability plans, in contrast, receive much less attention. In fact, disability plans in general, and long-term disability plans in particular, may be the most challenging and complex of all employee benefits. The subjective nature of determining the risk and the long-term nature of the liability mean that disability costs can be extremely volatile. A moment's inattention can result in a significant cost increase for both employers and employees.

To keep disability costs under control, employers should periodically review their disability plans, paying particular attention to the following 10 questions.

### 1. How is the current plan performing?

A disability plan's performance is measured most effectively through the use of loss ratios, i.e., the ratio of the incurred claims to the disability insurance premiums over a specified period of time. Incurred claims are the sum of paid claims (cash benefits paid to disabled employees during the time period) and the increase in claim reserves (the expected cost of future payments for currently disabled employees). In the case of self-insured plans, the premium is the amount set aside by the employer to fund the expected level of disability benefits, plus any contributions made by employees.

In general, a low loss ratio indicates favorable experience, while a high loss ratio indicates the opposite. But how high is too high? Employers should determine a "tolerable loss ratio"—the maximum acceptable ratio of incurred claims to premiums—by subtracting plan expenses (expressed as a percentage of premiums) from 100%. Tolerable loss ratios are

often in the range of 65%-85%. For insured plans, the tolerable loss ratio is established by the insurer and generally is lower than that for an equivalent self-insured plan in order to provide the insurer a profit. An actual loss ratio that exceeds the tolerable loss ratio may indicate the need for a premium rate increase or other remedial action.

Table 1 shows a sample loss ratio calculation for a plan with experience somewhat worse than expected:

TABLE 1

LOSS RATIO EXAMPLE	
A. Paid Claims	\$50,000
B. Change in Claim Reserve	\$150,000
C. Incurred Claims (A + B)	\$200,000
D. Premium	\$250,000
E. Actual Loss Ratio (C / D)	80%
F. Tolerable Loss Ratio	75%
G. Ratio of Actual to Tolerable (E / F)	107%

### 2. Does experience vary by segment?

The experience summarized in Table 1 shows overall claims slightly above tolerable levels. But many disability plans are composed of multiple business segments that may perform very differently. For example, a manufacturer may have different levels of benefits for management and union employees. Other firms may have one level of benefits provided at no cost to the employee (a "noncontributory plan") and another level of benefits requiring a payroll deduction (a "contributory" or "voluntary" plan). If at all possible, these different segments should be studied separately to determine whether they should be subject to the same or different remedial actions.

TABLE 2

LOSS RATIO EXAMPLE BY SEGMENT			
	Noncontributory	Contributory	Total
A. Paid Claims	\$10,000	\$40,000	\$50,000
B. Change in Claim Reserve	\$50,000	\$100,000	\$150,000
C. Incurred Claims (A + B)	\$60,000	\$140,000	\$200,000
D. Premium	\$100,000	\$150,000	\$250,000
E. Actual Loss Ratio (C / D)	60%	93%	80%
F. Tolerable Loss Ratio	75%	75%	75%
G. Ratio of Actual to Tolerable (E / F)	80%	124%	107%

For example, the experience in Table 1 could be segmented into a noncontributory and a contributory plan as shown in Table 2.

This refinement in the loss ratio analysis suggests that the higher than expected claims are due to poor experience in the contributory segment. Rather than applying a flat rate increase to the whole plan, the employer might want to consider actions that are targeted more specifically to the contributory segment.

### *3. What patterns are visible in the disability claims?*

Loss ratios are useful tools in understanding the performance of a disability plan, but they are only a high-level financial measure. To more fully understand the loss ratios, it is necessary to look deeper into the available data. One useful area to explore is the pattern of actual disability claims under the plan. For example, if a company has a high amount of incurred claims but discovers that most of the cost is due to a single abnormally large claim, then perhaps nothing is fundamentally wrong with the plan and the high claim was a one-time blip. On the other hand, if a company that traditionally pays 10% of its claims toward such subjective problems as stress and anxiety suddenly experiences 75% of its claims for these problems, then a widespread issue with the company's work environment or with the employees' motivation level might be an underlying cause.

### *4. Is the plan experiencing anti-selection?*

"Anti-selection" is a phenomenon that affects voluntary insurance programs. Individuals who believe they are most likely to need a benefit are most likely to purchase coverage. An employer that experiences anti-selection in its disability plan

may find itself with higher disability costs than it anticipated when designing the plan. Anti-selection can arise in a voluntary plan that charges a single premium for all ages but has only a small percentage of its employees electing to purchase coverage, or a voluntary plan that offers full coverage for normal maternity claims and that does not have a pre-existing condition exclusion of at least 10 months.

Employers should review all aspects of their disability plans closely to minimize the impact of anti-selection arising from either the structure of premium rates or a combination of plan language and underwriting issues.

### *5. How well are claims managed?*

The management of disability claims, especially for long-term disability plans, is a complex process. A large amount of money is at stake: claims of thousands of dollars per month may be paid for many years. In addition, the subjective nature of disability benefits and the complex plan language mean that claim managers must work closely with the claimant's physician to establish the degree of work ability that has been lost and to develop a program that will enable a return to work. The best disability claims departments draw heavily on nurses, doctors, rehabilitation specialists, and other experts to manage claims.

Employers should ensure that claims are managed fairly and diligently so that benefits are paid in a timely fashion to truly disabled employees while also avoiding benefit payouts in situations where an employee has the ability to work but chooses not to. It is critical for an employer to communicate closely with the insurance company or third-party administrator that manages the disability claims. Periodic audits of

this function can produce excellent results. In most cases, an employer should not manage its own claims. Not only does it probably lack the expertise, but denying benefits to one's own employees can often be difficult.

#### *6. Is the plan language up to date?*

Small differences in plan language can make a big difference in administering claims and paying benefits.

Consider, for example, the difference between the following two definitions of "total disability": a) due to a covered accident or sickness, the insured is unable to perform the material and substantial duties of his or her regular occupation; and b) the insured is unable to perform his or her job at ABC Company.

The first definition is typically found in disability plan language today. The second definition is used in many older plans and has several weaknesses: it does not specify that the loss must be due to a covered accident or sickness, creating the potential for ambiguity in the event of layoffs or transfers; it refers to the employee's specific job at the company rather than to the more general concept of the employee's occupation, thereby possibly considering disabled an employee who could perform an identical function at a more accessible location; and it does not refer to the "material and substantial duties" of the employee's occupation, meaning that someone who is unable to do a very specific but unimportant task could be considered disabled.

Similar considerations exist with other definitions used in a disability plan and with the wording of provisions related to benefit payments, rehabilitation, exclusions, and limitations.

#### *7. How does the disability plan relate to other employee benefits?*

Disability plans are just one piece of an employee benefit package, often overlapping with sick pay, retirement, workers' compensation, and other programs. Employers might have to revise portions of the disability plan to ensure that employees will not receive benefits in excess of their income in the event of a disability, since overinsurance can give employees an incentive to remain on a claim for disability rather than return to work. Most disability plans should:

- reduce the benefits for amounts paid by worker's compensation, Social Security, or other federal and state programs;

- reduce the benefits for employee sick pay or contain an appropriate elimination period so that benefits do not begin until sick pay has expired; and
- include an overall limit on the percentage of income that can be replaced by disability benefits in combination with work earnings and benefits from all other sources.

#### *8. What employment and economic factors affect the plan?*

Disability plans are sensitive to the work environment. For example, an employer that has gone through a recent merger with layoffs may find that employees have a low level of morale and job satisfaction. This situation might result in higher levels of disability claims among employees who are worried about losing their jobs, or who have a decreased level of motivation. Claims for subjective conditions such as stress and anxiety often increase in this type of work environment.

The financial performance of a disability plan also can be affected by economic factors such as interest rates. Employers are required to reflect the anticipated cost of future claim payments to disabled employees in their financial statements through the use of claim reserves. If interest rates decrease, then the claim reserves set aside by the employer will increase, since the employer can expect to earn less investment income on the money set aside to make future claims payments. In other words, falling interest rates can have the same effect as higher levels of incurred claims, even if the underlying disability experience does not change.

#### *9. How does the plan compare with those offered by similar employers?*

Every employer has its own benefit strategy, but there is generally a certain similarity among benefits offered by similar employers to similar classes of employees. When reviewing its disability plan, an employer should compare its benefits with those of similar employers and identify any major differences. Areas where the plan is either unusually restrictive or unusually generous should be addressed. For example, an employer that offers only a two-year benefit period to its management employees may find its plan under-competitive relative to other employers that extend benefits to age 65, thereby hurting employee recruiting and retention. Similarly, an employer that offers a lifetime benefit period with a cost-

of-living adjustment may find it is incurring unnecessarily high costs and volatility for its plan.

#### *10. What follow-up actions are needed?*

Once an employer understands the plan's performance, the underlying causes of that performance, and the plan's strengths and weaknesses relative to plans in other similar employers, it should consider the following actions:

- If experience is poor, change the plan language, risk management guidelines, or premium rates to improve loss ratios.
- If claims are not managed well, search for a new third-party administrator or insurer that has more expertise in this area.
- If the plan's experience is highly volatile and significantly impacting the employer's financial results, consider switching to an insured plan. The decision of whether to offer an insured plan or a self-insured plan must consider complex factors such as risk tolerance, cost, and risk management expertise.

Regardless of current plan performance, establish a system for obtaining ongoing experience reports that will monitor the plan's future performance through the use of loss ratio analysis and claim listings.

#### **Conclusion**

Disability plans may appear to be a small part of the overall employee benefit package relative to health insurance and pensions, but they can be surprisingly volatile and costly if they are not appropriately managed. Employers should perform regular reviews of their plans to ensure that they are performing well and to enable them to take early action to address any issues that may arise.

*Dan Skwire is a consulting actuary in Milliman USA's Portland, Maine office. This article was peer reviewed by consulting actuaries Robert W. Beal, also of the Portland, Maine office, and Timothy F. Harris of the St. Louis office.*

## **Tools for Successful Asset Allocation in a Defined Contribution Plan**

*by Charles Hodge*

Gravity is not just a good idea, it's a law. And while the laws of investing are not as clearly defined as Newton's discovery, they do apply to all investors, regardless of their risk profile, return objectives, or investment acumen. For an employer sponsoring a retirement plan that gives employees control over their investment decisions, asset allocation tools that have emerged in the past decade or two can play a role in plan participants' investment success.

This article examines a number of tools, available to 401(k) and other defined contribution plan sponsors, that can help employees maximize their retirement savings through strategic asset allocation.

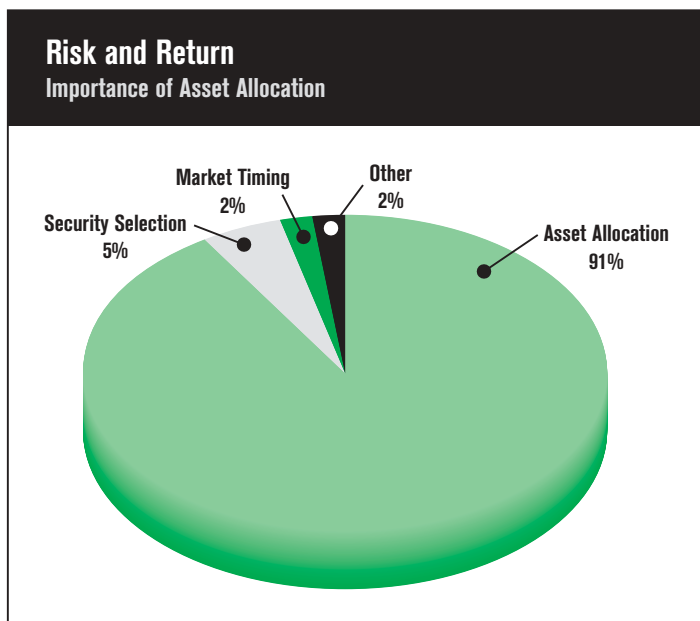
#### **The Importance of Asset Allocation**

Most professional financial advisors attribute investment success to asset allocation (see Chart 1 on p. 5). One highly regarded study, commonly referred to as the Brinson, Singer

and Beebower study, identified asset allocation as the key factor contributing to investment success. According to the 1991 landmark study, fully 91% of a portfolio's success or failure can be attributed to asset allocation—the apportioning of stocks, bonds, and cash within the portfolio. Effective asset allocation draws finer distinctions within these asset classes, taking into consideration stock capitalization (small-cap versus large-cap) and style (growth versus value) or bond duration (intermediate-versus long-term) and credit quality.

A mid- to large-sized defined benefit plan arguably presents an illustration of long-term investment strategy. Although in most cases the liability to pay out benefits extends into the distant future and is perpetual in nature, the plan sponsor must plan for and react to short-term challenges to meet its obligations and responsibilities. Typically, a plan sponsor will examine its liability first and then determine the appropriate asset allocation to fund the liability with a minimized and

CHART 1



Determinants of Portfolio Performance: Source: Brinson, Singer, Beebower (1991)

predictable range of expected contributions. To do so, plan sponsors draft a written policy, outlining their objectives, target asset allocations with allowable ranges, and periodically rebalance the investments accordingly. After three to five years, they re-examine the entire process to ensure that the objectives can be met or to modify the policy, objectives, or asset allocations if necessary.

An individual's retirement investment portfolio is not likely to approach the scale of a defined benefit plan. But the outcome is likely more important to that individual investor. Unlike in a defined benefit plan, a participant's income from a defined contribution plan at retirement is dependent on investment performance. Few individuals can afford the price tag of an asset liability study for a corporate plan, yet their investment success depends on the same 91% performance factor—asset allocation.

### Evolving Plans

Investment managers often describe the financial markets by using the metaphor of a pendulum swinging back and forth, between different factors that produce positive and negative results. Growth funds might be in favor for a period, then value funds or small-cap funds, then large-cap. For investments in defined contribution plans, the cycles are no different. The differences in return (and volatility) create the opportunity to

diversify a participant's portfolio. Successfully timing the market (i.e., guessing which asset class will be "in favor" in the near term) is beyond the skill of most, if not all, investors. Instead, a long-term oriented strategy of periodic rebalancing will take advantage of these market changes to lower the risk and enhance the return of a diversified portfolio.

In the early days, defined contribution plan participants typically had only a few investment choices, and due to transaction restrictions, participants were forced to focus on the long term. In the mid-90s, a rapidly rising market rewarded risk takers with unusually high returns. Some participants believed that a plan's core options were too timid for the "new economy" market environment. With strong demand for more frequent trading ability and with technology capable of catering to participants' and employers' desires, the defined contribution plan environment underwent a substantial change. Now, after the painful investing years of 2000 through 2002, employees and plan sponsors have learned a few lessons about investing in volatile times.

Today, financial advisors are once again reminding defined contribution retirement plan participants and sponsors of the need to continue to focus on long-term results and to rebalance a portfolio accordingly. A personal finance magazine is not likely to sell many copies with the headline, "Investor Rebalances to Strategic Goal of 15% International," yet an individual reallocating the assets in his or her retirement portfolio is far more likely to achieve success than one whose strategy relies on market timing.

Historically, only institutions and high-net-worth investors had an interest in or a need for investment advice. Employees had defined benefit plans that were managed by professionals and promised a specified retirement income. As companies shifted the retirement savings responsibility and investment management risk to the employee as participant-directed 401(k) plans proliferated, the need for investment assistance shifted to smaller account balances. Employees with limited investment management skills who have not yet deferred a percentage of their first paychecks are having to choose an asset allocation specific to their risk profile and time horizon.

### Evolving Tools

Fortunately, as the investment environment became more challenging, tools to assist individual plan participants have proliferated.

TABLE 1

ASSET ALLOCATION TOOLS				
Feature:	Core Options	Lifestyle Funds	Model Portfolios	Personal Advice
Flexibility	Yes	No	Yes	Yes
Customized to the plan	Yes	Limited	Yes	Yes
Customized to the participant	No	No	No	Yes
Participant profile input	None	Time Horizon	Questionnaire	Questionnaire or interview
Recognizes non-plan assets	No	No	No	Yes
Contributes to participant education	No	No	Yes	Yes
Typical additional fees above normal plan expenses	None	Low	Low	Yes

erated. Some developments are the consequence of investor demand, while technology has contributed others.

Plan sponsors now have tools that can assist participants in determining an appropriate asset allocation, as shown in Table 1 (above) and described below.

#### *Lifestyle Funds*

When 401(k) plans were in their infancy, participants could obtain investment advice only from a financial planner or broker. Because many brokers and financial planners were compensated based on the transactions they generated, they were not inclined to provide investment advice for an individual's plan assets because no "retail" commissions were produced. In the early 90s, "lifestyle" funds became available to 401(k) plans and mutual fund investors. These funds are balanced funds constructed with both stocks and bonds, and are usually diversified among different styles, capitalizations, and countries. Unlike balanced or "domestic hybrid" funds, lifestyle funds are typically constructed by a mutual fund company using a number of funds—usually four to six—within a single family and carrying varying degrees of risk, from conservative to aggressive.

There are about 90 lifestyle funds offered by about 15 mutual fund companies. Some lifestyle funds are passively managed to a fixed allocation, with managers not trying to add value by overweighting certain asset classes at certain times. Others are actively managed to add value through tactical changes in asset allocations. The mutual fund company can design lifestyle funds with a fixed level of risk and a fixed time horizon, or to reduce the risk level as a target maturity date approaches. For example, a lifestyle fund labeled 2020 will focus on that year as a terminating time horizon; in 2002, its asset allocation may be

80% stocks and 20% bonds. In 10 years, the asset allocation may change to be 50% stocks and 50% bonds. As the targeted termination date approaches, the risk profile of the fund becomes more conservative.

Lifestyle funds are simple for plan participants to understand. The selection process is often driven more by a retirement date than by responses to a risk tolerance questionnaire. For participants in a bundled environment, lifestyle funds might be the only option that offers some asset allocation assistance. Lifestyle funds, however, lack flexibility. Because they typically have been created within a single fund family, underperformance of one of the lifestyle fund components makes replacement difficult. They also can add additional management fees for the asset allocation component of the fund management process. In addition, research has shown that lifestyle funds are frequently misused; participants diversify among the lifestyle options and thus, defeat the purpose of investing in this type of arrangement. With the growing interest in and use of lifestyle funds, employers should educate participants about the underlying investments and emphasize that the funds are designed as stand-alone options, not as a series of additional choices.

#### *Model Portfolios*

Model portfolios are another approach to asset allocation. As in the case of lifestyle funds, the selection process for model portfolios is driven by a questionnaire. But instead of the questionnaire pointing to a lifestyle fund or generic asset-class allocations, the participants' responses suggest a specific allocation among the plan's core options. Chart 2 (see page 7), for example, illustrates suggested portfolios generated from plan participants' responses to a questionnaire that gauges and scores time horizon and risk tolerance. The model portfolio

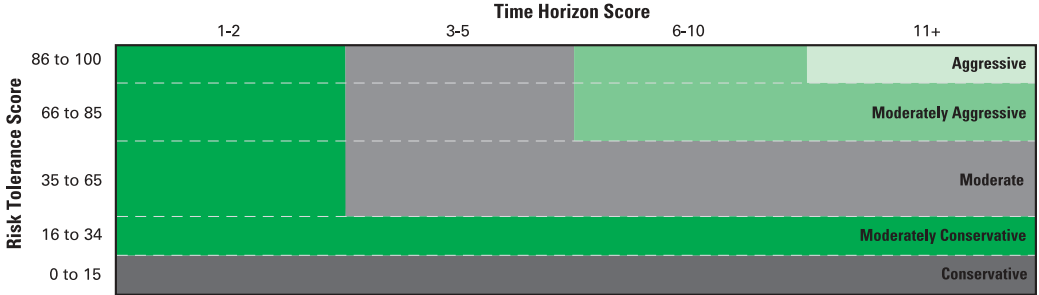
CHART 2

# ABC Company Profit Sharing and 401(k) Savings Plan

## MODEL PORTFOLIOS

### YOUR PERSONAL INVESTOR PROFILE RESULTS SHOW WHAT KIND OF INVESTOR YOU ARE

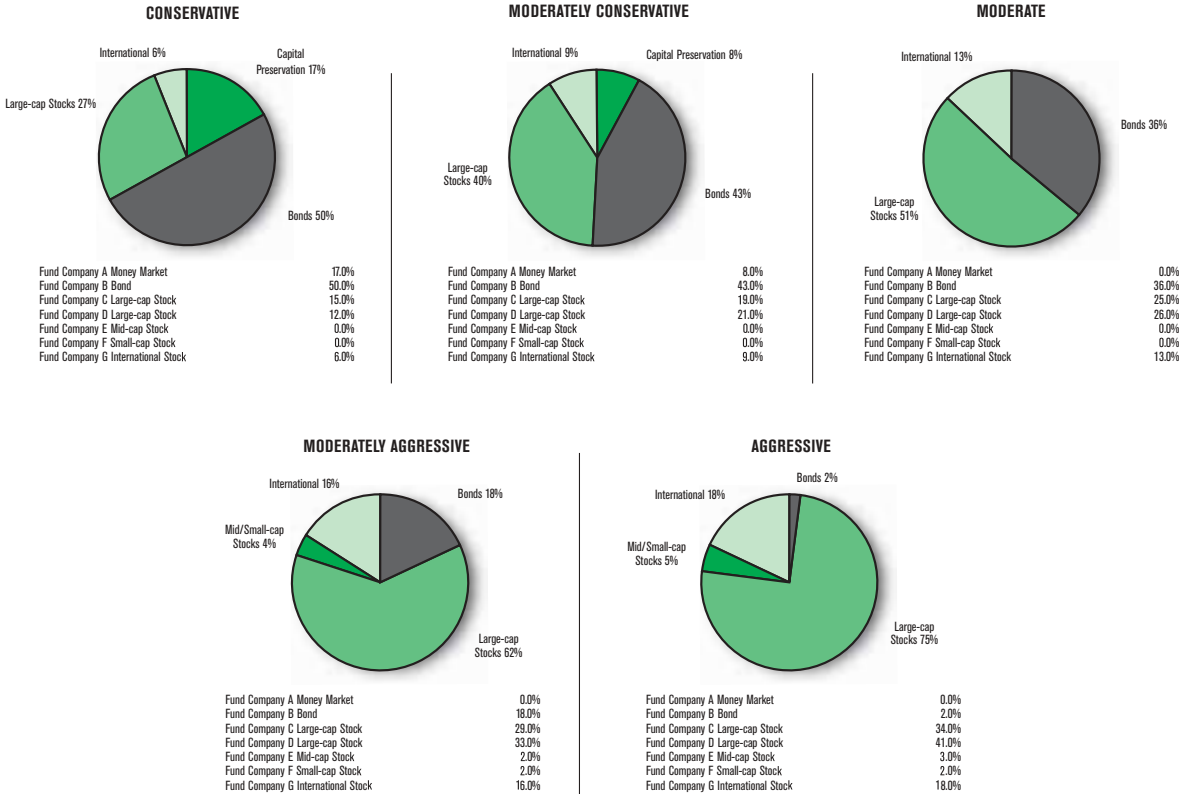
Locate the intersection point of your Time Horizon and Risk Tolerance scores from the previous page to find your matching investment strategy. Example: If your Time Horizon score is 8 and your Risk Tolerance score is 70, you would have a moderately aggressive risk profile.



Time Horizon Scores less than 1 are not included. Developing an asset allocation strategy under this short time horizon may not be appropriate. Please consult your investment adviser.

### MATCH UP YOUR INVESTMENT STRATEGY FROM ABOVE WITH THE FOLLOWING MODEL PORTFOLIOS

These pie charts show how you might want to invest your money among different types of investments. You can follow this strategy or you can change these percentages as you see fit to better meet your investment objectives. Review your investment strategy periodically and adjust it accordingly as your financial needs and life circumstances change. While the overall investment objective and strategy of each asset allocation model will remain the same over time, please note that the allocations depicted here may change from time to time to reflect changes in stock market conditions and/or a change to the plan's investment line-up.



will suggest that an investor with a one- to two-year time horizon and lower tolerance for risk have a lower equity and a higher fixed-income exposure. Conversely, for investors who have a higher tolerance for risk and a longer time horizon, they can take advantage of the higher expected returns that comes from a greater exposure to stock investments (see Chart 3).

With model portfolios, the fund selection and asset allocation decisions are separate. Models can be designed and selected by the plan sponsor to be unique to their plan participants' risk profile, goals, and objectives. Each model carries a different degree of risk. Model portfolios represent a series of allocations among the plan's core options, and thus can and must be updated as the options in the plan change. They typically maintain a consistent risk profile over time (i.e., they do not become more conservative as a maturity date approaches). For example, participants who retire at age 65 may have a life expectancy of more than 20 years. Depending on their goals for retirement, a low equity exposure might not provide the inflation protection needed to sufficiently fund their retirement. Additionally, model portfolios contribute to educating participants by requiring investors to address their own risk tolerance and time horizon. Participants actually own the diversified portfolio of the core options after they select the model.

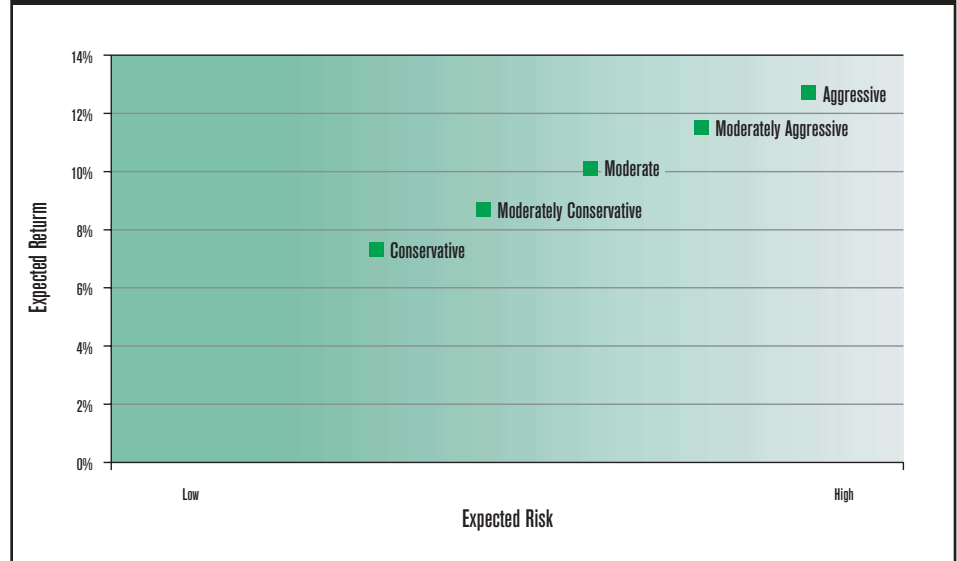
*Individual Advice*

The most recent development in participant asset allocation assistance is the result of technology. Through the Internet and powerful computer-driven algorithms, a number of companies are providing customized advice directly to individual plan participants. The advice providers typically gather information from a participant and then give specific advice on investing 401(k) plan assets. Some providers also give advice on investments outside of the participant's retirement plan.

Not long ago, individual advice was only available to senior executives under agreements with specialized financial service firms. Today, through both technology and the leveraging capabilities a total plan can bring, rank-and-file participants

CHART 3

Expected Long Term Risk / Return Trade-Off



can have access to a financial planner (electronically, over the phone, or in person) for a much lower fee than was required only a few years ago. Although discussion about plans providing advice raises several concerns—fiduciary concerns in particular—there is growing interest in this area. Pending legislation contemplates encouraging plan sponsors to provide investment advice, but Congress has yet to determine whether such advice should come from qualified “independent” advisors or whether allowing a plan's current service provider to do so can provide sufficient safeguards for participants.

**Conclusion**

While some participants are comfortable performing asset allocation among a plan's core options, others are looking for assistance. Lifestyle funds, model portfolios, and individual advisors can help participants identify their risk tolerance and time horizon, and provide asset allocation assistance that maximizes the participants' investment returns consistent with their risk tolerance. Defined contribution plan participants are more likely to reach their long-term retirement goals if they can understand and are more comfortable with the possible investment outcomes.

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# Nonqualified “401(k) Mirror” Plans: Gazing Beyond the Looking Glass

by Dominick Pizzano

Employers that sponsor a nonqualified deferred compensation plan (NDCP) for executives commonly present it as a “continuation” or “extension” of the company’s qualified retirement plan, particularly where the NDCP is designed to “mirror” the sponsor’s 401(k) plan. Although emphasizing the many similarities between the two plans facilitates employee appreciation and understanding of the NDCP benefits, doing so also fosters forgetfulness of the trade-offs that accompany such plans.

This article analyzes some of the major misconceptions surrounding NDCPs of *taxable* corporations. (For an article on the fundamentals of NDCPs and descriptions of basic terminology, please see “A Guide to Nonqualified Deferred Compensation Plans” by David Forbes in the Fall 2001 issue of *Benefits Perspectives*.)

## Eligibility— “Top-Hat” is Not a One-Size-Fits-All Plan

For the covered executives and the plan sponsor, one of the major advantages NDCPs offer is the ability to discriminate in favor of the highly paid; unlike qualified plans, NDCPs need not pass various nondiscrimination tests. Under the Employee Retirement Income Security Act (ERISA) definition of a “top-hat plan,” NDCPs are not only allowed but required to discriminate in favor of the top executives of the plan sponsor.

Yet many NDCP sponsors tread on dangerous ground by extending these plans to too many employees. The crux of the problem is the difference between the benchmarks used by the IRS and the Department of Labor (DOL) in determining who is highly compensated versus who is eligible to be part of the “top-hat” group:

- The IRS generally draws the line at a specific dollar mark (\$90,000 for 2002), to define “highly compensated employees” (HCEs) for purposes of nondiscrimination testing. In contrast, the DOL has never provided any bright-line guidance on the cut-off point for participation in NDCPs. However, the one point the DOL has made clear is that

meeting the HCE definition does not automatically make an employee eligible for top-hat plan participation. Nevertheless, because each HCE may be negatively affected by nondiscrimination tests, many NDCP sponsors are tempted to apply this definition—and some succumb.

- What the DOL originally had in mind was a truly select group consisting of those individuals with significant managerial duties and/or highly paid executives who can negotiate the terms of their compensation. The underlying reasoning was that because NDCP participants were not protected by ERISA’s and the tax code’s many safeguards, participation in “top-hat” plans should be limited to employees who had both a level of sophistication to fully grasp the risks and limited protection of NDCPs, and sufficient bargaining power not to need such protection.

While it is true that a small company where the top-paid group/key decision-makers earn less than the HCE dollar limit could justify the inclusion of such executives in the NDCP, there are many employees in the current workforce who meet or exceed the HCE dollar limit but do not fit DOL’s “top-hat” profile. In some cases, a relatively high level of compensation is paid for a position that does not also carry significant management authority and access to the company’s financial information. Using the HCE definition or any designated dollar amount can result in a company having many employees whose salaries reach or exceed the designated dollar mark during any given year because of commissions, overtime pay, or bonuses. In such cases, employees commonly will be HCEs for one year and then non-highly paid the next. Any such employees are not ideal candidates for top-hat status.

While there certainly are many NDCPs that stretch the fabric of their top-hat plan far beyond the measurements the DOL originally had in mind, companies should be particularly cautious with their eligibility requirements. In today’s litigious environment, NDCP sponsors should resist their all-inclusive inclinations or else be prepared for possible court battles with

disgruntled participants who may have been initially pleased to be in the plan but who soon grew disenchanting when negatively affected by the plan's limitations.

### **NDCP Deferral Elections—**

#### **The New Year's Resolution that Must be Kept**

Unlike in 401(k) plans where participants conceivably could be allowed to begin deferrals as of the beginning of any payroll period during the year, NDCP participants of a taxable corporation's plan must make their deferral elections before January 1 of the calendar year of reference. There are exceptions only for the plan's effective date (e.g., a plan begins on July 1) or for employees who first become eligible for participation after January 1 (e.g., a plan that has semi-annual, quarterly, or monthly entry dates). In the latter case, however, if an employee is first eligible to participate in the plan as of an entry date other than January 1 but declines at that time, he or she must then wait until the following January 1 (i.e., entering the plan on another mid-year entry date is prohibited).

Another important differentiating feature from a 401(k) plan is the NDCP's one-year irrevocability of the deferral election. For any given year, the deferral election must be made prior to January 1 and must remain in effect for the entire calendar year. Participants are prohibited from increasing, changing, and discontinuing their deferrals. Thus, plan sponsors should consider holding enrollment sessions in December (or November) to remind participants about the plan's benefits and limitations and to require them to sign a new deferral election form for the upcoming year.

From an administrative perspective, allowing participants to make an "evergreen" election that renews the previous election automatically each January 1 unless the participant elects a change might be tempting. However, from an employee relations standpoint, doing so can put the sponsor in the difficult position of having to deal with disgruntled participants who forget about the automatic renewal and realize after January 1 that their window to make changes has closed until the following year.

### **In-Service Access to Money—**

**Make No Loans About It and Not Many Withdrawals Either**  
401(k) plans can be designed to permit participants to access their funds while still employed. Plan loans are not taxed as long as amounts are repaid in accordance with the schedule

specified by the plan. Subject to certain restrictions, taxable withdrawals are permitted; however, if the withdrawal is received before the participant attains age 59-1/2, the amount of the withdrawal is subject not only to income taxes but also to a 10% penalty.

One of the dangers of blurring the lines between a company's qualified plan and the NDCP is that the participant's access to funds is considerably more limited in the NDCP. For example:

- No loans are permitted from the NDCP under any circumstances.
- Although withdrawals while employed can be allowed, the requirements are much tougher than even the strict 401(k) hardship rules that require participants to demonstrate a severe financial hardship. Under the NDCP rules, the hardship must not only be severe but also unforeseen, thereby eliminating withdrawals for such permissible 401(k) hardship reasons as college tuition or the purchase of a principal residence.
- While 401(k) plans may provide liberal withdrawal requirements for company contributions (e.g., mandating five years of plan membership or limiting withdrawals to amounts on deposit for at least two years), the strict NDCP rules apply both to participant deferrals and any company contributions made under the plan. The advantage the NDCP does enjoy is that if a participant qualifies for the withdrawal, the amount withdrawn will be subject to income tax but not the 10% premature distribution tax, even if the participant is under age 59-1/2.

### **Plan Asset Protection—**

#### **The NDCP Insecurity Complex**

In the event of the company's insolvency prior to the distribution of the nonqualified plan benefits, executives may lose some or all of their benefits. As a result, regardless of the vehicle(s) the company chooses for crediting investment experience to the NDCP participants' account or for actually investing the plan's assets, until the participant receives a total distribution, the actual amount the participant eventually will receive is tied to the ongoing viability of the company. Participants must be educated to this fact so as not to confuse the protection (i.e., against a change of control or change of heart by the sponsor) provided by a rabbi trust with that afforded by the 401(k) trust.

At the extreme downside, executives' interests in NDCPs are analogous to 401(k) participants who have their entire accounts invested in the stock of the plan sponsor—an investment strategy that has come under serious siege this past year with the collapse of Enron, Worldcom, and other major corporations. Whether from the media or from their plan sponsor, 401(k) participants recently have had plenty of exposure to the concept of asset diversification as a preventive measure to avoid the potential perils of over-investing in employer stock. If an NDCP is described to participants as an extension of their 401(k) plan, there is a chance some will wrongly assume that, provided their NDCP accounts are diversely invested in assets other than employer stock, such savings are immune from any financial ills that may plague their employer.

### Taxation, Timing, and Form of Distributions— If It Can be Touched, It Will be Taxed

When it comes time to make distributions from the NDCP, corporate plan sponsors must be aware of, and make sure that the participants on the receiving end know, the big three constructive receipt-inspired “can’t do’s.” NDCP participants are not permitted to:

- elect a form of payment at the time of a distribution;
- defer the receipt of benefits at employment termination; nor
- defer the immediate taxation upon distribution by any means (i.e., *no rollovers*, even though a recent law has greatly liberalized the rollover rules for qualified plans).

In a 401(k) plan, the participant can do all three of the above. Therein lies another danger of communicating the NDCP as a 401(k) mirror plan. Some NDCP sponsors avoid the lack of choice by designing the plan to provide an immediate lump-sum payment as the only option. Others try to avoid the appearance of an election by directly linking the timing and form of nonqualified plan payments to the qualified plan election (i.e., whatever the participant elects for the qualified plan applies automatically to the nonqualified plan). However, it is questionable whether the IRS accepts this approach.

In reality, most plans provide participants a choice between taking a lump sum or annual installments. The IRS requires the NDCP to mandate the form of payment, or if a choice is allowed, to require the decision to be made irrevocably when the participant is first eligible for the plan. This, of course, severely limits flexibility: how can someone select the form in which their benefits will be paid so many years in the future?

One possible solution is to allow for a separate form of election for different types of terminations (i.e., retirement, death, disability, resignation, and termination by employer). Another more aggressive approach is to mandate an initial election but allow the participant to change it as long as the change is made at least one full calendar year before termination. This approach is aggressive in that it does not conform to the IRS’s published guidelines on acceptable provisions; however, it has become more prevalent during the past decade, after the IRS lost a Tax Court case challenging the approach.

### Conclusion

Plan sponsors and participants cannot be blamed for their desire to see what they want to see. When looking into a nonqualified mirror 401(k) plan, this often means wanting a plan that is free from the qualified plan rules but that allows participants to enjoy all the flexibility and benefit protection they would have in a qualified plan. In an effort to prevent the NDCP from looking more like a “fun-house mirror” plan under which the sponsor’s original vision is so distorted as to be unappealing to sponsor and participants alike, many benefit practitioners have developed creative designs that attempt to negotiate these trade-offs. NDCP sponsors should be mindful that, because of the lack of clear-cut DOL and IRS guidance, some of the more aggressive plan designs might invite legal challenge. Accordingly, corporate sponsors of NDCPs should seek to balance a desire for a particular provision with their risk tolerance and ensure appropriate professional review when considering plan design.

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