Nonqualified Deferred Compensation Plans

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What is it?

In general

A nonqualified deferred compensation (NQDC) plan isn't really much more than a contract between an employer and an employee to pay compensation at a future time. More specifically, it's an arrangement between employer and employee that defers the receipt of currently earned compensation without using a qualified plan. An NQDC plan doesn't comply with the discrimination and administrative rules that govern qualified benefit plans , such as Section 401 of the Internal Revenue Code and the Employee Retirement Income Security Act (ERISA).

Since an NQDC plan doesn't have to comply with regulatory requirements, it's a flexible form of employee compensation that allows you to tailor the benefit amounts, payment terms, and conditions of the plan to both you and your employee's needs. As a result, an NQDC plan can cover any group of employees without regard to nondiscrimination requirements, provide unlimited benefits to any employee, and can provide different benefit amounts for different employees under different terms and conditions. In addition to its flexibility, an NQDC plan can also provide your employee with significant tax benefits. Unlike current cash compensation, which the IRS taxes currently, your employees can defer taxation of their benefits.

Example(s): Hal and his employee Mark agree that Hal will pay Mark a salary of $100,000 a year. In addition, Hal agrees to pay Mark another $10,000 for each year that Mark works for Hal, payable upon Mark's retirement. Hal and Mark have established a form of nonqualified deferred compensation. At the most basic level, this is how such a plan works.

Tip: The extent to which ERISA applies to an NQDC plan depends on the type of NQDC plan and the funding status of the plan. NQDC plans are almost always designed to avoid virtually all ERISA requirements. To avoid application of most ERISA requirements, the NQDC plan must be unfunded and provide deferred compensation benefits primarily to a select group of management or highly compensated employees. This means that although NQDC plans don't have all of the tax–favored benefits of qualified plans, they also don't have to follow the same strict

rules as qualified plans with regard to such matters as participation, vesting, funding, and reporting. The lack of government regulations associated with NQDC plans results in greater flexibility as well as lower setup and maintenance costs than with qualified plans.

Tip: When implementing an NQDC plan, there's only one ERISA regulation that you must follow. You must send a one–page notification letter to the Department of Labor indicating the plan's existence, your company's name and address, your company's employer identification number, the number of plans, the number of participants in each plan, and the name of the plan administrator.

Qualified plans versus nonqualified deferred compensation plans

A qualified plan like a profit–sharing plan or a 401(k) plan can be a valuable employee benefit, generally covering all or most employees. A qualified plan provides an immediate tax deduction to the employer for the amount of money contributed to the plan for a particular year. As for the employee, he or she isn't required to pay income tax on amounts contributed to the plan until those amounts are actually distributed from the plan. However, in order to receive this beneficial tax treatment, a qualified plan must comply with strict and highly complex ERISA and IRS rules.

In contrast, an employer will generally make NQDC plans available only to select executives and other key employees. With this type of plan, an employer typically won't be allowed to take a tax deduction for amounts contributed to the plan until such time as funds are actually distributed from the plan and received as taxable income by participating employees. In effect, an employer often isn't entitled to a tax deduction until years after contributions are made to the plan. As with a qualified plan, employees generally don't recognize the income (deferred compensation) currently (when it is earned) for income tax purposes. Rather, they recognize the income when payment is received from the NQDC plan.

Caution: Although most NQDC plans result in the tax structure described, actual tax consequences depend on the specific design and funding provisions of the NQDC plan.

Funded versus unfunded plans

Understanding funding in general

An understanding of the concept of funding is essential to NQDC plans. Unfortunately, it's not an easy concept to understand. Complicating matters even further is the fact that the term "funded" can have more than one meaning when it comes to nonqualified plans. When most people speak of funding an NQDC plan, they're usually talking about the types of assets that are used to secure the employer's future obligation to pay deferred compensation under the plan.

Remember that unless the nonqualified deferred compensation agreement explicitly requires it, an employer doesn't have to set aside any assets at all to satisfy future obligations under the plan. However, this lack of benefit security generally doesn't instill much confidence in participating employees; therefore, setting aside or allocating assets is rather common. So, people who speak of funding an NQDC plan are often referring to the specific type of asset used to back up the

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employer's obligation. For example, someone might say that an NQDC plan is funded with mutual funds or life insurance.

You have to be very careful when using the term "funding" in the context of NQDC plans. Funding has a very specific and important meaning for both tax and ERISA purposes.

Unfunded plans

Most NQDC plans are unfunded. What makes such a plan unfunded? An NQDC plan is unfunded when the plan pays benefits from the employer's general assets rather than from assets that are set apart and not subject to the claims of the employer's creditors. An unfunded plan is based solely on your promise to pay a specified amount to an employee on the occurrence of a particular event (e.g., retirement). From your employee's point of view, the biggest disadvantage of an unfunded NQDC plan is the lack of security that comes with relying solely on your promise to pay at a later date the money that your employee contributes to the plan.

Company records may document your employee's NQDC account and company financial statements may reflect your obligation to pay the deferred compensation. You can even physically segregate the funds to pay the compensation into a separate bank account. However, you still retain ownership of the funds, and your creditors can attach the funds in the event of your company's bankruptcy. As a result, your employee may be fearful that when it comes time for him or her to receive the deferred compensation, you may be unwilling or unable to pay the deferred compensation or a creditor may seize the funds through foreclosure, bankruptcy, or liquidation.

In general, any of the following permits an NQDC plan to be classified as unfunded:

- No assets: If an NQDC plan is maintained on paper only, with no assets set aside, it's unfunded. That's because benefits will depend on the employer's future ability to pay.
- Employer's general assets allocated to pay benefits: An employer may set aside assets to pay future benefits. As long as those assets are reachable by the employer's general creditors, the plan is considered unfunded. That is simply because participating employees run the risk that their benefits may not be paid when due.
- Rabbi trust : An employer may place assets in a rabbi trust to provide future benefits. Because assets held in a rabbi trust remain subject to the claims of the employer's general creditors, the participants' future benefits are at risk and the plan is therefore considered unfunded.

Unfunded plans are sometimes known as informally funded plans when assets are set aside to meet future obligations but the assets remain subject to the claims of the employer's creditors, as in the cases described. In unfunded or informally funded plans, the participants pay no income tax until they actually receive funds from the plan, and the plan is not subject to the more complex rules of ERISA.

Funded plans

If an employee fears losing deferred compensation, you may want to consider offering a plan that is either partially or fully funded. A plan is partially funded if the assets to pay the deferred amounts are placed beyond your reach. A plan is fully funded if the assets to pay the deferred amounts are placed beyond the reach of both you and your creditors. Several funding mechanisms are available, including a funded trust arrangement such as a secular trust ; life insurance such as

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company–owned life insurance , employee–owned life insurance , and split dollar life insurance ; and annuities.

In general, the IRS and the Department of Labor (DOL) consider an NQDC plan to be funded if assets are:

- Irrevocably transferred to participants or to a trust for the benefit of the participants, and
- The assets are not subject to the claims of the creditors of the employer

In other words, if participants are guaranteed to receive their benefits under the NQDC plan, the plan is considered funded. You will sometimes hear plans that are considered funded for IRS and DOL purposes referred to as formally funded plans.

If an NQDC plan is funded, the participant normally pays current income tax on amounts contributed to the plan. This isn't very beneficial from the participant's point of view for the obvious reason that the participant must pay tax now, but might not be able to access the funds until some point in the future. The employer also enjoys no tax advantage, since the employer gets the same tax deduction whether amounts are contributed to the NQDC plan or paid to the participant as current compensation. In addition, funded plans are subject to strict ERISA requirements. You don't see funded NQDC plans very often because of these negative consequences, but some familiarity with funded plans will help you understand why unfunded plans function the way they do.

Employee tax treatment

In general

Exact tax treatment will depend on the type of NQDC plan and the funding provisions of the plan. Any amount that an employer contributes to an unfunded NQDC plan is generally tax deferrable to the employee until the amount is paid or made available to the employee. Contributions to a funded plan generally are tax deferrable until the employee has a nonforfeitable right to, also known as becoming vested in, the contributions.

> **Caution:** There are examples where amounts that your employee contributes to an NQDC plan may be subject to federal income tax prior to your employee's actual receipt of the funds. The IRS has three methods that it uses to defeat the tax deferral benefit that accompanies an NQDC plan: (1) constructive receipt, (2) the economic benefit theory, and (3) Section 83 of the Internal Revenue Code.

Constructive receipt

Under the doctrine of constructive receipt, the IRS can tax your employee before the receipt of funds if the funds are credited to your employee's account, set aside, or otherwise made available to your employee. In other words, once the funds have been earned, your employee must report the income even if the employee has chosen not to actually accept current payment of the funds. Under IRS guidelines, your employee can avoid constructive receipt by making his or her election to defer compensation before the year he performs services that earn the compensation. For example, the employee could elect in December 2004 to defer payment until retirement of 10 percent of his earnings for the year 2005. Also, to avoid constructive receipt the employee generally can't have

any right to elect to receive payment of his or her deferred compensation before payment is due under the terms of the NQDC plan. The doctrine of constructive receipt is most relevant to NQDC plans that permit the employer to elect to defer receipt of a compensation or would allow the employer to elect to receive previously defined compensation.

Economic benefit theory

The economic benefit theory provides that an employee is currently taxable whenever there's a payment in kind to your employee or you make available to your employee property or a nonforfeitable interest in a trust that is a cash equivalent. In other words, if an NQDC plan provides a current economic benefit to an employee, the value of the benefit is taxable even if the employee isn't currently entitled to receive the cash or property. The reasoning behind this doctrine is that even though the employee didn't receive actual cash or property, the employee should nevertheless be taxed because he or she received something that can be reasonably valued. For example, the economic benefit doctrine may apply where the employee's NQDC plan benefit is funded with an annuity contract or an irrevocable trust. However, your employee will only be immediately taxed under the economic benefit doctrine if the funds are beyond the reach of the corporation and its creditors and the employee doesn't run a substantial risk of forfeiting the funds. In order to avoid the immediate taxation of your employee's benefits under the economic benefit doctrine, your employee should not be given greater rights than those of a general creditor.

Section 83 of the Internal Revenue Code

Section 83 of the Internal Revenue Code treats as a transfer of property an interest in assets that are set aside from the claims of the employer's creditors (e.g., a trust or escrow). For example, if you transfer cash to a trust held for the exclusive purpose of providing deferred compensation to your employees (and the trust assets are not subject to the claims of the employer's creditors), the transfer may be treated as a transfer of property on which the employee will be taxable currently under Section 83, unless the employee's benefit is subject to a substantial risk of forfeiture. If your employee's contributions under the NQDC plan are subject to creditors' claims, then the contributions don't meet the definition of property and do not result in a transfer of property within the meaning of Section 83. However, if your employee's contributions to an NQDC plan aren't within you or your creditors' reach and your employee is fully vested in the contributions, then there is a transfer of property within the meaning of Section 83. As a result, the IRS will currently tax your employee on the amount contributed to his or her plan account.

Employer tax treatment

Exact tax treatment of the employer will depend on the type of NQDC plan and its funding provisions. In general, the employer's tax deduction for an NQDC plan isn't available for the year when your employee earns the compensation. The deduction must be taken in the year when the income is taxable to your employee and not before that time. The income generally becomes taxable to the employee when he or she actually receives benefits from the plan. If the employee defers the compensation until retirement, the employer may have to wait 10, 20, or even 30 years to claim a deduction. The deduction is available only to the extent that the contributions meet the IRS tests for reasonable compensation.

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An additional tax consideration for the employer is that if the employer sets aside funds for the purpose of paying future benefits under the NQDC plan, the employer must pay income tax on any earnings attributable to those allocated funds.

Social Security tax (FICA and FUTA)

Social Security tax actually consists of several different component taxes: the Federal Insurance Contribution Act (FICA) taxes for old age and disability benefits, the hospital insurance or Medicare tax, and the unemployment tax (FUTA). Both FICA and FUTA taxes may be due currently on amounts deferred to an NQDC plan. However, FICA and FUTA don't have as significant an impact on NQDC plans as you might think. FUTA tax applies only to a limited amount of an employee's compensation. Most employees deferring compensation into an NQDC plan exceed the Social Security wage base ($87,900 in 2004). Compensation exceeding this amount would only be subject to the 1.45 percent Medicare tax rate that applies to both the employer and the employee.

The details regarding FICA and FUTA taxes as they apply to NQDC plans are very complicated. You should consult additional resources that specifically address this issue for further information.

Who can adopt an NQDC plan?

In general

Although many entities can adopt an NQDC plan, they're most suitable for entities that are financially sound and have a reasonable expectation of continuing profitable business operations in the future. In addition, since NQDC plans are more affordable to implement than qualified plans, it can be an attractive form of employee compensation for a new business that has potential but has limited cash resources.

Business owners

If you're a business owner, NQDC plans are suitable only for regular or C corporations . In S corporations or unincorporated entities (partnerships or proprietorships), business owners generally can't defer taxes on their shares of the business income. However, S corporations or unincorporated businesses can adopt NQDC plans for regular employees who have no ownership interest in the business.

Government and tax–exempt organizations

A government or tax–exempt organization may adopt an NQDC plan. However, such organizations must follow Section 457 of the Internal Revenue Code, which limits the amount and timing of pay–outs or in some cases may require current taxation of the employee with respect to the present value of his or her rights to deferred compensation.

Advantages of an NQDC plan

Supplements an employee's qualified benefits

You can supplement the benefits that your employees receive under a qualified benefit plan with an NQDC plan. Although employees favor qualified plans because they offer a tax–deferred method of saving for retirement, the amount of benefits that employees can receive under a qualified plan is subject to limitations. By adopting an NQDC plan, you can offer your employees higher amounts of tax–deferrable income.

Easier and less expensive than a qualified benefit plan

Because qualified benefit plans must follow complex IRS and ERISA rules, they're usually more expensive (and complicated) to implement and maintain than an NQDC plan. If you can't afford to maintain a qualified plan but wish to offer your select group of management or highly compensated employees the ability to receive tax–deferrable retirement benefits, you may want to consider implementing an NQDC plan. This way, you will be able to provide your key employees with retirement benefits while avoiding the administrative costs and complexities of qualified plans.

Can be offered on a discriminatory basis

Qualified plans are subject to specific discrimination and participation rules that require you to provide proportionate benefits to non–highly compensated employees. An NQDC plan isn't subject to these same rules. As a result, you can decide to allow a few or even one highly compensated employee to participate in the NQDC plan. You're not obligated to cover anyone.

Can provide unlimited benefits

Subject to the reasonable compensation requirement for deductibility, you can provide unlimited benefits to your employees.

Allows employer to control timing and receipt of benefits

Because ERISA's vesting rules don't apply to NQDC plans that aren't formally funded, you as the employer can control the timing and receipt of employee benefits payable under the plan. You therefore have considerable flexibility in determining conditions and times when employees will be entitled to their benefits.

Allows employer to attract and retain key employees

For obvious reasons, many employers strive to attract, recruit, and retain executives and other qualified key employees. An NQDC plan that provides future retirement benefits, whether in lieu of or in addition to a qualified plan, can offer an added incentive for these key employees to come to work for and remain with an employer.

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Disadvantages of an NQDC plan

Employee controls timing of employer's tax deduction

The employer generally can't deduct a contribution made to an NQDC plan until the year income is actually received from the plan by the participating employee. More often than not, this will be several years, particularly in the case of employees who choose to defer receipt of the income until retirement. In effect, employers have no control over when they will be entitled to take these tax deductions.

Lack of security for employees

From the standpoint of the participating employees, an NQDC plan isn't as secure as a qualified plan. Employees who participate in an NQDC plan generally have to rely on an employer's unsecured promise to pay benefits at a later time (except in the case of a formally funded NQDC plan). Most federal and labor law protections such as participation, vesting, fiduciary responsibility, and funding standards don't apply.

Generally not appropriate for partnerships, sole proprietorships, and S corporations

Partnerships, sole proprietorships, and S corporations can certainly establish NQDC plans to benefit key employees. However, the plan will be of little benefit to the owners themselves, since income earned by the organization is immediately taxed to the business owner. In other words, the business owner can't defer taxation of amounts contributed to the NQDC plan on his or her own behalf.

Generally more costly to employer than paying compensation currently

An NQDC plan defers the employer's payment and the deduction for compensation that might otherwise have been paid and deducted when earned. The deferred compensation is normally increased by some amount similar to interest or investment earnings. Until payment is actually made, the employer may realize investment income (or defer a deduction) with respect to the deferred amount that is subject to tax. Since the employer's deduction for both the deferred amount and the investment earnings is deferred until the actual payment of benefits, the employer incurs a greater net after–tax cost for the NQDC than for a payment of current compensation. This additional employer cost should be taken into account as the terms for any NQDC plan or agreement are considered and agreed upon by the employer.

How does an NQDC plan work?

In general

It depends on the particular type of NQDC plan, the specifics of the agreement itself, and how the plan is funded. In a typical nonqualified deferred compensation arrangement, employer and employee agree that a portion of the employee's compensation will be allocated to the NQDC plan.

The employee doesn't receive that portion of his or her compensation in the current year and doesn't pay tax on it in the current year. The amount of compensation deferred each year is credited to the employee's nonqualified deferred compensation account.

The employer, which is generally not entitled to an immediate tax deduction for the amount of compensation deferred, may set aside or earmark assets to cover this future liability. However, the employer may do nothing but keep track of the deferred compensation on paper without setting aside any assets at all. Again, it depends on the terms of the NQDC agreement. Upon the occurrence of some future event (usually the employee's termination of employment or retirement), the employee is entitled to all contributions credited to his or her nonqualified deferred compensation account, plus assumed investment earnings as defined in the agreement. At this time, the employee owes income tax on amounts received, and the employer may take a corresponding tax deduction.

Payment of benefits

The employer can structure an NQDC plan to pay benefits upon retirement, termination of employment, or some other triggering event. Benefits can be paid either in a lump sum or in a series of annual payments. Life annuities are common, as are payments for a fixed number of years (such as 5 or 10 years). Since the most stringent ERISA requirements will not apply if you structure the plan properly, the employer has some flexibility in establishing a vesting schedule and forfeiture provisions. For example, an employer can set up an NQDC plan so that employees may lose their rights to funds if they fail to work for that employer until age 65 or they go to work for a competitor.

Issues that concern key employees

Dollar limitations on contributions to and benefits payable from qualified plans

Sometimes a key employee is adversely affected by the dollar limitations on contributions to and benefits payable from qualified plans. As a result, they do not receive as high a percentage of their compensation as lower paid employees under a qualified plan.

> **Example(s):** Richard and Mary work at BCD Corporation. Richard earns $300,000 per year while Mary earns $100,000 per year. They both participate in a defined benefit plan that provides a general benefit of 50 percent of their salary. Though the plan formula dictates that Richard should get a benefit of $150,000 (50 percent of $300,000), he actually is only allowed to receive $102,500 (50 percent of $205,000) because $200,000 is the maximum compensation amount that may be used in calculating the benefit. Conversely, Mary is entitled to $50,000 (50 percent of $100,000) because her entire annual salary can be taken into account as it is below $205,000. As a result, Richard may only receive approximately 34 percent of his pay while Mary may receive the 50 percent as dictated by the plan formula. Richard is adversely impacted by the $205,000 limit while Mary is not.

Note: The $205,000 compensation limit is for 2004, and is indexed for inflation in $5,000 annual increments.

Tax benefits

Generally, a key employee is subject to a higher income tax rate. As a result, a key employee can benefit from deferring compensation since it can place the employee in a lower tax bracket.

> **Example(s):** Bill works at XYZ Company. His marginal tax rate is 35 percent. He's given the option of receiving as earned or deferring until retirement a $100,000 bonus. Under today's rules, Bill's marginal tax rate at retirement will be 25 percent. If he decides to receive the $100,000 bonus now, he will be taxed $35,000 (assuming no other variables), but if he defers the income until retirement, he will be taxed only $25,000.

Types of NQDC plans

In general

Since an NQDC plan is essentially a contract between employer and employee, there are almost unlimited variations of NQDC plans. In addition, the phrase "nonqualified deferred compensation" may be used to encompass various concepts. For example, stock plans can be forms of NQDC plans. Similarly, severance plans such as golden parachutes are generally considered forms of NQDC plans.

It's also important to note that NQDC plans established by government and tax–exempt organizations are governed by Internal Revenue Code Section 457. Although these plans also classify as NQDC plans, they're more commonly referred to as Section 457 plans. For more information, see Section 457 Plans .

The discussion here is primarily focused on the kinds of NQDC plans that are sometimes known as compensation deferral or supplement plans. These plans represent non–stock–based compensation agreements between employer and employee and are often the result of the compensation bargaining process. The major plans that fall into this category are briefly described in the following sections.

Rabbi trusts

A rabbi trust is a type of trust that an employer establishes for the purpose of holding NQDC plan assets apart from the employer. It thus provides some degree of security for the employees' deferred compensation benefits. It's called a rabbi trust because a rabbi was the beneficiary of the first such trust to receive a favorable IRS ruling. For more information, see Rabbi Trusts .

Secular trusts

A secular trust is an irrevocable trust that an employer establishes with a third party for the purpose of holding NQDC plan assets apart from the employer. This type of trust provides total security for employees' deferred compensation benefits in that participating employees generally have a

nonforfeitable and exclusive right to both contributions made to the trust and earnings on those contributions. For more information, see Secular Trusts .

Corporate–owned life insurance (COLI)

Corporate–owned life insurance (COLI) refers to a life insurance policy that an employer takes out on the life of an employee, whereby the employer is both owner and beneficiary of the policy. COLI is commonly used as a funding mechanism for NQDC plans, in which case participating employees have the assurance of knowing that payment of their deferred compensation benefits will not be dependent on the employer's cash flow. However, there are risks associated with using COLI to fund an NQDC plan. For more information, see Corporate–Owned Life Insurance (COLI) .

Employee–owned life insurance

Also known as split dollar life insurance, employee–owned life insurance is an arrangement whereby employer and employee share the premium cost of a life insurance policy on the employee's life. Upon the employee's death, the employer receives a portion of the death proceeds and uses those proceeds to fund deferred compensation benefits payable under an NQDC plan. For more information, see Employee–Owned Life Insurance .

Supplemental Executive Retirement Plans (SERPs)

A supplemental executive retirement plan (SERP), also known as a top–hat plan, is a type of NQDC plan that typically provides retirement benefits that specifically supplement or add on the benefits that the employee receives from the employer's qualified pension or profit sharing plans and from Social Security. As with other NQDC plans that avoid the more stringent requirements of the IRS and ERISA, a SERP is normally structured to be unfunded and to provide benefits primarily to a select group of management or highly compensated employees. Because benefits are paid out of the employer's general assets when due, participating employees must bear the risk associated with relying on the employer's unfunded promise to pay. The employer can use a variety of funding mechanisms to reduce or even eliminate this risk. For more information, see Supplemental Executive Retirement Plans (SERPs) .

Severance Trust Executive Programs (STEPs)

A severance trust executive program (STEP) provides employees with deferred compensation in the form of severance benefits and is generally funded through the purchasing of life insurance policies on the lives of one or more employees. A STEP has the double advantage of deferring income taxation to employees until they receive the deferred compensation benefits, while at the same time allowing the employer to take a tax deduction for contributions in the year made. For more information, see Severance Trust Executive Programs (STEPs) .

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