Executive Benefits

Non-qualified deferred compensation plans: A tool for employers to attract and retain top talent.

In the current "hot" job market, employers are facing the threat of losing their top people through competitive offers from other companies. Losing key people who help the company achieve its goals adds additional financial stress for the employer associated with recruiting, hiring, and training suitable replacements. It can result in lost profits and clientele due to a disruption in the flow of business.

Competition is fierce. Employers must offer a competitive salary and benefit package to attract, retain, and motivate top talent. What can an employer do to gain an advantage over the competition? A properly designed non-qualified deferred compensation plan can give the employer a competitive edge over competing offers.

What Are Non-Qualified Deferred Compensation Plans (NQDC)?

A non-qualified deferred compensation plan is an unsecured contractual agreement between an employer and a key employee in which the employer promises to pay a future benefit to the key employee. The plans are exempt from most ERISA and reporting requirements and are not subject to the participation, non-discrimination, and funding requirements of qualified plans. They are not subject to IRC Section 415-dollar limitations imposed on qualified plans.

Unlike qualified plans, the employer has the freedom to pick and choose which employees will participate as long as the plan is maintained for a "select group of management or highly compensated employees." The plans are flexible, enabling the employer to select a different benefit level for each key employee.

The plan is an additional financial incentive for the key employee to remain with the employer. The written agreement between the employer and the key employee will define what the conditions are for the key employee to receive the benefit, what the benefit will be and when it will be paid. As further motivation, a graduated vesting schedule might be included within the agreement that could make the key employee think twice about leaving when he/she sees the amount of money that will be left on the table.

Plan Design Options – One Size Does Not Fit All

There are several options for NQDC plans. Selection of the type of plan depends upon the employer and key employee objectives.

Non-Qualified Defined Benefit Plan

A defined benefit plan typically provides a specific benefit at retirement or other stated time to be paid for a specified number of years. It can be used to enhance a retirement benefit paid under a qualified plan which may be limited due to benefit limitations. The employer pays for the cost of the plan. The employee pays income tax on the payments when received at his/her ordinary income tax rate. The employer receives a corresponding tax deduction when the payments are made. The benefit could be based on a percentage of final pay or could be a stated dollar amount.

Non-Qualified Defined Contribution Plan

The employer sets aside a contribution amount each year for the employee and credits the account with interest. The contribution amount may vary each year depending upon the employer's objectives. The employee's benefit at retirement or other stated date is based on the account value at that time. The contributions could be based on company profits and achievement of individual performance benchmarks. The employee pays income tax on the payments when received at his/her ordinary income tax rate. The employer receives a corresponding tax deduction when the payments are made.

Non-Qualified Deferred Income Plan (DIP)

Deferred income plans allow the key employee to defer a portion of his/her salary and/or bonus each year. The amounts deferred are not subject to income tax until they are distributed. The plan can be structured to accommodate an employer matching contribution. The employee is vested in his/her deferrals; the employer may choose to impose a vesting schedule on the employer contributions. The payments are subject to income tax at the employee's ordinary income tax rate when received. The employer receives a corresponding tax deduction when payments are made.

Deferred Compensation Plans for Non-Profits

Non-profit organizations may also enhance their benefit packages through the use of deferred compensation arrangements. Plans for non-profits are generally referred to as Section 457(b) plans (limited contribution amounts) and Section 457(f) plans (no contribution limits but accounts must remain subject to a substantial risk of forfeiture to avoid current income taxation).

Plan Funding

To maintain the flexibility and tax advantages that non-qualified plans afford, the plan must remain "unfunded." Assets set aside to meet the plan benefit obligations must remain a general asset of the company. Plan participants cannot have access to the assets before the benefits become due in order to avoid current income taxation.

Life insurance is frequently used as a method of "informally" funding the benefit plan, and it offers many advantages over other types of informal funding. Its cash values normally accumulate income-tax free, while income generated from other funding methods, such as mutual funds, would be currently taxable. The employer can use the cash value of the contract to provide the benefit payments when they become due.

Additionally, in the event of an early death of a key employee, the life insurance death benefit is received income-tax free by the employer. This provides assurance that the employer will have the funds available to pay any survivor benefit due and, structured properly, can also provide key person protection for the company.

Taxation of Non-Qualified Deferred Compensation Plans

THE KEY EMPLOYEE – The key employee has no reportable income prior to retirement or termination. When benefits are paid to the executive they are taxed as ordinary income in the year received.

THE BENEFICIARY – Payments made to the executive's beneficiary will be taxed as ordinary income in the year of receipt. The present value of benefits payable in installments will be included in the executive's estate, but if payable to the surviving spouse, may qualify for the unlimited marital deduction.

THE EMPLOYER – Benefits paid to the executive or to the executive's beneficiary are tax deductible in the year they are made. Life insurance premiums are not tax deductible, but insurance cash values accumulate on a tax-deferred basis and are recorded as an asset on the employer's balance sheet. Life insurance death proceeds used to offset benefit payment liabilities are received by the employer income tax free.

FICA/FUTA TAXES – Nonqualified plan contributions and earnings on them are generally taxable for employment tax purposes when they are vested.

IRC Section 409A

IRC §409A provides the rules that relate to most non-qualified deferred compensation plans:

DEFERRAL ELECTION – Time and form of distribution must be specified at the time of election to defer compensation. Election must be made before the beginning of the taxable year that the compensation is earned.

- Newly eligible employees may make deferral election within 30 days of first becoming eligible to defer compensation earned after the date of the election.

- Election for performance-based compensation that is based on service of at least 12 months may be made at least six months before the end of the performance period.

SUBSEQUENT DEFERRAL ELECTIONS – An election to defer the timing of a distribution or change the form of payment.

- May not take effect for at least 12 months after the election;
- Must be made at least 12 months before the date of the first scheduled payment of previous election; and
- Must provide for additional deferral of at least five years.

PERMISSIBLE DISTRIBUTIONS –

- Death or disability (as defined by the Act);
- Separation from service (payment delayed at least six months after separation of service for key employees of a public company);
- A specified time or based on a fixed schedule under the plan (not an event);
- An unforeseeable emergency; or
- A change in control as defined by the IRS.

ACCELERATION OF DISTRIBUTIONS – The Act prohibits acceleration of the time or schedule of payment(s) under a plan, subject to IRS regulation. Installment payments cannot be changed to a lump-sum payment unless commencement of payment delayed for at least five years from the previously scheduled commencement date.

COMPLIANCE WITH SECTION 409A – Plans must be documented in writing and must operate in good-faith compliance with Section 409A. Failure to comply with Section 409A results immediate taxation and a 20% penalty imposed upon the participant.

SHORT TERM DEFERRAL EXCEPTION – Section 409A will not apply if payment is required to be made on or before the 15th day of the third month following the end of the employee's tax year or the employer's tax year, whichever is later, in which the right to the payment vests.

In Summary

Non-qualified deferred compensation plans can provide employers with a competitive advantage in attracting, retaining, and rewarding employees that are key to the success of the company. They allow for design flexibility without the anti-discrimination provisions or funding and reporting requirements of qualified plans and can be customized for each key employee to align with corporate and individual objectives.

For the key employee, non-qualified deferred compensation plans can provide additional benefits beyond those provided through traditional qualified plans such as a 401(k) plan or other savings plans, without current income taxation, which can incentivize long term employee loyalty.