THE NAUTILUS GROUP®

GUIDEPOST

Nonqualified Deferred Compensation

Nonqualified Deferred Compensation

A nonqualified deferred compensation plan is an agreement between an employer and an employee to defer the payment and receipt of compensation for services performed currently. The employer makes an unsecured and unfunded promise to pay the amounts specified under the agreement to the key employee at some future date. Nonqualified deferred compensation can be utilized in both the employer/employee and the employer/independent contractor context.

An employer may consider implementing a nonqualified deferred compensation plan if the employer wishes to:

- Attract, retain, and reward key employees who are important to the company's success;
- Provide an incentive to key employees to remain with the company and motivation to contribute to the company's success;
- Create "golden handcuffs" for key employees making it costly for them to leave or become a competitor of the company; or
- Provide key employees with supplemental retirement benefits in addition to other retirement plans currently in place.

Nonqualified deferred compensation plan design

A nonqualified deferred compensation plan allows for flexible design, but generally such a plan is structured as a supplemental executive retirement plan, a deferred income plan, or a nonqualified 401(k) look-a-like plan.

Supplemental executive retirement plan

A supplemental executive retirement plan (SERP) is generally funded through employer contributions only. There are two types of SERPs: defined benefit SERPs and defined contribution SERPs. With a defined benefit SERP, benefits received by the employee are based on a specific formula, such as a percentage of the employee's income. With a defined contribution SERP, benefits received by the employee are based on the accumulated account value on the designated distribution date. Benefits are paid to the employee over a defined period (usually corresponding with the employee's retirement) or upon the occurrence of an event as defined in the plan document. Both defined benefit SERPs and defined contribution SERPs can be structured to provide a survivor benefit to the employee's spouse.

Deferred income plan

A deferred income plan (DIP) can be funded through employee deferrals only, or the plan can be structured to combine both employee deferrals with matching employer contributions. Deferred amounts accrue interest at a rate defined in the plan document. Deferred amounts (plus accrued interest) are paid to the key employee over a defined period beginning at a specified date or the occurrence of events defined in the plan document. In the event of the key employee's death, the designated beneficiary may be entitled to pre-retirement or post-retirement survivor benefits. The key employee is always vested in his/her deferrals and typically entitled to them upon separation of service, but employer contributions could be subject to a vesting schedule.

401(k) look-a-like plan

A 401(k) look-a-like plan applies the same "employee saving and employer match strategy" used in a qualified 401(k) plan without qualified plan contribution limits. Key employees can defer a portion of current income and the employer agrees to make matching contributions equal to a percentage of the key employee's deferral, as specified in the plan document. The key employee is fully vested in his/her deferral amounts, but a vesting schedule can be implemented for employer contributions as an additional retention strategy. Benefits are paid to the employee over a defined period (usually corresponding with the employee's retirement) or upon the occurrence of an event as defined in the plan document.

Nonqualified deferred compensation plan funding

A deferred compensation agreement must be unfunded for Internal Revenue Code (IRC) and Employee Retirement Income Security Act (ERISA) purposes to avoid current income taxation. An agreement is generally considered unfunded if the employer's obligation is an unsecured promise to pay. This generally requires that the assets backing the agreement be subject to the claims of general creditors of the employer. The employee is a general creditor of the employer with respect to claims under the agreement.

To protect the employee from a "change of heart" by the employer, a rabbi trust could be created. In a rabbi trust, the employer transfers assets to a trust for the benefit of the key employee. While a rabbi trust does not protect the assets from the claims of the employer's creditors, it provides the key employee the added security that funds have been set aside by the employer and will not be used for any other purpose. For the employer, a rabbi trust has up-front and ongoing costs associated with it.

Methods of informal funding

Various investment vehicles can be used to informally fund a nonqualified deferred compensation plan including savings accounts, bonds, stocks, mutual funds, and annuities. However, such assets would be subject to current income taxation and may be subject to market value fluctuation. Also, such assets generally provide no cost recovery, no survivor benefit, and no guarantees.

Accordingly, permanent insurance on the life of the key employee is often utilized to informally fund a nonqualified deferred compensation plan. The employer is owner and beneficiary of the life insurance policy and may access the policy's cash to fund the promised benefits to the employee. The cash value of the life insurance policy accumulates on an income tax-deferred basis. Depending on the product, the cash values may be credited based on a guaranteed crediting rate. The death benefit may provide both cost recovery to the employer as well as the funds needed to provide the promised survivor benefits.

If the employer purchases insurance on the life of an employee, the employer must comply with the "Notice and Consent" requirements under IRC §101(j) to preserve the income tax-free nature of the life insurance policy's death benefit.

Nonqualified deferred compensation taxation

Income tax considerations – Employer

The employer receives an income tax deduction when the benefit is paid to the key employee as long as the benefit, when taken together with all other compensation paid to the key employee, is considered reasonable compensation considering the services provided.

Income tax considerations – Employee

As long as employer deferrals are subject to a substantial risk of forfeiture (e.g., subject to the claims of the employer's general creditors) and if the employee is not in "constructive receipt" of deferred amounts and does not possess an economic benefit, there should be no income tax consequence to the employee upon deferral. To avoid constructive receipt on amounts deferred by the employee, the employee deferral agreement must be entered into before the compensation is earned or services are performed. Where life insurance will be used to informally fund a deferred compensation agreement, to ensure the employee has no economic benefit, he/she should have no beneficial interest in the policy, including the right to name the beneficiary for any part of the death benefit proceeds. The employer should be sole applicant, owner, beneficiary, and premium payer of any policy used.

If properly structured, an employee will not include any deferred compensation in taxable income until it is received. Once received, the entire amount received will be included in taxable income for that year. Similarly, any amount received by the employee's beneficiary after death will be treated as income in respect of a decedent and will be taxable to the beneficiary in the year received. The beneficiary will be entitled to an income tax deduction for any estate tax paid resulting from the benefits being included in the decedent's estate.

FICA and FUTA implications

The Social Security Act Amendments of 1983 established a definition of wages for the Federal Income Contributions Act (FICA) and Federal Unemployment Tax Act (FUTA). Nonqualified deferred compensation benefits are part of an employee's FICA and FUTA wage bases at the later of the tax year in which the services are performed or the year in which there is no substantial risk of forfeiture of the rights to that amount (or, said another way, when the employee becomes vested in a benefit).

In a DIP or 401(k) look-a-like plan, the employee should be vested in his/her deferrals immediately and such amounts will be subject to FICA/FUTA taxes in the year earned. In a defined contribution SERP, the FICA/FUTA tax will apply to the account balance as the account vests. In a defined benefit SERP, upon vesting the key employee pays FICA/FUTA on the present value of the vested benefit.

Nonqualified deferred compensation compliance requirements

Section 409A

IRC §409A (Section 409A), which governs the timing of when compensation and benefits can be deferred and distributed, was enacted in October 2004 and became generally effective on January 1, 2005. Section 409A applies to compensation earned in one year but that is not paid until a future year. Section 409A generally applies to most nonqualified deferred compensation plans except for IRC § 457(b) plans, which are exempt from §409A.

Section 409A imposes a series of requirements on nonqualified deferred compensation plan documents, the timing of elections to defer compensation, and the timing and form of payment under a plan. Section 409A requires the plan remain in compliance from the time the plan is established until the final distribution under the plan. The following highlights some key requirements that must be met to comply with Section 409A:

- The nonqualified deferred compensation plan must be in writing and include provisions designed to comply with Section 409A.
- An employee's election to defer compensation generally must be made before the start of the taxable year in which the compensation is earned.
- The election to defer compensation must specify the amount of compensation to be deferred.
- The election to defer compensation must state the time and form in which any deferred compensation will be paid.
- Neither the employer nor the employee may retain discretion regarding when payments will be made.
- The timing of the payments generally may not be accelerated by either or both parties.
- Deferred compensation may be paid only upon one or more of the following events:
    - At a specified time or pursuant to a fixed schedule;
    - The employee's separation from service;
    - The employee's death or disability;
    - A "change in control" of the employer; or
    - The employee's unforeseen financial hardship.
- Once established under the agreement, the timing of payments generally cannot be altered unless an election is made at least 12 months prior to the date of distribution as provided in the agreement and if the election defers the distribution by at least five years beyond the originally scheduled payment date.

If deferred compensation arrangements comply with the requirements of Section 409A, the employee's deferred compensation is not taxed until actual receipt of compensation payments (as described above). If the arrangement does not meet the requirements of Section 409A, the compensation is subject to retroactive constructive receipt (i.e., back to the time

of the deferral). In addition to normal income tax, a 20% penalty tax will be imposed as well as interest at a rate 1% higher than the effective underpayment rate.

ERISA compliance

ERISA was enacted on September 2, 1974, and is designed to protect the interest of employees in both pension and welfare benefit plans sponsored by their employers. The term employee pension benefit plan is defined in part to mean any plan, fund, or program which is established or maintained by an employer which "results in a deferral of income by employees for periods extending to the termination of covered employment or beyond…." Thus, ERISA clearly covers nonqualified deferred compensation agreements that provide for distribution of the deferred amount at termination of employment.

Generally, this means that a nonqualified deferred compensation agreement must comply with certain ERISA requirements, including: (1) reporting and disclosure, (2) participation and vesting, (3) funding, (4) fiduciary responsibility, and (5) plan termination insurance. However, if a nonqualified deferred compensation plan is structured as an excess benefit plan or if it is unfunded and established only for a select group of management or highly compensated employees (often referred to as a "top hat" plan), it will be exempt from most of the ERISA requirements.

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