Nonqualified Deferred Compensation

The Concept...

- Nonqualified deferred compensation is an arrangement employers use to provide retirement income—and often death and/or disability benefits—to a select group of managerial or highly paid employees.
- The arrangement is a contractual agreement between an employer and an employee (or independent contractor) specifying when and how future compensation will be paid.
- When properly set up, the employee can postpone income taxation on the deferred amounts until the benefits are paid.
- Deferred compensation arrangements are "nonqualified," meaning they don't have to be preapproved by the IRS, and employers can favor selected employees without risking claims of discrimination.
- Properly arranged, they're exempt from nearly all of ERISA's regulatory requirements.

The Rationale...

- Providing attractive compensation and benefits to owner-employees and key executives is a continuing source of concern for large and small businesses.
- In this environment, strict regulations surrounding qualified retirement plans—coupled with high administrative costs, anti-discrimination rules, and caps on benefits and contributions—have steered many businesses toward supplemental arrangements for key executives.
- Nonqualified deferred compensation permits employers to reward selected executives without taking on the administrative burden of a qualified plan.
- Deferred compensation is typically viewed as an added benefit, and is used in conjunction with a qualified retirement plan, group life and health insurance coverage, and other broadly based employee benefits.

Prospect Profiles...

- An employer who wants to benefit a select, highly compensated employee or group of employees
- C-corporation executives who are looking for ways to improve compensation and benefit packages
- An employer who needs to attract, retain, or reward one or more key employees
- A key employee who is already contributing maximum amounts—or accruing maximum benefits from—a qualified retirement plan
- An employer who does not want to establish a qualified retirement plan

Unique Flexibility...

- Nonqualified deferred compensation permits a business to pick and choose among "top-level" employees with no danger of running afoul of anti- discrimination rules or minimum funding requirements.
- A business can provide a different level of benefits for different employees.
- No government-mandated vesting rules apply.

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- Deferred compensation can be customized to suit individual situations.
- Paperwork and administrative costs are kept to a minimum.

The Process…

- Nonqualified deferred compensation typically provides that an employee will receive a stipulated sum for a fixed period of time, or for life, beginning at a future date—the employee's scheduled retirement, for example.
- If the employee dies after payments have begun, the agreement may direct that remaining benefits be paid to the employee's designated beneficiary.
- A "true deferral" arrangement provides that the employee will receive future compensation as a result of a current salary reduction agreement, or in lieu of a future bonus or expected salary increase.
- In contrast, a "salary continuation" arrangement commits the employer to pay future compensation to the employee without a reduction in current compensation.

Funding…

- In a "funded" arrangement, the employer sets aside specific assets to meet this future obligation, out of the reach of general creditors and with the employee as beneficiary. However, a funded arrangement results in the current inclusion of the deferred amounts in the employee's income unless the funds are subject to a "substantial risk of forfeiture."
- An "unfunded" arrangement is therefore more common, giving the employee only a contractual, unsecured right to future income—either there are no reserves set aside to pay promised benefits, or reserves remain within the reach of general creditors or as a general asset of the business. The employee may not have beneficial ownership rights in any reserved assets.
- In an unfunded arrangement, deferred amounts are included in the employee's gross income only when benefits are actually or constructively received.
- The employer can purchase life insurance to unofficially fund the arrangement without losing the income tax deferral. The policy must be available to the employer's creditors and the employee has no beneficial ownership rights in the policy.
- To avoid taxation of death proceeds, the employer must meet the notice and consent requirements of IRC Sec. 101(j).

Acceleration of Benefits…

- Historically, participating employees were generally not taxed until they actually received payments as long as three conditions were met: (1) the deferral was agreed upon before compensation was earned, (2) the deferred amount was not unconditionally placed in trust or escrow, and (3) the employer's promise to pay was merely a contractual obligation and not evidenced by notes or secured in any other way.
- The employee can lose income tax deferral if the arrangement doesn't follow the rules of IRC §409A (for example, if an employee has control over deferred amounts or has a right to early access to benefits).
- Moreover, if the statutory requirements are not met, the employee must pay a 20% penalty on the amounts included in gross income, plus interest charged at one percent over the normal rate on underpayments.
- Deferred amounts are generally includible in the employee's gross income— for all tax years in which they are not subject to substantial risk of forfeiture—if the plan fails to meet: (1) distribution requirements, (2) no- acceleration-of-benefits requirement, and (3) election of deferral requirements.
- Distributions are permitted only upon separation from service, death or disability, a fixed time specified in the plan, a change in an employer's ownership or control, or an unforeseeable emergency such as severe financial hardship. Distributions at any other time will result in the loss of income tax deferral.
- Any changes in distribution methods that create an acceleration of payments will result in loss of income tax deferral, as will adopting an arrangement that gives the plan administrator discretion over the timing of benefit payments that could result in accelerated payments.

The Timing...

- To achieve income tax deferral, the employee must generally make the election to defer compensation no later than the end of the preceding tax year.
- In the first year of eligibility, the employee can make the initial deferral election within 30 days of becoming eligible and it will apply to compensation for services subsequently performed.

The Bottom Line...

Even though the tax law places restrictions on the distribution of benefits, nonqualified deferred compensation arrangements are an effective way to reward and retain valuable, highly compensated employees on a selective basis.

Non-Qualified Deferred Compensation

1. The employer and employee enter into a written nonqualified deferred compensation agreement.
2. The employer may purchase an insurance policy.
3. When the employee satisfies the conditions to receive benefits, the employer begins to pay retirement—or disability—benefits from the policy values, subject to the federal income tax rules regarding policy withdrawals, loans and surrenders.
4. At the employee's death, the employer may use the insurance proceeds to pay benefits to the employee's beneficiary if so pro- vided in the deferred compensation agreement. To avoid taxation of death proceeds, the employer must meet the notice and consent requirements of IRC Sec. 101(j).

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