



# Nonqualified Deferred Compensation Programs Is One Right for Your Organization?

Many employers use nonqualified deferred compensation programs to help attract, retain, and reward executives or other highly compensated employees. Throughout this brief we are going to use the term “key employee” to mean an executive or highly compensated employee who is eligible to participate in a nonqualified deferred compensation plan. A nonqualified plan can be used to provide additional long-term savings or retirement benefits to key employees, to provide incentives to achieve business objectives, or both.

*Note: This Findley brief provides a basic overview of nonqualified deferred compensation plans in common use by private sector, for-profit employers providing programs that are not stock based. Although beyond the scope of this brief, there are a variety of nonqualified, incentive compensation, and stock equity programs in use. Further, the rules can vary by type of plan and type of employer; government entities, churches and church-affiliated organizations, other tax-exempt employers, and private sector companies can each sponsor nonqualified programs. Contact Findley to learn more about the programs available and how they can be used in your organization.*

## What Is a Nonqualified Deferred Compensation Plan?

Simply stated, a nonqualified deferred compensation program is an unfunded, unsecured promise by the employer to the key employee to pay compensation at a specific time or upon a specific event in the future. The program is a contract between the employer and the key employee for the payment of these future benefits.

The term “nonqualified” means that the plan is not required to meet most of the requirements of the Employee Retirement Income Security Act (ERISA) or the Internal Revenue Code that are imposed on tax-favored, or qualified, plans. But, there are a number of requirements imposed on plan sponsors and participants for the design and operation of nonqualified deferred compensation programs. Many of these requirements are found in Internal Revenue Code Sections 409A and 83, which will be discussed later in this brief.

### Employer Objectives

Unlike the comprehensive body of rules applying to qualified plans, the broad framework imposed by ERISA and the Internal Revenue Code leaves room for creativity in designing a nonqualified deferred compensation plan. This design flexibility gives the employer the ability to customize their plan to be unique to their organization and their key employees, and accomplishes a wide variety of objectives:

- To attract key employees through significant benefits that are deferred to a future date, which can also ensure a long-term commitment by the new hire. In fact, offering a nonqualified deferred compensation program can level the playing field by tailoring a benefits package that is equal to or better than that of larger companies;
- To retain key employees through “golden handcuffs” by offering deferred benefits that are subject to forfeiture unless certain conditions are met;
- To make up benefits that cannot be provided under the qualified plan due to various limitations of law;
- To avoid nondiscrimination rules and issues that would otherwise apply if benefits were provided through the employer’s qualified plan. Providing benefits to only a select group of management or highly compensated employees can also be a more cost-effective approach for providing benefits than under a qualified plan;
- To provide supplemental benefits in addition to a qualified plan that would allow the key employee to retire with the same total pay replacement that staff employees receive;
- To provide key employees with incentives and rewards without creating an immediate corresponding tax burden to the individual;
- To provide future benefits without the legal requirement to fund those benefits.

### Key Employee Objectives

High-earning key employees with substantial discretionary income find these plans attractive due to their favorable tax treatment. Typical objectives are:

- Avoidance of current taxation on regular or incentive pay;
- Avoidance of current taxation on any growth of accounts or benefits;
- Managing personal cash flow and taxes by deferring compensation until a future date when there may be a lower tax rate applied and when the money may be better used;
- Accumulation of tax-favored savings and wealth beyond that allowed by their qualified plans and personal savings.

### Disadvantages — for the Individual

Key employees covered by these plans should know that the amounts they and the company defer and their earnings are at all times unsecured contractual obligations of the employer. Therefore, any amounts set aside in the key employee’s name are not protected from the claims of general creditors of the company. The key employee is an unsecured general creditor of the employer.

The rules for the timing of elections to defer compensation and the ability to change deferral rates in a nonqualified deferred compensation program are much less flexible than the typical 401(k) plan. Elections to defer compensation must occur before the compensation is earned, and the election timing rules differ depending upon whether the compensation is considered base pay, performance-based, or some other form of compensation. Also, Internal Revenue Code Section 409A is clear that any key employee who chooses to defer compensation is generally not allowed to change their deferral election during the year. As a result, the timing of the election to defer can often be well in advance of the actual deferral of compensation from that key employee’s paycheck, and the key employee must plan carefully when making their election to defer.

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Further, unless dictated by the plan language, the key employee must determine when and in what form the deferred compensation is to be paid at the time of the election to defer. Thus, key employees who choose to defer compensation under the program commonly choose to defer compensation for periods that correspond to major life events such as retirement, college education for children, or for other personal needs. Since the election of the timing and form of distribution is generally made in advance of such payment(s), financial and other circumstances may change for the key employee during the period of deferment. Once an election has been made, there are limited ways in which the distribution election can be changed. So the key employee must also plan carefully for the timing and the form of distribution well in advance of those events.

### Disadvantages — for the Employer

The almost complete flexibility to determine who is eligible and what benefits are provided under a nonqualified deferred compensation program comes with a price. There is no current tax deduction to the employer for any amounts that may be set aside to pay future benefits from the plan. Further, if funds are set aside, any investment earnings on those funds can be taxable income to the employer. Finally, the requirements of Internal Revenue Code Section 409A raise the risk of adverse tax consequences to the key employee

as a result of an error in the design, the written plan documentation, or the administration of the program.

### ERISA Framework for Key Employee Eligibility

The Employee Retirement Income Security Act of 1974 provides the basic framework for deferred compensation plans in the private sector. This law establishes specific exemptions to the otherwise-required coverage, participation, vesting, funding, benefit security, and fiduciary rules that are imposed on nonqualified deferred compensation programs. A nonqualified deferred compensation program is mostly exempt from ERISA if the benefits are provided to a group that is considered a select group of management or highly compensated employees (commonly called a “top hat plan”) and the plan sponsor notifies the Department of Labor of the plan’s existence.

The definition of what constitutes a select group of management or highly compensated employees is not clearly defined in the law, and the Department of Labor has not yet issued regulations on this topic. However, the courts have decided some relevant cases that give further definition of these terms. The Department of Labor has provided an Advisory Opinion that expresses a key qualitative standard, “that certain individuals, by virtue of their position or compensation level, have the ability to affect or substantially influence, through negotiation or otherwise, the design and operation of their deferred compensation plan, taking into consideration any risks attendant thereto, and, therefore, would not need the substantive rights and protections of Title I [of ERISA].”

### Plan Types and Characteristics

The main types of plans in use are defined contribution deferred compensation plans and defined benefit deferred compensation plans. These nonqualified plan types are like their qualified plan counterparts in that:

- 1) a defined contribution deferred compensation plan defines its benefits in the form of contributions to an account accumulating interest or investment earnings.

- 2) a defined benefit deferred compensation plan defines its benefits in the form of a formula or fixed dollar amount of income that will be provided based on the occurrence of certain events, such as retirement at age 65.

### **Tax Consequences to the Individual**

An unfunded nonqualified plan operates much the same as a qualified plan for the benefit of the individual covered. As long as the individual is neither in constructive receipt of nor derives any economic benefit from the benefits or contributions accumulated under the plan, federal income tax (and generally state or other income tax) is not assessed. Contributions provided and interest or investment income on the contributions or benefits accruing under a nonqualified deferred compensation plan do not create a current tax liability to the covered individual if the benefits are considered unfunded. Rather, the individual pays taxes on the benefit received at the time of constructive or actual receipt of the plan benefits.

Payroll tax treatment differs from qualified plans in that a covered key employee is generally subject to FICA retirement and Medicare payroll withholdings when the benefits become vested and can be readily determined. This withholding treatment can work in his or her favor when their compensation in the vesting year is greater than the retirement taxable wage base for FICA withholding. In this situation, withholding is only at the Medicare withholding rate (1.45% of pay in 2011).

### **Tax Consequences to the Employer**

The tax consequences to the employer are substantially different from qualified plans. Unlike qualified plans, contributions to a nonqualified deferred compensation plan are not a currently deductible expense to the corporation. Corporations may only obtain a deduction from the plan at the point when the key employee is subject to tax on the benefits due to actual or constructive receipt. What's more, if any funding amounts are informally set aside, the employer is generally subject to taxation on any investment earnings generated by those assets. Thus, interest, dividends, and realized gains or losses on any investments would generally be taxable income to the employer. There are

certain forms of investment, such as Corporate Owned Life Insurance, where the growth of cash value is not considered taxable income. The tax treatment of assets set aside for funding is described more fully in the funding section of this brief.

At the time the key employee becomes subject to FICA retirement and Medicare payroll withholding upon vesting, the employer must pay its own portion of such required withholding.

### **Benefit Security Issues**

Amounts contributed to a qualified plan are held in trust for the exclusive benefit of the employees covered by the plan. By contrast, amounts set aside for a key employee under an unfunded top hat plan must be available to general creditors in order to avoid the imposition of ERISA requirements on these plans.

If the plan is for a select group of management and highly compensated employees, then the employer's desire is generally for that plan to remain unfunded in order to avoid the imposition of ERISA requirements. Principles of prudent financial management (and key employees' personal financial interest), however, often push a company to set aside funds in order to lessen the risk that it will be unable to pay benefits when due. To fund or not to fund, the conflict is obvious—an unfunded plan avoids cumbersome ERISA regulations and key employee taxation but presents the possibility of a future financial strain when benefit obligations become due.

Through a series of rulings, the IRS and DOL have established two tests to determine whether the plan remains unfunded:

- 1) assets set aside must remain subject to the claims of general creditors, and
- 2) assets set aside must not be directly identified or associated with a specific key employee.

If these tests are met, the plan remains an unfunded plan. As a result, employers use various devices to increase (but not perfect) the security of the amounts

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deferred under a deferred compensation program without triggering constructive receipt.

A common method to increase the security of the benefits is to establish a rabbi trust to hold the assets set aside for future payment of deferred compensation. A rabbi trust is generally a trust designed to be a grantor trust for federal income tax purposes. Thus, the rabbi trust investment earnings are generally taxable to the employer. The trust pays benefits solely to the key employees covered under the deferred compensation program. So long as the employer remains solvent, the trust cannot divert any funds held in trust for any other purpose than payment of benefits, expenses of administration, or taxes under the deferred compensation plan. A typical rabbi trust also includes provisions that require the full funding of obligations of the plan upon a change in control, and its associated plan may require immediate vesting and distribution of benefits. The assets in the trust are subject to the claims of the employer's creditors in the event of the employer's bankruptcy or insolvency.

### Indirect Funding of the Deferred Compensation Obligation

Returning to the tax effects to the employer, because the employer or a rabbi trust remains the owner of the assets, the employer also must pay

tax on the investments based on the character of those investments.

For example, if the corporation informally sets aside funds for a deferred compensation program in mutual funds or other taxable investments, any dividends, capital gain distributions, or realized gains and losses flow through to the taxable income of the corporation. The fundamental problem here is the mismatch of taxable income without the offsetting tax deduction: the corporation must often pay income tax well before receiving a tax deduction for the distribution of the benefits from the deferred compensation plan. For a corporation earning healthy profits and with a sizable fund securing nonqualified plan benefits, the accumulation of taxable investment earnings before receiving the tax deduction may become a significant consideration.

To avoid the mismatch of taxable earnings before deductible payment of the benefits, many corporations use insurance funding strategies to informally fund their deferred compensation benefits. Insurance funding allows for the tax-deferred buildup of cash value under the policies, and taxable income is only created if the policy is liquidated for payment of the benefits. In addition, some companies choose to hold the policies until the death of the key employee, which greatly increases the return on the investment in the policy and which also improves the corporation's bottom line because the death proceeds generally are not included in the corporation's taxable income. In return for this favorable taxation, insurance companies must charge for the cost of the death benefit coverage, thus a company's before-tax rate of return on an insurance policy will generally be lower than on equivalent mutual funds

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return before taxes. On an after-tax basis, the reverse is often true; the insurance policy provides a better return than the mutual funds.

## Conclusion

A deferred compensation plan for key employees is often a cost-effective, flexible, and powerful tool to provide appropriate incentives and rewards and encourage the retention of valuable leaders within the organization.

With the right design and careful implementation, a nonqualified deferred compensation arrangement can help achieve many organization objectives.

Findley consultants can work with you and your team of legal, tax, and accounting advisers in considering and implementing nonqualified deferred compensation arrangements and options, including:

- defining overall goals and objectives;
- maximizing benefits under existing qualified plans and coordinating nonqualified plan benefits;
- providing analysis of possible nonqualified benefits under different plans and formulas;
- designing the nonqualified deferred compensation plan;
- drafting plan documents for review by your legal counsel, or reviewing plan documents drafted by your legal counsel;
- assisting with reporting requirements;
- providing recordkeeping and administrative services.

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