Non-Qualified Deferred Compensation

While saving for retirement is a key priority for many executives, the amount that they can accumulate through employer-sponsored qualified retirement plans and individual retirement accounts is limited. Employers can reward their executives and help them achieve their retirement goals by establishing a non-qualified deferred compensation (NQDC) plan.

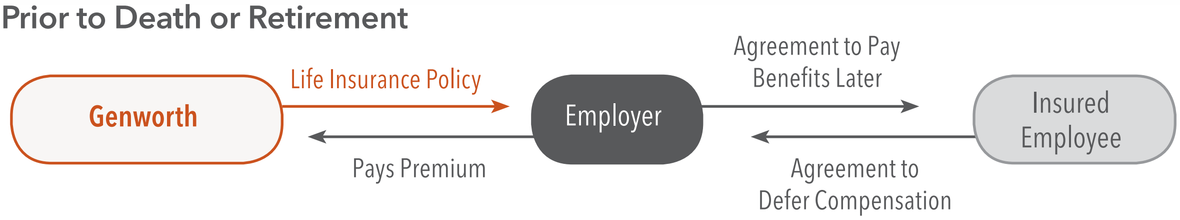
NQDC plans allow the employee to defer receipt of earnings and postpone corresponding income taxation on those earnings until they receive them, usually at retirement. The employer may also contribute to the plan, further enhancing the employee's future benefit.

A deferred compensation agreement between the employee and the employer establishes the amount and timing of benefits at the inception of the plan.

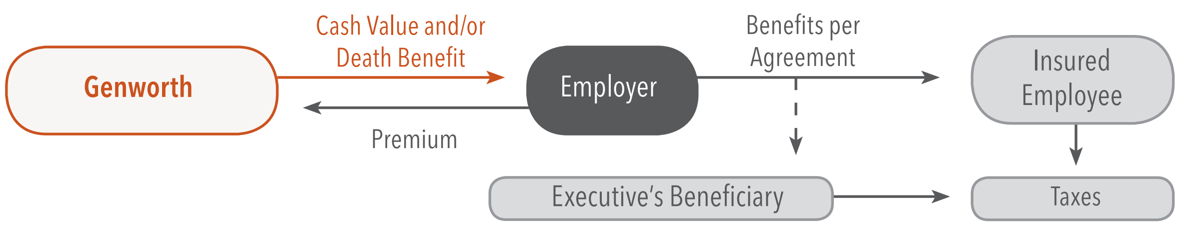
The agreement also establishes the time or triggering events when the payment of benefits will begin. Typical payment options include a lump sum or a series of payments over a period of years. The plan may also include a payment in the event of the executive's death.

The plan may be informally funded using the death benefits from a life insurance policy owned by, and payable to, the employer and insuring the employee. The employer may access any available cash surrender value to help meet payment obligations.[1] Death benefits paid to the employer may be used to meet the employer's obligations to the employee's family or to provide the employer with cash to recover the costs of the plan.

Prior to Death or Retirement



At Death or Retirement



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Advantages of Non-Qualified Deferred Compensation

- The availability of non-qualified deferred compensation arrangements can help the employer recruit and retain quality key executives who may want to contribute more to retirement accounts than qualified plan limitations allow.
- The employer can select participants among its key employees and, within certain restrictions, customize the plan's features to meet employer objectives.
- Minimal IRS reporting is required.
- Plan benefits can replace income at retirement or death.

Plan Considerations

Establishing a Plan

Participation must generally be limited to a select group of management and highly compensated employees to avoid most ERISA (Employee Retirement Income Security Act of 1974) requirements. The employer must notify the Department of Labor (DOL) of the establishment of the plan within 120 days.[1]

Availability

Non-qualified deferred compensation is not available to S corporation shareholders, LLC owners, partners, and sole proprietors.

Special Rules

Special rules may apply to plans sponsored by governmental bodies (e.g., municipalities) or tax-exempt employers.

Unfunded Plans

Non-qualified deferred compensation plans are typically "unfunded" agreements. This means that account values remain subject to the claims of the employer's general creditors and the employee has only the employer's unsecured promise to pay future benefits and no right to access the money or accelerate distributions. Unfunded plans are generally not subject to additional requirements under ERISA.

Substantial Risk of Forfeiture

The employee's rights to an "informally funded" account must be subject to a "substantial risk of forfeiture." A substantial risk of forfeiture exists if the employee's right to receive the money is contingent upon his/her performing future services or a particular event occurring, and if the possibility the condition will not be satisfied is substantial.

Deferment Election

Generally, under Internal Revenue Code (IRC) section 409A, the employee must elect to defer compensation prior to the year the compensation is earned and the timing and method of the benefit payment cannot be changed.

Deferred compensation payments may generally not be accelerated – the employee may not request early payments in exchange for forfeiting some benefits.

Payment Events

IRC section 409A limits the events that can trigger payment to the employee to separation from service, death, disability, severe and unforeseeable financial hardship, change in control of the business, a fixed time or a fixed schedule.

Tax Advantages & Considerations

Plan Deferred Amounts

In most cases, the amount deferred into the plan is not currently taxable income to the employee because the employee doesn't actually receive it ("constructive receipt") and because the employee's right to it is subject to substantial limitations.

Failing to comply with IRC section 409A may mean that amounts deferred for that and previous years would be included in the employee's income and the employee would pay ordinary income tax plus a 20% federal penalty tax on those amounts.

Life Insurance Used to Informally Fund the Plan:

Premiums

Premiums paid by the employer for life insurance used to "informally fund" the plan are not income tax deductible.

Tax-Deferred Growth

Growth in a life insurance policy's cash value is income tax deferred until removed from the policy. The employer may access the policy cash value on a tax-favored basis, provided the policy is not a Modified Endowment Contract and the policy is not subsequently surrendered.[2]

Death Benefits

Death benefits paid under an employer-owned life insurance policy are generally income tax free unless the policy has been transferred for valuable consideration where no safe harbor applies, or where the employer fails to comply with the requirements of Internal Revenue Code §101(j).

C Corporation

In a C corporation, life insurance cash value and death benefit proceeds may be subject to corporate Alternative Minimum Tax (AMT).

Benefits Paid:

Employee in First Year

Benefits paid to the employee or his/her family are usually taxable as ordinary income in the first year in which the employee has the ability to access or receive the money.

Retiring Employees

For a retiring employee who is no longer subject to a "substantial risk of forfeiture", payments – and the income tax burden – may be spread out over a specific period assuming the agreement was entered into before the compensation was earned. The employee will not be in constructive receipt if future payments are not secured.[3]

Employer Deduction

Benefits paid to the employee or his/her designated beneficiary are income tax deductible to the employer in the year in which they are included in the taxable income of the employee or beneficiary.

Estate

If benefits are payable beyond the employee's lifetime, the present value of future benefits may be included in the employee's gross estate.

[1] 29 CFR 2520.104-23

[2] Policy loans and withdrawals will reduce the death benefit and surrender value. If a policy is surrendered, any outstanding loan balances will be used to determine whether there is a taxable gain in the contract/policy. In certain highly funded cases, life insurance policies may be considered Modified Endowment Contracts (MECs). Distributions including loans from a MEC will be taxable income to the extent that there is gain in the contract. In addition, a 10% IRS penalty tax may be due on any taxable income received from a MEC prior to age 59½.

[3] Rev. Rul. 60-31, 1960-1 CB 174, as modified by Rev. Rul. 70-435, 1970-2 CB 100