401(k) v. Nonqualified Deferred Compensation Plans

Saving income on a tax-advantaged basis has long been an important element of an effective retirement savings strategy, but limited opportunities exist. Tax-qualified 401(k) plans provide pretax savings opportunities, but contribution limits are restrictive. Nonqualified Deferred Compensation Plans provide additional means to leverage tax-advantaged savings and have become a key element of an employer's ability to attract, retain and reward their key management employees. While the two types of plans have many similarities, important tax, financial and operational differences exist. The table below compares the plans and their impact from a company and a participant perspective.

	1 401(k) Plan	2 Nonqualified Deferral Plan
Company Perspective		
▪ Eligibility	All employees	Highly compensated and key management employees only
▪ Contribution Limits	Contribution and catch up limits Eligible Compensation limits Discrimination testing	No limits required. However, some employers may place a cap on deferrals to ensure payroll taxes/other withholdings can be made from payroll. No Eligible Compensation limits No discrimination testing. Plan can discriminate with regard to plan eligibility and company contribution/match by employee.
▪ Liability (Plan) Taxation		
– Contributions	Employee elective contributions are currently tax deductible and subject to FICA/Medicare Employer contributions are not subject to FICA/Medicare	Contributions are *not* tax-deductible Employee elective contributions are subject to FICA/Medicare Employer elective contributions, if any, are subject to FICA/Medicare upon vesting
– Distributions	Distributions to participants have no tax impact on the company	Distributions (contributions plus earnings) are tax-deductible to the company when paid
▪ Asset (Funding) Taxation	Assets accumulate in a tax-qualified trust tax-free	Asset accumulation is taxable unless a tax-favored asset such as COLI is used, which accumulates tax-deferred (tax-free if held until death)
▪ Liability (Plan) Accounting	Deferral results in compensation expense, just as salary payment would if there were no deferral made by the employee Any employer contribution (e.g., company match) creates an additional charge There is no charge for investment gains in participant accounts Liability is "off-balance-sheet"	Deferral results in compensation expense, just as salary payment would if there were no deferral made by the employee Any employer contribution (e.g., company match) creates an additional charge Investment gains/(losses) credited to participant accounts create an additional charge/(gain) Company liability is carried equal to the participant's account balance
▪ Asset (Funding) Accounting	Once funded, assets and liabilities are off the balance sheet	Assets are accounted as they would be under any other investment strategy Assets do not directly offset liabilities, instead, they are presented as separate balance sheet line items

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	1 401(k) Plan	2 Nonqualified Deferral Plan
Company Perspective (*Cont.*)		
■ Tax Compliance	Section 401(k) ERISA	Section 409A Exempt from most ERISA requirements
■ Legal/Reporting	Annual DOL filing	One-time DOL filing Possible SEC reporting (Proxy, S-8, Form 4)
Participant Perspective		
■ Taxation		
– Contributions	Income-tax deferred. Subject to FICA/Medicare.	Income-tax deferred. Subject to FICA/Medicare.
– Distributions	Subject to income tax. No FICA/Medicare (already paid)	Subject to income tax. No FICA/Medicare (already paid).
■ Contribution Limits	Subject to various restrictions. E.g., 2017 maximum 401(k) deferral under 402(g) is $18,000.	None, except as mandated by plan
■ Timing of Elections		
– Contributions	Generally, prior to the commencement of the plan year. Contribution levels can be changed during the year, subject to plan design	Must be made prior to the beginning of the calendar year in which the compensation to be deferred is earned. Changes are not permitted.
– Distributions	Form of distribution is elected at the point of distribution	Form and timing of distribution must be elected at the time of the deferral election
■ Election Changes	Deferral election can be changed at any time, subject to rules of the plan	Deferral election can be changed only for subsequent calendar years Distribution elections may be modified with advance notice, subject to plan terms and Internal Revenue Code restriction
■ Timing of Distributions	Limited distribution options. Payments made before age 59 1/2 subject to penalty. Required Minimum Distributions commence at age 70 1/2.	Flexible. Election must be made prior to beginning of earnings period. No penalty for distributions payable before age 59 1/2. Separation from service (retirement, termination, etc.) generally triggers payment.
■ Hardship Distributions	Available at any age without penalty	If included in plan design, available anytime without penalty. Stricter qualifications for meeting definition of "hardship."
■ Loans	Allowed	Not allowed. However, shorter-term cash needs may be satisfied from scheduled in-service distributions, if allowed by plan design.
■ Tax-free Rollovers	Allowed without penalty	Not allowed. Distributions typically commence upon separation from service.
■ Benefit Security	Plan balances are secured: contributions plus earnings are held in trust and owned by the participant	Plan balances are unsecured: payments are a contractual obligation of the employer to the employee ("promise to pay")

This information is provided for information purposes only. This material is not intended to present an opinion on tax matters. Please consult your attorney or tax advisor, as applicable.

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