



WRMarketplace

An AALU Washington Report

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TOPIC: Part 1: The Fundamentals of Non-Qualified Deferred Compensation Plans.

MARKET TREND: Employer-sponsored retirement plans are at the forefront of discussions regarding individual preparedness for retirement, as a significant percentage of many individuals’ retirement income depends on such plans.

SYNOPSIS: Because of restrictions and limitations in the tax and ERISA rules that apply to tax-qualified retirement plans, many employers have created non-qualified deferred compensation (“NQDC”) plans to provide additional compensation and retirement benefits to key executives. There are two main types of NQDC plans: (1) defined contribution and (2) defined benefit. A general understanding of the tax and ERISA implications for these plans can help an employer select the best plan for its executives.

TAKE AWAYS: Combining an understanding of the practical and technical aspects of types of NQDC plans will be valuable in advising employers in the selection and implementation of an effective executive compensation plan. To assist in plan selection, attached is a table summarizing key factors and differences between the two main types of NQDC plans.

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There are two main types of NQDC plans: (1) defined contribution and (2) defined benefit. A general understanding of the tax, ERISA, and financial accounting implications of these plans can help an employer select the best plan for its executives. Part 1 of this series looks at the fundamentals of NQDC plans, while Part 2 will discuss funding options and financial accounting considerations.

NQDC PLAN TYPES

NQDC plans involve a promise by the sponsoring employer to pay part of the executive's salary or bonus and/or some additional employer-provided benefit to the executive at a later date (e.g., upon retirement or other termination of employment). Within this general framework, there are two traditional types of NQDC plans:

Defined Contribution. A defined contribution plan (“**DC plan**”) is an employer-sponsored retirement plan where the employer and/or employee make specified contributions that are credited to a separate bookkeeping account established for the employee (a “**participant**”). A participant's benefit is determined by the amount of contributions credited to his or her account, along with the earnings or losses accrued with respect to those contributions over time.

- ✓ **Practical Point:** Since the investment performance of plan assets affects the amount ultimately payable to the participant, he or she bears the investment risk.

Contributions. Contributions to DC plans may come from the employee-participant, the employer-sponsor, or both:

1. **Employee Contributions.** A participant may elect to contribute a percentage of his salary or bonus to the plan. By making elective contributions, the executive can defer the income tax (but not FICA, Medicare, or FUTA taxes) on the amounts contributed. The executive is always fully vested in the total value of his or her elective contribution account.
2. **Employer Contributions.**
 - ***Matching.*** As an added benefit, the employer may agree to make matching contributions to the executive's account (e.g., 50% for each dollar contributed by the executive up to a specified maximum). The matching contribution amount may be mandatory or left to the employer's discretion and may differ among participants.
 - ***Discretionary.*** The employer also may make additional contributions on a discretionary basis or pursuant to a formula specified in the plan. In most plans, the employer can determine on an annual basis whether it wishes to make these contributions to an executive's account and the basis upon which those contributions are to be determined and allocated among participants.

- ✓ **Practical Point:** Matching contributions and discretionary employer contributions may be subject to a vesting schedule as a means of providing a “golden handcuff,” and, unlike qualified retirement plans, may be subjected to forfeiture in the event of termination for cause or breach of non-competition and/or confidentiality covenants.
- 3. Optional 401(k) Wrap-Around. Due to 401(k) plan contribution limitations, many employers have established “401(k) wrap-around plans” to provide additional deferred compensation for executives. Under this type of plan, amounts elected to be contributed by salary reduction, and matching contributions associated with those contributions, are made into the 401(k) plan to the extent they do not exceed the contribution limitations and non-discrimination requirements applicable to 401(k) plans. Once those contribution limitations are met, excess contributions would be made to the nonqualified plan.

Investments. Participants can select how the value of their benefits should be measured, and as long as the employer is under no obligation to actually make the selected investments, the participant should not be deemed to have constructive receipt of those funds, so they will still be tax-deferred for income tax purposes. Employers typically invest the funds set aside in the same manner as participants have elected to have their benefits measured so that the assets set aside will match the benefit obligations under the plan.

Earnings. Earnings that accrue on the deferred compensation benefits generally are credited in one of the following manners: (a) by using a flat interest rate (b) by tying the earnings rate to the prime rate or some other index, or (c) most commonly, by tying earnings to the performance of certain investments (usually mutual funds) selected by the employer and/or the participant.

Defined Benefit. In contrast to a DC plan, a defined benefit plan (“**DB plan**”) pays a benefit to the participant in a specified amount (e.g., 50% of a participant’s average compensation over the 5 years before retirement) that is payable for a specified number of years after retirement, or as an annuity over the executive’s lifetime or the lifetimes of the executive and his spouse. The sponsoring employer may create an account or fund to which contributions are made on a regular basis to pay future specified benefits.

Investments & Contributions. Unlike a DC plan, under which the plan’s investment gains and losses affect the benefits paid to the participant, earnings and losses in a DB plan do not affect the amount payable to a participant. That amount is determined solely by reference to the plan’s benefit formula. Instead, earnings and losses affect the amount the employer sets aside to ensure that the plan is adequately funded.

- ✓ **Practical Point:** In contrast to DC plans, employers, not employees, bear the risk of a DB plan’s investment performance.

Determination of Benefits. The benefit is typically based on a formula that takes into account the participant's compensation and number of years of service. This amount is generally specified as the amount payable as of the participant's "normal retirement date." Most plans also allow a participant to receive a benefit as of an "early retirement date" if certain conditions are satisfied, although the amount of the benefit is often reduced to reflect early commencement and, therefore, a longer anticipated payout period. The benefit also is frequently offset by the value of benefits payable under the employer's tax-qualified retirement plans.

TAXATION OF NQDC PLANS

Participant Taxation. Although participants, as cash method taxpayers, generally report income in the year of actual receipt, NQDC plan benefits may become taxable before that if one of the following applies:

1. **Constructive Receipt.** Income is deemed constructively received by, and taxable to, a taxpayer in the taxable year during which it is credited to the taxpayer's account, set apart for him or her, or otherwise made available so that he or she may draw upon it during the taxable year. Income is not constructively received, however, if the taxpayer's control of its receipt is subject to substantial limitations (*WRMarketplace No. 2013-41* discussed the constructive receipt doctrine).

2. **Economic Benefit.** Under the economic benefit doctrine, amounts are included in the gross income of a cash basis taxpayer when the right to the future payment is non-forfeitable and a fund is set aside for the future payment. Inclusion results if the taxpayer obtains a right in some property which is valuable, unconditional, and non-forfeitable, even though the taxpayer does not have immediate control over the property or the power to obtain payment directly or indirectly from the employer (see *WRMarketplace No. 2013-41* for a discussion of the economic benefit doctrine).

3. **IRC §409A.** IRC §409A imposes various requirements upon "deferred compensation" paid to employees and many independent contractors. For this purpose, taxable compensation for services generally is deemed to be "deferred compensation" if the employee or other service provider has a legally binding right to that compensation (even if that right is subject to a substantial risk of forfeiture) and the compensation is payable in a later taxable year. The rules applicable to deferred compensation subject to IRC §409A include the following:

- NQDC plan distributions only are permitted (a) on account of death, disability, separation from service (b) at a specified time or pursuant to a fixed schedule (c) on account of a change in control (as permitted by regulations), or (d) on account of an unforeseeable emergency.
- Initial deferral elections generally must be made before the taxable year for which the compensation is earned.

- Subsequent elections as to the timing or form of payments generally must be made at least 12 months before the payments otherwise would start, and subsequent deferrals generally must be for at least 5 years (unless the payment is on account of the employee's death, disability, or an unforeseeable hardship).
 - Any of the following will cause the immediate taxation of benefits: (a) provisions allowing the acceleration of the timing of benefit payments (e.g., allowing distributions subject to a 10% "haircut" penalty) (b) transfers of assets to offshore trusts, or (c) employer financial triggers for payment of benefits.
- ✓ **Practical Point**: There are significant consequences to violations of these IRC §409A rules, including: (1) the benefit becoming taxable as soon as it is no longer subject to a substantial risk of forfeiture (b) an increase in the tax due by the amount of interest accrued (at the tax underpayment rate plus 1%) from the date on which the benefit becomes taxable, and (c) the imposition of an additional 20% tax on the taxable amount (see *WRMarketplace No. 2013-45* for a discussion of IRC §409A).

Employer Taxation. Employers may not take an income tax deduction under a NQDC plan until the amount attributable to the employer's contribution is includible in the executive's gross income. Generally, if the employer sets aside amounts to fund future benefits, it will be taxable on the earnings (an exposure that can be mitigated by investing in life insurance policies or tax-exempt securities, as will be discussed in Part 2 regarding funding options). The employer receives a tax deduction for those earnings (along with the balance of the plan benefits) when the benefits are distributed to the participant.

Employment Taxes. Amounts deferred pursuant to a NQDC plan constitute "wages" subject to FICA, Medicare, and FUTA tax at the later of (a) when the services are performed or (b) when the benefit is no longer subject to a substantial risk of forfeiture (whether or not the benefit then is subject to income tax). FICA, Medicare, and FUTA taxes do not apply to the amounts so treated as wages (and the income attributable thereto) when distributed.

NQDC PLANS & ERISA

In addition to the numerous substantive rules governing the operation of employee benefit plans, ERISA imposes significant reporting and disclosure obligations on the plan administrators. Certain NQDC plans, however, are not subject to these requirements or can fall under an exemption, with the proper structure.

Top-Hat Plans and Excess Benefit Plans.

ERISA Exemptions. Unfunded NQDC plans benefiting management or highly compensated employees (so-called “top-hat plans”) and plans that only provide benefits in excess of the benefit limits applicable to tax-qualified plans (so-called “excess benefit plans”) are exempt from ERISA’s participation and coverage rules, minimum vesting and funding requirements, and fiduciary responsibility rules. For this purpose, “unfunded” means that the employer’s obligation to pay deferred compensation is unsecured, with no trust or similar arrangement created that would set aside assets beyond the reach of the employer’s general creditors. While ERISA’s reporting and disclosure rules still apply to unfunded top-hat plans, these plans can meet these requirements through a one-time filing with the Department of Labor made within 120 days after plan adoption. Unfunded excess benefit plans are not subject to these reporting and disclosure requirements.

Qualification. To qualify as a top-hat plan, not only must the plan be unfunded, but it also must benefit only “a select group of management or highly compensated employees.” Note that neither ERISA nor the regulations define the phrase “a select group of management or highly compensated employees,” and case law on the matter is limited and inconclusive. Employers thus must proceed cautiously in deciding on the employees who may participate in the plan (see *WRMarketplace No. 13-38* for a discussion of top-hat plans).

- ✓ **Practical Point:** For employers, unfunded top-hat plans and excess benefit plans can provide certain advantages, since various requirements under ERISA and the Internal Revenue Code do not apply. For instance, longer vesting schedules can apply to employer-provided benefits under top-hat and excess benefit plans than to those under qualified plans. Also, benefits under these plans (1) may be forfeitable if the executive is terminated for cause and (2) conditioned upon the executive’s compliance with non-competition and/or confidentiality covenants (and benefit payments may be extended over the restrictive covenant period so benefits can be withheld due to breach).

Other Plans. Employee benefit plans not qualifying as unfunded top-hat or excess benefit plans (or under other exceptions to ERISA (like those for governmental plans)) must satisfy ERISA requirements that the employer’s benefit obligations be funded in a trust, the assets of which are beyond the reach of the employer’s creditors. The funding of such a trust would result in taxable income to the employee when his or her benefits are no longer subject to a substantial risk of forfeiture (rather than only when actually distributed). Other ERISA requirements also would apply, such as the minimum vesting and funding rules. Excess benefit plans are not subject to those requirements.

SELECTING A NQDC PLAN

Employers considering the creation of a NQDC plan should consider the following when selecting between the two main types:

Defined Contribution	Defined Benefit
<ul style="list-style-type: none"> • Better suited to employers who want <i>flexibility</i> in determining their annual contribution requirement. • Desirable to employers who do not want to bear the <i>risk of a plan’s investment performance</i>. • The 401(k) wrap-around option is useful for employers who want to (1) <i>make employees responsible</i> for some/all of their retirement planning and savings and/or (2) integrate their NQDC plans with their qualified 401(k) plans. • Matching and discretionary employer contributions may be subject to a vesting schedule as a means of providing a “golden handcuff,” and may be subjected to forfeiture in the event of termination for cause or breach of non-competition and/or confidentiality covenants. 	<ul style="list-style-type: none"> • Far <i>less prevalent</i> than DC plans. • Provides the employee with a retirement benefit that is fixed and determinable. • Creates a fixed employer obligation that is not dependent upon contributions or earnings, and that must be reflected on the employer’s financial statements. • Also may be subject to a vesting schedule as a means of providing a “golden handcuff”.

- ✓ **Practical Point:** Most employers prefer to structure their NQDC plans as DC plans rather than DB plans because of the flexibility DC plans afford and the fact that DC plans can be structured in a manner that enables the employer to annually determine each year’s contribution. Employers wishing to assure select key executives of a certain fixed level of retirement benefit, however, may choose to create DB plans.

TAKE AWAYS

Combining an understanding of the practical and technical aspects of types of NQDC plans will be valuable in advising employers in the selection and implementation of an effective executive compensation plan.

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