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Nonqualified Deferred Compensation (NQDC) Plans: A Primer for Business Owners

What is ERISA?

ERISA stands for the Employee Retirement Income Security Act of 1974, landmark legislation that protects workers' retirement benefits. ERISA contains complex rules governing participation, vesting, funding, reporting, disclosure, administration, and fiduciary activities. While ERISA governs most qualified retirement plans, NQDC plans can be structured to avoid almost all of ERISA's requirements.

A nonqualified deferred compensation (NQDC) plan is an arrangement between an employer and one or more employees to defer the receipt of currently earned compensation. You might want to establish a NQDC plan to provide your employees with benefits in addition to those provided under your qualified retirement plan, or to provide benefits to particular employees without the expense of a qualified plan.

NQDC plans vs. qualified plans

A qualified plan, such as a profit-sharing plan or a 401(k) plan, can be a valuable employee benefit. A qualified plan provides you with an immediate income tax deduction for the amount of money you contribute to the plan for a particular year. Your employees aren't required to pay income tax on your contributions until those amounts are actually distributed from the plan. However, in order to receive this beneficial tax treatment, a qualified plan must comply with strict and complex ERISA and IRS rules, and the plan must generally cover a large percentage of your employees. In addition, qualified plans are subject to a number of limitations on contributions and benefits. These limitations have a particularly harsh effect on your highly paid executives.

In contrast, NQDC plans can be structured to provide the benefit of tax deferral while avoiding almost all of ERISA's burdensome requirements. There are no dollar limits that apply to NQDC plan benefits (although compensation must generally be reasonable in order to be deductible). And you can provide benefits to your highly compensated employees without having to provide similar benefits to your rank and file employees.

Funded vs. unfunded NQDC plans

NQDC plans fall into two broad categories — funded and unfunded. A NQDC plan is considered funded if you have irrevocably and unconditionally set aside assets with a third party (e.g., in a trust or escrow account) for the payment of NQDC plan benefits, and those assets are beyond the reach of both you and your creditors. In other words, if participants are guaranteed to receive their benefits under the NQDC plan, the plan is considered funded.

You might consider establishing a funded plan if your employees are concerned that their plan benefits might not be paid in the future due to a change in your financial condition, a change in control, or your change of heart. Because the assets in a funded plan are beyond your reach, and the reach of your creditors, these plans provide employees with maximum security that their benefits will eventually be paid. Funded plans are rare, though, because they provide only limited opportunity for tax deferral and may be subject to all of ERISA's requirements.

Unfunded plans are by far more common because they can provide the benefit of tax deferral while avoiding almost all of ERISA's requirements. With an unfunded plan, you don't formally set aside assets to pay plan benefits. Instead, you either pay plan benefits out of current cash flow ("pay-as-you-go") or you earmark property to pay plan benefits ("informal funding"), with the property remaining part of your general assets and subject to the claims of your general creditors. You can set up a trust ("rabbi trust") to hold plan assets, but those assets must remain subject to any claims of your bankruptcy and insolvency creditors. A rabbi trust can protect your employees against your change of heart or change in control, but not against a change in your financial condition leading to bankruptcy.

In order to achieve the dual goals of tax deferral and avoidance of ERISA, your NQDC plan must be both unfunded and maintained solely for a select group of management or highly compensated employees. These unfunded NQDC plans are commonly referred to as "top-hat" plans.

While there is no formal legal definition of a "select group of management or highly compensated employees," it generally means a small percentage of the employee population who are key management employees or who earn a salary substantially higher

What is IRC Section 409A?

Section 409A is a provision of the Internal Revenue Code that provides specific rules relating to deferral elections, distributions, and funding that apply to most NQDC plans. If your plan fails to comply with Section 409A's requirements, your employee's NQDC plan benefits may become immediately taxable and subject to significant penalties and interest charges. It is very important for you to be aware of and follow the rules in IRC Section 409A when establishing or maintaining a NQDC plan.

than that of other employees.

Income tax considerations

Generally you can't take a tax deduction for amounts you contribute to a NQDC plan until your participating employees are taxed on those contributions (which can be years after your contributions have been made to the plan).

Employees generally don't include your contributions to an unfunded NQDC plan, or plan earnings, in income until benefits payments are actually received from the NQDC plan. The taxation of funded NQDC plans is more complex. In general, your employees must include your contributions in taxable income as soon as they become nonforfeitable (i.e., as soon as they vest). The taxation of plan earnings depends on the structure of the plan; in some cases employees must include earnings in taxable income currently, and in some cases they aren't taxed until they're actually paid from the plan.

Who can adopt a NQDC plan?

NQDC plans are suitable only for regular (C) corporations. In S corporations or unincorporated entities (partnerships or proprietorships), business owners generally can't defer taxes on their shares of business income. However, S corporations and unincorporated businesses can adopt NQDC plans for regular employees who have no ownership in the business.

NQDC plans are most suitable for employers that are financially sound and have a reasonable expectation of continuing profitable business operations in the future. In addition, since NQDC plans are more affordable to implement than qualified plans, they can be an attractive form of employee compensation for a growing business that has limited cash resources.

Types of plans

Because a NQDC plan is essentially a contract between you and your employee, there are almost unlimited variations. Most common are deferral plans and supplemental executive retirement plans (also known as SERPs). In a deferral plan your employee defers the payment of current compensation (e.g., salary or bonus) to a future date. A SERP is typically designed to supplement your employee's qualified plan benefits (for example, by providing additional pension benefits).

How to implement a NQDC plan

An ERISA lawyer can guide you through the maze of legal and tax requirements, and draft the plan document. Often the board of directors or compensation committee must approve the plan. Your accountant or consulting actuary can help you decide how to finance the plan. If you choose an unfunded plan, almost all that ERISA requires is that you send a simple statement to the Department of Labor informing them of the existence of the plan, and the number of participants.

Advantages of NQDC plans

- *Easier and less expensive to implement and maintain than a qualified benefit plan*
- *Can be offered on a discriminatory basis*
- *Can provide unlimited benefits*
- *Allows you to control timing and receipt of benefits*
- *Enables you to attract and retain key employees*

Disadvantages of NQDC plans

- *Employee taxation controls timing of your tax deduction*
- *Lack of security for employees in an unfunded plan*
- *Generally, not appropriate for partnerships, sole proprietorships, and S corporations*
- *Generally, more costly to employer than paying compensation currently*

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