NON-QUALIFIED DEFERRED COMPENSATION PLANS

DEFINITION

Non-qualified deferred compensation (NQDC) plans are an incentive bonus used by employers for key employees. They represent contractual agreements in which an employee agrees to be paid in a future year for services rendered. These plans are regulated by Section 409A of the Internal Revenue Code and used by businesses to supplement existing qualified plans. In a NQDC plan, compensation is deferred while the employee is working for the company, and is paid out to the employee when he or she experiences a qualified event such as separation from service, disability, or death. These funds are subsequently taxed when distributed from the plan.

HOW THEY WORK

ELIGIBILITY

Employers may discriminate and have complete discretion in determining who is eligible to participate in these plans. Since these are utilized as an incentive for key employees, employers tend to favor senior and highly-compensated employees. In addition, vesting schedules are not required.

TYPES OF PLANS

NQDC plans typically fall into one of four categories:

- Salary Reduction Arrangements defer the receipt of otherwise currently taxable compensation by allowing the participant to defer receipt of a portion of his or her salary.
- Bonus Deferral Plans resemble salary reduction arrangements, except they enable participants to defer receipt of bonuses.
- Top-Hat Plans, or Supplemental Executive Retirement Plans (SERPs), are NQDC plans maintained primarily for a select group of management or highly compensated employees.
- Excess Benefit Plans are NQDC plans that provide benefits solely to employees whose benefits under the employer's qualified plan are limited by Section 415 of the Internal Revenue Code.

CONTRIBUTIONS

NQDC plans emerged because of the contribution limits of government-sponsored retirement savings plans. In proportion to their income, high-income earners are unable to contribute the same amounts to their tax-deferred retirement savings as average or low-income earners. NQDCs are a way for high-income earners to defer a greater proportion of their income than normally provided by qualified plans. There are no compensation or benefit limits. Contributions are actually deferrals of an employee’s income and there are no matching contributions by employers.

DISTRIBUTIONS

The NQDC plan states when the agreed amounts will be paid and over what time frame. Plans may require distribution upon a qualifying event such as separation of service. Aside from forced distributions due to qualifying events, distributions may be made in a lump sum as a specified future date or may be spread over a certain time period like five or ten years.

EMPLOYEE ADVANTAGES AND DISADVANTAGES

Deferring parts of an employee's compensation allows them to also defer taxation until benefits are received. In addition, funds grow tax-deferred (earnings are taxable to the employer) until receipt. By deferring income an employee is hopefully able to receive benefits when they are in a lower tax bracket than they currently are. However, due to the "non-qualified" nature, funds may not be protected from an employer's creditors and could be lost in the case of company financial troubles.

TAX BENEFITS

Contributions to a NQDC plan are not deductible for the employer. The employer can take the deduction in the year the employee is taxed on the benefits. In addition, earnings on the deferrals are taxable to the employer in most cases. They are excluded from income for the employee and earnings on the contributions grow tax-deferred. Employees benefit from this tax-deferred growth in anticipation that they will be in a lower tax bracket during retirement.

Even though employee contributions to an NQDC plan are not subject to federal or state income tax at the time of deferral, they are subject to FICA taxes (Social Security and Medicare) at the later of when the related services are performed or when there is no substantial risk of forfeiture to the right to receive the compensation. FICA taxes apply up to the annual maximum wage base for Social Security (for 2015, it is compensation up to $118,500) and there are no limitations for amounts to be paid for Medicare taxes.

ASSET PROTECTION

If a company were to experience financial difficulties or a change of heart, there is no guarantee in place that ensures an employee's funds will be there when the employee is ready to receive them. Employers can establish a rabbi trust, sometimes called a "grantor trust," which is an irrevocable trust used to protect these assets. However, a significant risk with any non-qualified plan is that funds are fully subject to the claims of the employer's creditors, and a rabbi trust will not protect the assets from creditors.