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Non-Qualified Deferred Compensation Plans

Non-Qualified Deferred Compensation (NQDC) plans are often used by employers as an incentive to retain key employees and enables employees to defer pre-tax dollars over and above traditional employer-sponsored plans. NQDC plans are contractual agreements in which an employee agrees to be paid in a future year for services rendered and they are regulated by Section 409A of the Internal Revenue Code. In this plan, an employee's compensation (salary and/or bonus) is deferred while he or she is working for the company, and is paid out to them when upon separation from service, retirement, disability, or death. These funds are subsequently taxed when distributed from the plan.

Eligibility

Employers may discriminate and have complete discretion in determining who they want to offer this plan as part of an employee's benefit package. Since these plans are utilized as an incentive for key employees, employers tend to favor senior and highly-compensated employees. All contributions are fully vested.

Types of Plans

There are four main types of NQDC plans:

- Salary Reduction Arrangements – they 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 – these are similar to Salary Reduction Arrangements, except for the fact they enable participants to defer receipt of bonuses.
- Top-Hat Plans, or Supplemental Executive Retirement Plans (SERPs) – these are maintained primarily for a select group of management or highly compensated employees.
- Excess Benefit Plans - these 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 first became available due to 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. These plans provide for high-income earners to defer a greater proportion of their income compared to what they would be able to in qualified plans. There are no compensation or benefit limits with NQDC plans. Contribution amounts are flexible on a year-by-year basis and there are no matching contributions by employers.

Distributions

The amount and timing of distributions from NQDC plans are plan-specific. Plans may require distribution upon a qualifying event such as separation of service or retirement. Aside from forced distributions due to qualifying events, distributions may be made in a lump sum at a specified future date or may be spread over a certain time period like five or ten years.

Advantages and Disadvantages

Deferring a portion 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 they are distributed. By deferring income, an employee may potentially pay less tax in the future when they start distributions if they are in a lower tax bracket. However, due to the "non-qualified" nature, funds may not be protected from an employer's creditors and could be lost in the event of a company going through financial difficulties.

Tax Benefits

Contributions to a NQDC plan are not deductible for the employer but 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 tax-deferred growth as they would with most other employer sponsored retirement plans.

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 are subject to the annual maximum wage base for Social Security (for 2014, it is compensation up to $117,000) and there are no limitations for amounts to be paid for Medicare taxes.

Asset Protection

In the event, the employer were to experience financial difficulties, there is no guarantee in place that ensures an employee's funds will be readily available when the employee is ready to receive them. To address this concern, employers can establish a rabbi trust, which is an irrevocable trust used to protect these assets. However, a rabbi trust will not protect the assets from creditors due to the fact that non-qualified plans are fully subject to the claims of the employer's creditors.

Conclusion

Non-Qualified Deferred Compensation (NQDC) plans should be viewed as more than just an additional vehicle for savings toward retirement as many allow for the participant to select distributions while still working so these can be used to pay for future goals including the purchase of a home or paying for a child's college education.