Nonqualified Deferred Compensation

Essentials 2018

A well-designed nonqualified deferred compensation plan can provide attractive supplemental retirement benefits to executives who have "maxed out" their qualified plan contributions. It can be a much needed incentive for employers to attract and retain these individuals. Unlike qualified plans, the nonqualified plan can be custom-designed to fill the unique needs of different executives and employers.

The Benefits of a Nonqualified Deferred Compensation Arrangement

- The agreement can be designed to meet the executive's individual needs and provide a select group of executives with supplemental retirement benefits with minimal ERISA reporting requirements.
- Cash value accumulates on an income tax deferred basis.
- The agreement can be self-completing in the event of the executive's death.
- The executive can compensate for the limited benefits available to highly compensated employees under qualified plans.
- Employer controls the plan.
- Benefits paid to executive are tax deductible to the employer and taxable to the executive.

Types of Nonqualified Retirement Plans

1. Supplemental Executive Retirement Plan (SERP) generally provides defined benefit payments for executives over a period of 5 to 20 years.
2. Deferred Income Plan (Deferred Compensation) allows executives to defer income without the contribution limits of IRAs or 401(k) plans.
3. 401(k) Look-Alike Plan (Deferred Compensation) offers a savings and employer match strategy similar to a qualified 401(k) plan without being limited by qualified contribution limits.
4. Split SERP Plan with Endorsement Split Dollar combines two nonqualified executive benefits. It provides a pre-retirement income tax-free benefit to the executive's beneficiaries, if the executive dies before retiring or retirement income to the executive during retirement.

Funding Arrangements

Plans can be classified as a funded or unfunded arrangement.

- An **unfunded** plan has no specific reserve set aside to fund the plan. It is an unsecured promise, and the assets targeted to fund the plan are general assets of the business and subject to creditors.
- A **funded** plan has a specific reserve. For these plans, the executive's deferral of taxation is more complicated because the plan must provide the executive's benefits are subject to a substantial risk of forfeiture.
- It is important to remember that with an unfunded plan the assets set aside are a general asset of the business, subject to creditors. For this reason most plans are considered unfunded arrangements.

Because of its unique characteristics, life insurance is the most commonly used asset to "informally fund" and unfunded deferred compensation plan. The cash values grow tax deferred, tax-free death benefits create an immediate fund to pay survivor benefits to heirs,

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and cash values can be accessed tax free to pay retirement benefits via withdrawals and policy loans if the policy is not a Modified Endowment Contract. It is important to note that if life insurance is used to informally fund the plan, the employer must comply with the notice and consent requirements of IRC §101(j). If not, the employer would lose many of the tax advantages life insurance can offer. Remember, the life insurance policy is not the plan – it's a general asset of the business.

Participant Taxation

The amounts in an unfunded arrangement are generally includible in the participant's gross income for the year they are actually or constructively received. A funded plan must make sure there is a risk of forfeiture or the plan becomes taxable immediately.

In addition to adhering to the 409A rules, nonqualified deferred compensation plans must meet three conditions in order to avoid immediate taxation:

1. The income deferral was agreed upon before compensation was earned
2. The deferred amounts were not unconditionally placed in escrow or trust
3. The employer's promise to pay was merely a contractual obligation and was unsecured.

The IRC §409A may be a little intimidating to some employers, however with the help of trusted advisors, it should not present any hurdles to accomplishing the objectives of most small employers whose stock is not traded publicly. If the objective is to tie the key employee to the owner's business, nothing in the marketplace can accomplish this as effectively as nonqualified deferred compensation. The future payments are the "carrot," and the plan and the conditions of the plan are "golden handcuffs" keeping the key employee as a valuable member of the operating team.

Considerations

- A deferred compensation plan creates a deferred liability of the business, and most will choose to set aside funds to meet these obligations. The business should hold all rights to the fund and should not grant any vesting rights in any of the assets to the participants before benefits are paid.
- The American Jobs Creation Act of 2004 enacted Section 409A of the Internal Revenue Code. This code section significantly changed nonqualified deferred compensation rules. If a plan fails to meet the rules, compensation deferred under the plan becomes immediately taxable, and penalties and interest apply. All plans had to comply with the final regulations under IRC §409A as of January 1, 2009. Therefore, it is crucial for business owners to work with knowledgeable advisors. In addition to complying with these regulations, the following design considerations should be considered:
    - Eligibility of key employees, while considering that the plan must restrict benefits to upper management and highly compensated employees
    - The conditions that would cause future benefits to be forfeited
    - Incentives that the benefits are based upon
    - Vesting of benefits
- A business structured as a C corporation can design a nonqualified deferred compensation plan to allow the owners to defer compensation to a later date, when more advantageous.

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If a business is structured as a partnership, an LLC taxed as a partnership, or a corporation taxed under Subchapter S, an owner-employee or controlling shareholder generally will not benefit from a nonqualified deferred compensation plan.

- IRC §101(j) requirements of "notice and consent" paperwork should be completed.

Essentially

A Nonqualified Retirement Plan is an agreement between an employer and selected executives to pay a future benefit for services performed today. Via the agreement, the employer makes an unsecured and unfunded promise to pay the executive at some future date. It can provide significant incentives to covered executives.

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