Business

NONQUALIFIED DEFERRED COMPENSATION

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NONQUALIFIED DEFERRED COMPENSATION

The Concept…

- Nonqualified deferred compensation is an arrangement employers use to provide retirement income—and often death or disability benefits or both—to a select group of managerial or highly paid employees.
- The arrangement is a contractual commitment between an employer and an employee (or independent contractor) specifying when and how future compensation will be paid.
- When it's properly set up, the employee can postpone income taxation on the amounts currently being deferred until the benefits are paid.
- The deferred compensation arrangements discussed in this section may be "nonqualified," meaning they don't have to be preapproved by the IRS, and employers can discriminate in favor of selected employees.
- Properly arranged, they're exempt from nearly all of ERISA's regulatory requirements.

The Rationale…

- Providing attractive compensation and benefits packages to owner-employees and key executives is a continuing concern to businesses, large and small.
- In this environment, strict regulations on qualified retirement plans—coupled with their administrative costs, anti-discrimination rules, and caps on benefits and contributions—have steered many businesses toward supplemental arrangements for key executives.
- Nonqualified deferred compensation arrangements allow employers to reward selected executives without taking on the administrative burdens of qualified plans.
- In many cases, deferred compensation is used in addition to qualified retirement plans, group insurance plans, and other broadly based employee benefit plans.

Potential Candidates…

- The employer is a C corporation.
- The employer wants to benefit a select, highly compensated employee or group of such employees.
- The owner-employees of a business are looking for a way to improve their own compensation and benefits package.
- The employer needs to attract, retain, or reward one or more key employees.

- A key employee is already making maximum contributions to—or accruing maximum benefits from—a qualified retirement plan.
- The employer doesn't have a qualified retirement plan in place and doesn't want to establish one.

The Flexibility...

- Only a nonqualified deferred compensation arrangement lets a business pick and choose among "top-level" employees without running afoul of anti-discrimination rules or minimum funding standards.
- A business can provide a different level of benefits for different employees.
- No government-mandated vesting rules apply.
- A deferred compensation arrangement can be customized to suit many individual situations.
- Paperwork and administrative costs are kept to a minimum.

The Process...

- A nonqualified deferred compensation arrangement typically provides that an employee will receive a stipulated sum for a fixed period of time—or for life—beginning at a future date, such as the employee's scheduled retirement.
- If the employee dies after payments have begun, the agreement may direct that any remaining benefits be paid to the employee's designated beneficiary.
- A "true deferral" arrangement provides that the employee will receive future compensation as a result of a current salary reduction agreement, or in lieu of a future bonus or expected salary increase.
- In contrast to true deferral, a "salary continuation" arrangement commits the employer to pay future compensation to the employee in addition to current compensation, which isn't reduced by the employee's participation in the arrangement.

The Funding...

- An arrangement in which the employee has only a contractual right—an unsecured promise to receive benefits in the future—is called an "unfunded" arrangement.

- An arrangement is unfunded if the employer has not set aside a reserve to pay promised benefits, or if such reserves remain a general asset of the corporation, within the reach of general creditors.
- The employer can purchase life insurance or other assets to provide a source of reserves. To avoid taxation of death proceeds, the employer must meet the notice and consent requirements of IRC Sec. 101(j).
- The employee can't have a current beneficial interest in the funds if the arrangement is to be considered unfunded for tax purposes. In this case, the deferred amounts are generally included in the employee's gross income when actually or constructively received.
- By contrast, an arrangement is "funded" when the employer sets aside specific assets to meet its future obligations—with the selected employee as beneficiary and the assets out of reach of general creditors.
- In a funded arrangement, the amounts set aside by the employer are currently includible in the employee's gross income unless they're subject to substantial risk of forfeiture.

Acceleration of Benefits...

- Historically, participating employees were generally not taxed until they actually received payments as long as three conditions were met: (1) the deferral was agreed upon before compensation was earned, (2) the deferred amount was not unconditionally placed in trust or escrow, and (3) the employer's promise to pay was merely a contractual obligation and not evidenced by notes or secured in any other way.
- The employee can lose income tax deferral if the arrangement doesn't follow the rules of IRC §409A (for example, if an employee has control over deferred amounts or has early access to them).
- Moreover, if the statutory requirements are not met, the employee must pay a 20% penalty on the amounts included in gross income, plus interest charged at one percent over the normal rate on underpayments.
- Deferred amounts are now generally includible in the employee's gross income—for all tax years in which they aren't subject to a substantial risk of forfeiture—if the plan fails to meet any of the following: (a) distribution requirements, (b) no acceleration of benefits requirement, and (c) election of deferral requirements.
- Distributions are permitted only upon separation from service, death or disability, a fixed time specified in the plan, a change in an employer's ownership or control, or an

unforeseeable emergency such as severe financial hardship. Distributions at any other time will result in the loss of the income tax deferral.

- The plan generally meets the acceleration-of-benefits requirement if it doesn't permit a prohibited acceleration of any payment or schedule of payments.
- Any changes in distribution methods that create an acceleration of payments will violate this rule, as will arrangements giving the plan administrator discretion over the timing of benefit payments that could result in accelerated payments.

The Timing...

- To achieve income tax deferral, the employee must generally make the election to defer compensation no later than the end of the preceding tax year.
- In the first year of eligibility, the employee can make the initial deferral election within 30 days of becoming eligible and it will still apply to compensation for services subsequently performed.

The Bottom Line...

Even with the tax law placing restrictions on the distribution of benefits, nonqualified deferred compensation arrangements are an effective way to reward and retain valuable, highly compensated employees on a selective basis.

Summary

What Is Nonqualified Deferred Compensation?

Nonqualified deferred compensation is an arrangement established by employers to provide retirement income and often death and/or disability benefits to selected managerial or highly compensated employees. When it's properly arranged, the employee can defer income taxation of the deferred amounts until the benefits are paid.

Deferred compensation arrangements are "nonqualified," which means they don't have to be preapproved by the IRS, and employers can discriminate in favor of selected employees. Also, when properly arranged, they are exempt from nearly all of ERISA's regulatory requirements.

How Does It Work?

A nonqualified deferred compensation arrangement typically provides that an employee will receive a stipulated sum for a fixed period of time—or for life— beginning at a future date such as the employee's retirement. If an employee dies after payments have begun, the arrangement may direct that the remaining benefits be paid to the employee's beneficiary.

The arrangement may provide that the employee will receive future compensation as a result of a current salary reduction or in lieu of a bonus or salary increase. This is sometimes called a "true deferral arrangement."

An alternative is a "salary continuation arrangement." Here, the employer commits to pay future compensation to the employee in addition to current earnings, which aren't reduced by participation in the arrangement.

What's the Tax Picture?

Generally speaking, the deferred amounts in an unfunded plan are includible in the employee's gross income when they are actually or constructively received. The deferred amounts in a funded plan are currently includible in the employee's gross income unless they are subject to a substantial risk of forfeiture.

The employee can lose income tax deferral if the arrangement doesn't follow the rules of IRC §409A (for example, if an employee has control over deferred amounts or has early access to them).

Amounts deferred under a deferred compensation plan will be includible in the employee's gross income for all tax years in which such amounts are not subject to a substantial risk of forfeiture if the plan fails to meet (1) distribution requirements, (2) no acceleration-of-benefit requirements, and (3) election requirements.

The rules only permit distributions upon separation from service, death, disability, a fixed time specified in the plan, a change in ownership or control of the employer, or an

unforeseeable emergency such as a severe financial hardship. Distributions at any other time will result in loss of income tax deferral.

The plan meets the acceleration-of-benefits requirement if it does not permit a prohibited acceleration of any payment, or schedule of payments. The plan administrator may not have discretion over the timing of benefit payments that could result in an acceleration of payments.

When Should the Deferral Election Take Place?

To achieve income tax deferral, the employee must generally make the election to defer compensation no later than the end of the preceding tax year.

In the first year of eligibility, the employee can make the initial deferral election within 30 days of becoming eligible and it will still apply to compensation for services subsequently performed.

What's the Conclusion?

Even with the tax law placing restrictions on the distribution of benefits, nonqualified deferred compensation arrangements remain an effective way to reward and retain valuable, highly compensated employees on a selective basis.

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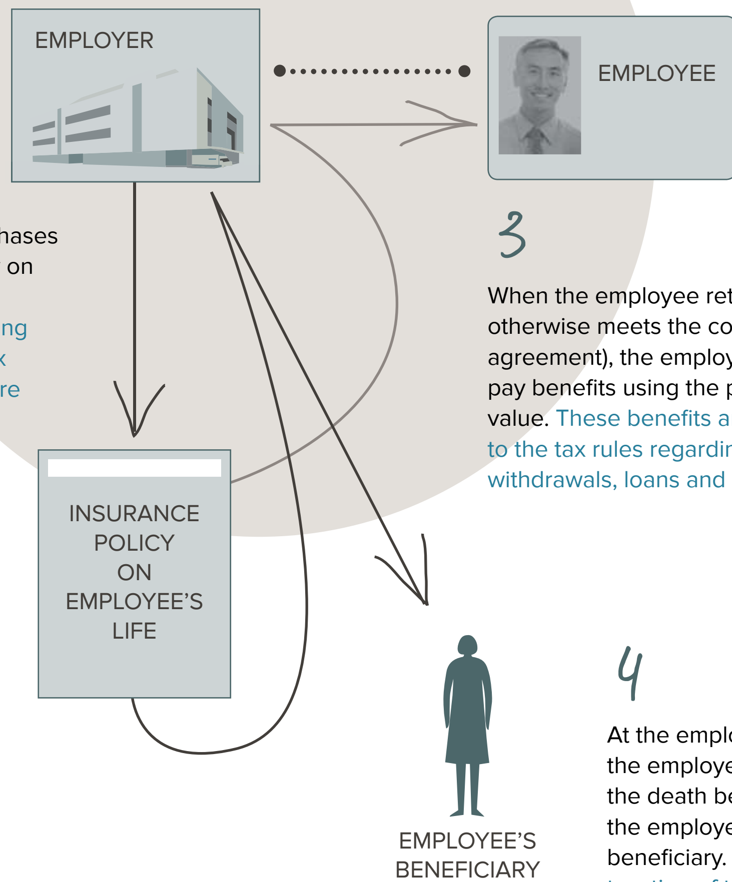
1

The employer and employee enter into an agreement specifying future compensation. This future income is currently taxed if the employer formally funds the agreement.

2

The employer purchases an insurance policy on the employee's life. This unofficial funding method ensures tax deferral on the future income.



3

When the employee retires (or otherwise meets the conditions of the agreement), the employer begins to pay benefits using the policy's cash value. These benefits are subject to the tax rules regarding policy withdrawals, loans and surrenders.

4

At the employee's death, the employer pays out the death benefits to the employee's named beneficiary. To avoid taxation of these death benefits, the employer must meet the notice and consent requirements.

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