An Employer's Guide to Nonqualified Deferred Compensation Plans

What is a Nonqualified Deferred Compensation Plan?

A nonqualified deferred compensation ("NQDC") plan is an elective or non-elective plan, agreement, method, or arrangement between an employer and an employee -- or service recipient and service provider -- to pay the service provider compensation in the future.

The NQDC rules apply to employees and other "service providers", including directors and independent contractors. This article uses the term "employee" to refer to all service providers of an employer.

NQDC plans can provide for employee-only elective contributions, employer-only elective contributions, or both employee and employer contributions.

NQDC plans can provide for a single benefit (such as payment in a lump sum after retirement, upon reaching a stated event, or at a specified time or date in the future) or can permit the employee to select from various benefit payment options (such as a choice between benefit payments after 3, 5 or 7 years).

Employers typically offer NQDC plans only to top management or other highly compensated employees and generally should not cover non-highly compensated employees.

What are the Advantages of NQDC Plans for Employers?

NQDC plans can help attract and retain key employees by providing additional benefit incentives and awards for both performance and length of service.

NQDC plans are exempt from most Employee Requirement Income Security Act ("ERISA") requirements and related reporting requirements. This means there are no limitations on the amounts that can be deferred and no minimum distribution rules. In addition, NQDC plans can discriminate in favor of highly compensated employees and amongst employees in various compensation levels, which is largely impermissible for qualified plans.

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NQDC plans allow companies to defer payments and related taxes into later years, which can help with cash flow and tax planning issues. There is significant flexibility for employers in determining the plan parameters, vesting schedules, and awards criteria.

The key for employers to take into account is that NQDC plans must comply with the rules of Internal Revenue Code ("IRC") Section 409A, which are fairly simple to navigate with the assistance of an experienced employee benefits attorney.

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What are the Advantages of NQDC Plans for Employees?

NQDC plans offer highly compensated and key employees an opportunity to earn performance awards, defer compensation and taxes until a later date, reduce certain payroll taxes, and potentially help facilitate buy-in opportunities for business succession plans.

What are the Tax Consequences of NQDC Plans?

Taxation of NQDC plans depends on whether the NQDC plan is "funded" or "unfunded". Most NQDC plans in the United States are unfunded, and this article solely addresses unfunded plans.

Under IRC Section 409A, deferred compensation is includable in an employee's taxable income when the amount is paid (or becomes available) to the employee. As with other compensation, employers report the distributed amount as taxable compensation. If a NQDC plan provides for contributions and "earnings" on the contributions, both the contributions and the earnings are taxable compensation.

While a NQDC plan offers long-term tax-deferred savings for employees, the deferral also applies to the employer's tax deduction. The employer taxes a deduction at the time the employee includes the deferred amounts in his or her taxable compensation. Under a qualified retirement plan (such as a 401(k) plan), employers deduct expenses in the year they remit payments to the trust, even though employees will not recognize income until later years, upon receipt of distributions from the plan. Under a NQDC plan, employers can only deduct the benefit when the employee includes such benefit in the employee's taxable income. The deductible amount is the total amount included in the employee's taxable compensation, including any earnings on the compensation.

How Do Payroll Taxes Apply to NQDC Plans?

The NQDC plan rules impose federal (and generally state) income tax withholding requirements in the year(s) in which the employer distributes deferred compensation to the employee. For employees or former employees, employers report the NQDC plan distributions on Form W-2.

A special rule for Social Security taxes and Medicare taxes (collectively referred to as "FICA Taxes") applies to most NQDC plans. For purposes of FICA Taxes, employers generally take into account NQDC amounts as FICA wages at the later of: (1) when the employee performs services; or (2) when the employee vests in the right to receive the deferred amounts. Thus, FICA Taxs typically apply to NQDC before the employee receives payment and is subject to income tax. As an added benefit, any earnings accruing under a NQDC plan after the vesting dates is not subject to FICA Taxes.

Note that the special FICA Taxes rule does not apply to a "short term deferral", which is a benefit payment made within the year of vesting or no later than 2 1/2 months after the year of vesting. Normal payroll tax withholding applies at the time of distribution for a short-term deferral.

When considering establishing a NQDC plan, an employer must determine the company's overall business strategy.

While NQDC plans generally provide greater flexibility than qualified plans in many respects, employers must strictly comply with the Section 409A rules.

What are the Key Considerations for Employers when Establishing a NQDC Plan?

When considering establishing a NQDC plan, an employer must determine the company's overall business strategy. NQDC plans can be used to achieve many business goals, including the following:

- Compensation/bonus deferral
- Tax deferral
- Key employee retention
- Business succession planning
- Establishing performance objectives and awards
- Providing supplemental retirement benefits

Many companies establish more than one type of NQDC plan to achieve several different business objectives. By working with an experienced employee benefits attorney, employers can implement and maintain customized NQDC plans to meet their needs and the needs of their employees.

Because NQDC plans are "nonqualified", there are many variables that the employer has control over -- as long as the plan complies with IRC Section 409A.

These factors include:

- Eligible participants - generally only highly com-ensated employees
- Vesting
- Payment amounts and/or formulas
- Performance objectives
- Timing of payment(s)
- Form of payment(s)

How Important is Section 409A Compliance?

Section 409A compliance is very important!

While NQDC plans generally provide greater flexibility than qualified plans in many respects, employers must strictly comply with the Section 409A rules. Failure to comply with Section 409A results in immediate income taxation to the service provide plus a 20 percent excise tax and a "premium interest tax" on the taxable amount.

The Section 409A rules can be readily navigated by an employee benefits attorney with significant ERISA and Section 409A experience.

What is the Bottom Line?

NQDC plans are excellent employee benefit plan options with the flexibility to meet many types of business objectives due to their "nonqualified" nature.

If you are considering offering one or more NQDC plans, you should discuss with your tax professional and employee benefits attorney to review the alternatives and get one or more plans established to best meet the needs of your business and your employees.

Contact Us.

Fraser Stryker has years of experience counseling a wide array of employers on every facet of employee benefits law.

Emily Langdon focuses her practice on employee benefits and ERISA, assisting clients with matters related to health and welfare benefits, executive compensation, pension and retirement plans, wellness plans, and health care reform.

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Contact Emily at elangdon@fraserstryker.com or (402) 978-5386 for assistance with NQDC plans.