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Nonqualified Deferred Compensation Plans





Nonqualified Deferred Compensation Plans

What is it?

A nonqualified deferred compensation (NQDC) plan is an arrangement between an employer and an employee to defer the receipt of currently earned compensation. NQDC plans do not have the tax-favored benefits of qualified retirement plans. On the other hand, most NQDC plans do not have to comply with the participation, vesting, funding, distribution, and reporting requirements imposed on qualified plans by Internal Revenue Code (IRC) Section 401(a) and the Employee Retirement Income Security Act (ERISA).

Since a NQDC plan doesn't generally have to comply with these IRC and ERISA requirements, it's a flexible form of employee compensation that allows you to tailor the benefit amounts, payment terms, and conditions of the plan to both you and your employee's needs. As a result, a NQDC plan can cover any group of employees without regard to nondiscrimination requirements, provide unlimited benefits to any employee, and can provide different benefit amounts for different employees under different terms and conditions. In addition to its flexibility, a NQDC plan can also provide your employee with significant tax benefits. Unlike cash compensation, which the IRS taxes currently, your employees can defer taxation of their NQDC plan benefits.

Caution: *In order to achieve tax deferral for employees, a NQDC plan must either be "unfunded," or if "funded" the benefits must be nontransferable and subject to a substantial risk of forfeiture.*

Example(s): *Hal and his employee Mark agree that Hal will pay Mark a salary of \$100,000 a year. In addition, Hal agrees to pay Mark another \$10,000 for each year that Mark works for Hal, payable upon Mark's retirement. Hal and Mark have established a form of nonqualified deferred compensation. At the most basic level, this is how such a plan works.*

Tip: *The extent to which ERISA applies to a NQDC plan depends on the type of NQDC plan and the funding status of the plan. NQDC plans are almost always designed to avoid virtually all ERISA requirements. To avoid application of most ERISA requirements, the NQDC plan must be unfunded and provide deferred compensation benefits primarily to a "select group of management or highly compensated employees," as discussed below. This is often referred to as a "top-hat" plan.*

Tip: *One type of NQDC plan, an "excess benefit plan," can be funded, and yet avoid most of ERISA's requirements. See the discussion later in this article.*

Caution: *The SEC has sometimes taken the position that NQDC plans may be subject to registration under the Securities Act of 1933. Even if this position is correct, many exceptions to registration apply. Public companies may also need to report NQDC plans to the SEC or shareholders. Consult a securities expert for more information about these requirements.*

NQDC plans vs. qualified plans

A qualified plan like a profit-sharing plan or a 401(k) plan can be a valuable employee benefit, generally covering all or most employees. A qualified plan provides an immediate tax deduction to the employer for the amount of money contributed to the plan for a particular year. As for the employee, he or she isn't required to pay income tax on amounts contributed to the plan until those amounts are actually distributed from the plan. However, in order to receive this beneficial tax treatment, a qualified plan must comply with strict and highly complex ERISA and IRS rules. In addition, qualified plans are subject to a number of limitations on contributions and benefits. These limitations have a particularly harsh effect on highly paid executives.

In contrast, an employer will generally make NQDC plans available only to select executives and other key employees in order to avoid ERISA's requirements, and adverse tax consequences. And there are no dollar limits that apply to NQDC plan benefits (although compensation must generally be reasonable in order to be deductible). With this type of plan, an employer typically won't be allowed to take a tax deduction for amounts contributed to the plan until such time as funds are actually distributed from the plan and received as taxable income by participating employees. In effect, an employer often isn't entitled to a tax deduction until years after contributions are made to the plan. As with a qualified plan, employees generally don't recognize the deferred compensation income currently (when it is earned) for income tax purposes. Rather, they recognize the income when payment is received from the NQDC plan.

Caution: *Although most NQDC plans result in the tax structure described, actual tax consequences depend on the specific design and funding provisions of the NQDC plan.*



Caution: Unlike qualified plan benefits, unfunded NQDC plan benefits may be lost in the event of an employer's bankruptcy or insolvency. This is one of the primary drawbacks to unfunded NQDC plans.

Funded vs. unfunded plans

In general

Nonqualified deferred compensation (NQDC) plans fall into two broad categories, funded plans and unfunded plans. It is important to understand the technical meaning of these terms in order to understand the tax and ERISA consequences that flow from establishing a NQDC plan. Unfunded plans are far more common than funded plans because they can provide the benefit of tax deferral while avoiding almost all of ERISA's burdensome requirements. Funded plans, on the other hand, must generally comply with ERISA, and provide only limited deferral opportunities.

The following chart shows the general features of unfunded and funded plans.*

Plan Type	Coverage	Taxation of Benefits	ERISA	Creditor Protection
Unfunded (and informally funded)	Limited to select group of management or highly compensated employees	Benefits generally taxed when paid	Very limited application	Benefits subject to claims of employer's creditors
Funded	Any employee may be covered	Benefits generally taxed when vested**	ERISA applies***	Benefits protected from employer's creditors***

*Special rules apply to excess benefit plans, church plans, and plans maintained by governmental and tax-exempt employers.

**See our separate topic discussion, Secular Trusts and Annuities, for more detailed information.

*** Employee secular trusts may not be covered by ERISA. If not, then whether benefits under these plans are protected from the claims of the employer's creditors may depend on state law.

When is a plan considered "funded"?

There is no specific definition of "funding" in either ERISA or the Internal Revenue Code. But the concept has been defined by court cases and guidance from the Department of Labor and the Internal Revenue Service. In general, a plan is considered funded if assets have been irrevocably and unconditionally set aside with a third party for the payment of NQDC plan benefits (for example, in a trust or escrow account) and those assets are beyond the reach of both you and your general creditors. In other words, if participants are guaranteed to receive their benefits under the NQDC plan, the plan is considered funded. This is also sometimes referred to as "formal funding." One of the most common methods of formally funding a NQDC plan is the secular trust.

Conversely, unfunded plans are those where either assets have not been set aside (that is, a "pay as you go" plan), or assets have been set aside but those assets remain subject to the claims of your general creditors (often referred to as an "informally funded" plan--see discussion below). In general, in an unfunded plan, your employees rely solely on your unsecured promise to pay benefits at a later date. In order to avoid ERISA, you must limit participation in unfunded NQDC plans to a select group of management or highly compensated employees. These plans are often referred to as "top-hat plans".

Caution: Funding may also be deemed to occur if your employees have any legal rights to specific assets you set aside to meet your NQDC plan benefit obligations that are superior to those of your general creditors, or if employee communications lead employees to believe that their benefits are secured by specific assets. Careful drafting of all plan documents and consultation with pension professionals is important to avoid this potential problem.

Tip: While there may be some fine distinctions between funding for tax purposes and funding for ERISA purposes, in almost all cases if a plan is considered funded for one purpose, it will be considered funded for the other.

What is an informally funded plan?

While most employers want to avoid formally funding their NQDC plans in order to avoid ERISA and provide the benefit of tax



deferral, they often want to accumulate assets in order to ensure they can meet their benefit obligations when they come due. This is commonly referred to as "informally funding" a NQDC plan. Even though you set aside funds, these plans are not considered formally funded because the assets remain part of your general assets and can be reached by your creditors. Informal funding allows you to match assets with your future benefit liabilities, and provides your employees with psychological assurance (at least) that their benefits will be paid when due. The most common methods of informally funding NQDC plans are corporate-owned life insurance (COLI) and the rabbi trust, discussed below.

Example(s): *Widget Corporation wishes to establish a NQDC plan for its executives. To fund the plan, it establishes a rabbi trust (a particular type of irrevocable grantor trust approved by the IRS). Although Widget Corporation has set aside these assets solely for the employees of its plan, the funds contained in this trust must remain subject to the claims of all of Widget's creditors. The plan will therefore be considered unfunded from an ERISA perspective.*

Why would an employer establish a funded NQDC plan?

In general, you might choose to establish a funded plan, instead of an unfunded plan, if benefit security is your employees' main concern. In unfunded plans, any assets set aside to pay benefits must remain subject to the claims of your general creditors. This lack of security may make employees fearful that when it comes time to receive the deferred compensation, you may be unwilling (due to a change of heart or change in control) or unable (due to a change in financial condition) to pay the deferred compensation, or that a creditor may seize the funds through foreclosure, bankruptcy, or liquidation. Since funded plans are generally protected from the claims of your creditors, they provide maximum security to employees that their benefits will be paid when due. You may also want to establish a funded plan to provide deferred compensation benefits to an employee who does not qualify as a member of the top-hat group.

Employee tax treatment--unfunded plans

In general

Generally, there are no income tax consequences to your employee until benefits are paid from the plan. Your employee must then include the full amount received in his or her gross income. However, there may be times when the IRS taxes an employee on contributions made to an NQDC plan prior to the receipt of plan assets.

Constructive receipt doctrine

Under the doctrine of constructive receipt, the IRS can tax your employee before he or she receives funds from the plan if the funds are credited to the employee's account, set aside, or otherwise made available to the employee without substantial restrictions or limitations. In other words, once the funds have been earned and are available, your employee must report the income even if the employee has chosen not to actually accept current payment of the funds.

The doctrine of constructive receipt is most relevant to NQDC plans that permit the employee to elect to defer receipt of compensation or would allow the employee to elect to receive previously deferred compensation. Under IRS guidelines, an employee can avoid constructive receipt by making his or her election to defer compensation before the year he or she performs the services that earn the compensation. Also, to avoid constructive receipt, the employee generally can't have any right to elect to receive payment of his or her deferred compensation before payment is due under the terms of the NQDC plan.

Section 409A of the Internal Revenue Code

IRC Section 409A provides specific rules relating to deferral elections, distributions, and funding that apply to most NQDC plans, and in part codifies the constructive receipt rules described above. If your NQDC plan fails to follow these rules, the NQDC plan benefits of affected participants, for that year and all prior years, may become immediately taxable and subject to penalties and interest charges. It is very important that you be aware of and follow the rules in IRC Section 409A when establishing a NQDC plan.

Employee tax treatment--funded plans

In general, your employee must include your contributions to a funded NQDC plan in gross income in the year they are made or, if later, in the year your employee becomes vested in the contributions--that is, when the employee's benefit is no longer subject to a substantial risk of forfeiture. However, the specific tax consequences depend on the type of funding vehicle used.

Caution: *Your employees may be taxed on your contributions to a funded NQDC plan, as well as investment earnings, prior to*



their actual receipt of the plan funds. If desired, you can pay your employee a cash bonus to cover his or her tax liability. Or, if your plan is funded with a secular trust, your employee can receive a distribution from the trust in order to pay the taxes.

Tip: A funded NQDC plan can provide the benefit of tax deferral only if the employee's benefit is subject to a substantial risk of forfeiture. In contrast, an unfunded NQDC plan can provide the benefit of tax deferral even if the employee's benefit is fully vested.

Tip: Some NQDC plans are designed so that a change in control of the employer triggers accelerated vesting or distribution of benefits. In these cases, the "golden parachute" rules of Internal Revenue Code Section 280G may apply.

Employer tax treatment

Unfunded plan

In general, you receive a tax deduction in the taxable year an amount attributable to your contribution is included in your employee's gross income. This means that you receive the deduction in the year your employee actually receives the plan benefits. You can deduct the total amount paid to your employee, including any earnings on your contributions.

An additional tax consideration is that if the employer sets aside funds for the purpose of paying future benefits under the NQDC plan (for example, in a rabbi trust), the employer must pay income tax on any earnings attributable to those allocated funds. For that reason, NQDC plans are often informally funded with corporate-owned life insurance (COLI), because policy earnings (the increase in the cash value) are generally not subject to current income taxation (unless the alternative minimum tax (AMT) rules apply).

Funded plan

In general, you are entitled to a tax deduction in the taxable year an amount attributable to your contribution is included in your employee's gross income. This means that you are entitled to the deduction in the year you make your contributions to the plan, or if later, when your employee becomes vested in the contributions. You are generally not entitled to a deduction for any earnings on your contributions to a funded plan.

Caution: In order for you to be able to receive a deduction for contributions to a NQDC plan funded with an employer secular trust you may need to maintain separate accounts for each employee when more than one employee participates in the plan.

Caution: Further, a deduction is permitted only to the extent that the contribution or payment is both reasonable in amount and an ordinary and necessary expense incurred in carrying on a trade or business.

Caution: Publicly-held companies can't deduct total compensation in excess of one million dollars in any one year for certain executives.

"Top-hat" plans

In general

As discussed earlier, most NQDC plans are unfunded in order to provide employees with the benefits of tax deferral while avoiding ERISA's most burdensome requirements. In order to achieve these goals, unfunded NQDC plans must be maintained for a select group of management or highly compensated employees. This is the most common type of NQDC plan. When discussing unfunded NQDC plans in the balance of this article, we are referring to NQDC plans maintained for a select group of management or highly compensated employees. Such a plan is commonly referred to as a top-hat plan.

What constitutes a "select group of management or highly compensated employees?"

While there is no formal legal definition of a "select group of management or highly compensated employees," it generally means a small percentage of the employee population who are key management employees or who earn a salary substantially higher than that of other employees. Over the years, the courts and the Department of Labor (DOL) have looked at one or more of the following factors: the number of employees in the firm versus the number of employees covered under the NQDC plan; the average salaries of the select group versus the average salaries of other employees; the average salary of the select group versus the average salary of all management or highly compensated employees; and the range of salaries of employees in the select group.



The DOL has also indicated that the phrase refers only to the group of employees who, by virtue of their position or compensation level, have the ability to affect or influence the design or operation of the deferred compensation plan. In other words, according to the DOL, the select group should consist of employees who would typically be in a position to negotiate their compensation packages. Under this view, a NQDC plan could benefit only a very small percentage of the employee population. However, the courts have typically been more liberal than the DOL.

ERISA considerations

If a NQDC plan is unfunded (i.e., a top-hat plan) then generally only two ERISA requirements apply. First, you (or more specifically, the plan administrator, which is typically the employer) must send a one-page notification letter to the DOL indicating your company's name and address, your company's employer identification number, the number of top-hat plans you maintain, the number of participants in each plan, and a declaration that the employer maintains the plan(s) primarily for the purpose of providing deferred compensation for a select group of management or highly compensated employees. The letter must be filed with the DOL within 120 days of the plan's inception; otherwise the plan will be subject to all of ERISA's reporting and disclosure requirements. Second, since top-hat plans are subject to ERISA's administrative provisions, you must inform plan participants about the ERISA claims procedures that apply to your plan (these will generally be described in the NQDC plan document).

If a plan is funded, it must generally comply with all of ERISA's requirements. This includes ERISA's rules governing administration, reporting, disclosure, participation, vesting, funding, and fiduciary activities.

Caution: *It is not clear if ERISA applies to a NQDC plan funded with an employee secular trust. ERISA applies only to plans established or maintained by an employer or employer organization, and employee secular trusts are deemed to be created by the participating employees for tax purposes.*

Tip: *ERISA doesn't apply to governmental and most church plans, plans maintained solely for the benefit of non-employees (for example, company directors), plans that cover only partners (and their spouses), and plans that cover only a sole proprietor (and his or her spouse).*

Social Security tax (FICA and FUTA)

Social Security tax actually consists of several different component taxes: the Federal Insurance Contribution Act (FICA) taxes for old age and disability benefits, the hospital insurance or Medicare tax, and the unemployment tax (FUTA). Both FICA and FUTA taxes may be due currently on amounts deferred to a NQDC plan. However, FICA and FUTA don't have as significant an impact on NQDC plans as you might think. FUTA tax applies only to a limited amount of an employee's compensation. And most employees deferring compensation into a NQDC plan exceed the Social Security wage base (\$127,200 in 2017, up from \$118,500 in 2016). Compensation exceeding this amount would only be subject to the 1.45 percent Medicare tax rate that applies to both the employer and the employee.

Caution: *The details regarding FICA and FUTA taxes as they apply to NQDC plans are very complicated. You should consult additional resources that specifically address this issue for further information.*

Who can adopt a NQDC plan?

In general

Although many entities can adopt a NQDC plan, they're most suitable for entities that are financially sound and have a reasonable expectation of continuing profitable business operations in the future. In addition, since NQDC plans are more affordable to implement than qualified plans, it can be an attractive form of employee compensation for a new business that has potential but limited cash resources.

Business owners

If you're a business owner, NQDC plans are suitable only for regular or C corporations. In S corporations or unincorporated entities (partnerships or proprietorships), business owners generally can't defer taxes on their shares of the business income. However, S corporations or unincorporated businesses can adopt NQDC plans for regular employees who have no ownership interest in the business.

Caution: *NQDC plans covering controlling shareholders may be subject to attack by the IRS under the constructive receipt doctrine because of the shareholder's control over the corporate employer.*



Government and tax-exempt organizations

A government or tax-exempt organization may adopt a NQDC plan. However, such organizations must follow Section 457 of the Internal Revenue Code, which limits the amount and timing of payouts or in some cases may require current taxation of the employee with respect to the present value of his or her rights to deferred compensation.

Advantages of a NQDC plan

Supplements an employee's qualified benefits

Qualified plans are subject to a number of limitations on contributions and benefits. These limitations have a particularly harsh effect on highly paid executives. For example, the total amount of employer and employee contributions plus forfeitures that may be contributed to a participant's annual account in a qualified defined contribution plan is limited to the lesser of \$54,000 (for 2017, up from \$53,000 in 2016) or 100 percent of the participant's compensation income. Employees age 50 and older can defer up to \$6,000 to a 401(k) plan in excess of these dollar limits in 2016 and 2017. In addition, the maximum annual compensation that can be considered when making these calculations is \$270,000 (for 2017, up from \$265,000 in 2016). And the maximum employee salary deferral in a 401(k) plan is limited to \$18,000 (for 2016 and 2017) (plus catch-up contributions). These are only a few of the restrictions on contributions for qualified benefit plans. NQDC plans allow you to provide deferred compensation to your employees in excess of these qualified plan limits.

Example(s): *Richard and Mary work at BCD Corporation. Richard earns \$300,000 in 2017 while Mary earns \$100,000. They both participate in a defined benefit plan that provides a general benefit of 50 percent of their salary. Though the plan formula dictates that Richard should get a benefit of \$150,000 (50 percent of \$300,000), he actually is only allowed to receive \$135,000 (50 percent of \$270,000) because \$270,000 is the maximum compensation amount that may be used in calculating the benefit in 2017. Conversely, Mary is entitled to \$50,000 (50 percent of \$100,000) because her entire annual salary can be taken into account as it is below \$270,000. As a result, Richard may only receive 45 percent of his pay while Mary may receive the 50 percent as dictated by the plan formula. Richard is adversely impacted by the \$270,000 limit while Mary is not.*

Easier and less expensive than a qualified benefit plan

Because qualified benefit plans must follow complex IRS and ERISA rules, they're usually more expensive (and complicated) to implement and maintain than a NQDC plan. If you can't afford to maintain a qualified plan but wish to offer your select group of management or highly compensated employees the ability to receive tax-deferrable retirement benefits, you may want to consider implementing a NQDC plan. This way, you will be able to provide your key employees with retirement benefits while avoiding the administrative costs and complexities of qualified plans.

Can be offered on a discriminatory basis

Qualified plans are subject to specific discrimination and participation rules that require you to provide proportionate benefits to non-highly compensated employees. A NQDC plan isn't subject to these same rules. As a result, you can decide to allow a few or even one highly compensated employee to participate in the NQDC plan. You're not obligated to cover anyone.

Can provide unlimited benefits

Subject to the reasonable compensation requirement for deductibility, you can provide unlimited benefits to your employees.

Allows employer to control timing and receipt of benefits

Because ERISA's vesting rules don't apply to NQDC plans that aren't formally funded, you as the employer can control the timing and receipt of employee benefits payable under the plan. You therefore have considerable flexibility in determining conditions and times when employees will be entitled to their benefits.

Allows employer to attract and retain key employees

For obvious reasons, many employers strive to attract, recruit, and retain executives and other qualified key employees. A NQDC plan that provides future retirement benefits, whether in lieu of or in addition to a qualified plan, can offer an added incentive for these key employees to come to work for and remain with an employer.



Disadvantages of a NQDC plan

Employee controls timing of employer's tax deduction

The employer generally can't deduct a contribution made to a NQDC plan until the year income is actually received from the plan by the participating employee. More often than not, this will be several years away, particularly in the case of employees who choose to defer receipt of the income until retirement. In effect, employers have no control over when they will be entitled to take these tax deductions.

Lack of security for employees

From the standpoint of the participating employees, a NQDC plan isn't as secure as a qualified plan. Employees who participate in a NQDC plan generally have to rely on an employer's unsecured promise to pay benefits at a later time (except in the case of a formally funded NQDC plan). Most ERISA protections such as participation, vesting, fiduciary responsibility, and funding standards don't apply.

Generally not appropriate for partnerships, sole proprietorships, and S corporations

Partnerships, sole proprietorships, and S corporations can certainly establish NQDC plans to benefit key employees. However, the plan will be of little benefit to the owners themselves, since income earned by the organization is immediately taxed to the business owner. In other words, the business owner can't defer taxation of amounts contributed to the NQDC plan on his or her own behalf.

Generally more costly to employer than paying compensation currently

An unfunded NQDC plan defers the employer's payment and the deduction for compensation that might otherwise have been paid and deducted when earned. The deferred compensation is normally increased by some amount similar to interest or investment earnings. Until payment is actually made, the employer may realize investment income (or defer a deduction) with respect to the deferred amount that is subject to tax. Since the employer's deduction for both the deferred amount and the investment earnings is deferred until the actual payment of benefits, the employer incurs a greater net after-tax cost for the NQDC than for a payment of current compensation. This additional employer cost should be taken into account as the terms for any NQDC plan or agreement are considered and agreed upon by the employer.

How does a NQDC plan work?

In general

It depends on the particular type of NQDC plan, the specifics of the agreement itself, and how the plan is funded. In a typical unfunded NQDC plan (i.e., a top-hat plan) you pay the benefits provided under the plan out of your general assets at the time the payments become due. As a result, the executive must rely solely on your unfunded promise to pay the benefits and assumes the risk that these benefits may not be paid at all. To provide your employees with varying degrees of assurance that the promised benefits will be paid, you can choose to informally fund your top-hat plan with a rabbi trust or corporate-owned life insurance. However, any vehicle you use to informally fund your top-hat plan must remain subject to the claims of your general creditors. Therefore, your employees may lose their benefits in the event of your insolvency or bankruptcy. From your employee's perspective, this is one of the major disadvantages of an unfunded NQDC plan.

Caution: *Top-hat plans must be sure to comply with the rules of IRC Section 409A that govern NQDC plan deferral elections, distributions, and funding.*

Employee elective salary and bonus deferrals

A top-hat plan can be structured to allow participants to elect to defer a portion of their salary and/or bonus into the NQDC plan. This is often referred to as an "elective" NQDC plan, as compared to a "nonelective" plan, which provides benefits financed solely by the employer. The election must generally be made in writing before the tax year that the compensation is actually earned. In some cases, elections to defer bonuses can be made as late as six months prior to the end of the performance period, if the performance period is at least 12 months. In general, an employee must also elect the timing and form of payment at the time he or she elects to defer the compensation. Unlike a qualified plan, a top-hat plan may allow a participant to defer up to 100 percent of compensation into the plan. Participants are usually fully vested in their own elective deferrals, and any related earnings.



Discretionary employer contributions

A top-hat plan can also provide for employer contributions in addition to, or sometimes in place of, employee salary deferrals. Such employer contributions are generally discretionary. That is, most plans are set up to allow an employer to make contributions at the employer's complete discretion. No deposits are required to be made by the employer in any given year. Employer contributions are often subject to a vesting provision. For example, a plan may require that employer contributions and related earnings are forfeited if an employee fails to work for the employer for a particular number of years, or terminates employment before a specified age.

Accounting and investment control

There are two main types of unfunded NQDC plans--defined contribution (or individual account) plans and defined benefit plans. Defined benefit plans pay a pension-like benefit, often based on years of service and/or final average pay. Often the plan will provide benefits in excess of what can be provided under an employer's qualified pension plan. In an individual account plan, the employee's benefit depends entirely on the value of his or her individual deferred compensation account. This is not a real, funded account, but is a bookkeeping account that is credited with employee deferrals and employer "contributions" and investment earnings. These are often referred to as "hypothetical" or "notational" earnings to reflect the fact that they are simply credits to the participant's NQDC plan bookkeeping account. Often employees can "direct" the investment of their individual account. Usually, the employer (or trustee in a NQDC plan informally funded with a rabbi trust) is not obligated to actually invest any assets in the manner selected by the participant. The participant's investment election merely controls the amount of hypothetical earnings that the employer agrees to credit to the participant's bookkeeping account on a periodic basis. The IRS has suggested in the past that if the employer (or trustee) is obligated to actually invest assets as directed by the participant, this "dominion and control" by the participant may result in immediate taxation under the constructive receipt or economic benefit theories.

Top-hat plans that supplement qualified plan benefits

A common form of nonelective top-hat plan provides for a post-retirement pension benefit that supplements the employee's qualified plan benefits and Social Security benefits. These plans are often called supplemental executive retirement plans, or SERPs. Such SERPs may, for example, calculate a certain pension for the employee, then offset that by the benefits the employee actually receives from the employer's qualified plans and Social Security; the resulting difference is the NQDC plan retirement benefit paid by the employer to the employee after the employee's retirement. These plans often include a vesting provision, or are tied to the vesting schedule in the employer's qualified plan.

Payment of benefits

As the employer, you can structure a top-hat plan to pay benefits upon retirement, separation from service, disability, death, unforeseen emergency, or at a specified time. Benefits can be paid either in a lump sum or in a series of annual payments. Life annuities or payments for a fixed number of years (such as 5 or 10 years) are common. Since most ERISA requirements will not apply if you structure the plan correctly, you generally have some flexibility in establishing your own vesting schedule and forfeiture provisions. For example, you can stipulate that employees will forfeit their rights to benefits if they fail to work for your company until retirement age. However, you must make sure the distribution provisions in your NQDC plan satisfy the requirements of IRC Section 409A.

Types of NQDC plans

In general

Since a NQDC plan is essentially a contract between employer and employee, there are almost unlimited variations of NQDC plans. In addition, the phrase "nonqualified deferred compensation" may be used to encompass various concepts. For example, stock plans can be forms of NQDC plans. Similarly, severance plans such as golden parachutes are generally considered forms of NQDC plans.

It's also important to note that NQDC plans established by government and tax-exempt organizations are governed by Internal Revenue Code Section 457. Although these plans also classify as NQDC plans, they're more commonly referred to as Section 457 Plans.

The discussion here is primarily focused on the kinds of NQDC plans that are sometimes known as compensation deferral or supplemental plans. These plans represent non-stock-based compensation agreements between employer and employee and are



often the result of the compensation bargaining process. While there is sometimes significant overlap, the major plans that fall into this category are briefly described in the following sections. Except for excess benefit plans, NQDC plans are almost always unfunded top-hat plans.

Deferral plan

Deferral plans provide employees with deferred benefits in lieu of current compensation, a raise, or a bonus. A typical example of such a plan is the salary reduction plan, in which employees are able to defer dollars that could be received currently as income.

Supplemental executive retirement plan (SERP)

A SERP is generally a NQDC plan that provides participants with deferred compensation benefits that supplement the employer's qualified plan benefits. A SERP can be either a defined benefit plan or a defined contribution plan. The term SERP is also sometimes used more broadly to refer to any top-hat plan.

Wraparound 401(k) plan

A wraparound 401(k) plan is often referred to as a mirror 401(k) plan or executive 401(k) plan. These plans imitate the employer's qualified 401(k) plan, allowing deferrals in excess of the qualified plan limits. Under the typical plan design, an employee will determine how much he or she wants to defer for the year. The entire deferral will first flow into the nonqualified wraparound plan. Then, at year-end, when the 401(k) plan's discrimination testing is complete, the maximum amount the employee is eligible to defer to the 401(k) plan is transferred from the wraparound plan. This ensures the employee is able to defer exactly the amount he or she wishes, while making the maximum permitted contribution to the 401(k) plan.

Excess benefit plan

An excess benefit plan is designed solely to provide benefits in excess of the limits that apply to qualified plans under Internal Revenue Code (IRC) Section 415. In general, Section 415 limits contributions to defined contribution plans to the lesser of \$54,000 (for 2017, up from \$53,000 in 2016) or 100 percent of pay, and limits benefits from defined benefit plans to the lesser of \$215,000 (for 2017, up from \$210,000 in 2016) or 100 percent of final three year average pay. Excess benefit plans are different from other NQDC plans because if unfunded, they are entirely exempt from ERISA, and even if funded, they are exempt from most of ERISA's requirements. Also, excess benefit plans need not be limited to a top-hat group of employees (although typically only highly compensated employees will be impacted by the Section 415 limits).

Ways to "secure" the NQDC plan benefit

Employees are often concerned that the promised benefits under a NQDC plan may not be paid, either because of the employer's change of heart, a change in control of the employer, a change in the employer's financial position, or the employer's bankruptcy. The following are some methods of providing employees with varying degrees of assurance that their NQDC benefits will in fact be paid :

- Secular trusts
- Secular annuities
- Rabbi trusts
- Rabbicular Trusts (SM)
- Corporate-owned life insurance (COLI)
- Split dollar life insurance
- Surety bonds, indemnity insurance
- Third-party guarantees

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