



Nonqualified Deferred Compensation Plans

A nonqualified deferred compensation (NQDC) plan is a contractual arrangement between an employer and an employee under which compensation earned today is paid at a later date. Unlike qualified retirement plans, NQDC plans do not receive preferential tax treatment under Internal Revenue Code (IRC) Section 401(a). In exchange, they offer significantly greater flexibility in plan design, participation, benefit levels, and payout timing.

Most NQDC plans are structured to avoid many of the participation, vesting, funding, reporting, and nondiscrimination requirements imposed on qualified plans by ERISA and the Internal Revenue Code. As a result, NQDC plans are commonly used to attract, reward, and retain executives and other key employees.

To preserve tax deferral for participants, an NQDC plan must generally be unfunded, or if assets are set aside, those assets must remain subject to the claims of the employer's general creditors and the benefits must be subject to a substantial risk of forfeiture

Key Characteristics

- Highly flexible plan design
- No statutory limits on benefit amounts (subject to reasonable compensation rules)
- Participation may be limited to selected executives or key employees
- Employer deductions are generally deferred until benefits are paid
- Participant benefits are unsecured obligations of the employer in unfunded plans

NQDC Plans vs. Qualified Plans

Qualified plans such as 401(k) and profit-sharing plans provide broad-based employee benefits and favorable tax treatment, but they are subject to extensive IRS and ERISA requirements, including contribution limits, nondiscrimination testing, and mandatory vesting schedules.

NQDC plans, by contrast, are typically offered only to a select group of management or highly compensated employees. While they lack the immediate tax deductions and creditor protections of qualified plans, they allow employers to provide benefits above qualified plan limits and tailor arrangements to individual executives.



Funded vs. Unfunded Plans

Unfunded Plans

Most NQDC plans are intentionally structured as unfunded plans. Benefits are paid from the employer's general assets when due, and participants rely on the employer's unsecured promise to pay. These plans may be informally funded for accounting or planning purposes, but assets must remain available to the employer's creditors.

Common informal funding methods include: - Rabbi trusts - Corporate-owned life insurance (COLI)

Funded Plans

A plan is generally considered funded if assets are irrevocably set aside for participants and protected from the employer's creditors. Funded plans are typically subject to ERISA and may cause participants to recognize taxable income before benefits are actually received.

Informal Funding

Employers often accumulate assets to offset future benefit obligations without formally funding the plan. Informal funding does not change the unsecured nature of participant benefits but can help employers manage cash flow and future liabilities.

Careful drafting is essential to avoid creating participant rights to specific assets, which could trigger unintended tax or ERISA consequences.

Employee Treatment

Unfunded Plans

Participants generally recognize income only when benefits are actually paid or made available, provided the plan complies with IRC Section 409A and constructive receipt rules.

Constructive Receipt

Participants may be taxed earlier if compensation is credited or made available without substantial restrictions. Deferral elections must generally be made before the year in which services are performed.

IRC Section 409A

Section 409A governs deferral elections, distribution timing, and funding restrictions for most NQDC plans. Failure to comply may result in immediate taxation, penalties, and interest. Proper plan design and administration are critical.

Funded Plans

In funded arrangements, participants may be taxed when contributions vest or when economic benefits are provided, even if cash is not yet received.

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Employer Tax Treatment

- Unfunded plans: Employer deductions are generally allowed when benefits are paid and included in the employee's income.
- Funded plans: Employer deductions are generally allowed when contributions become taxable to the employee.

Deductions are subject to reasonable compensation standards and other applicable tax limitations, including executive compensation deduction limits for publicly traded companies.

Top-Hat Plans

Most NQDC plans are structured as “top-hat” plans, maintained for a select group of management or highly compensated employees. While there is no precise statutory definition, courts and regulators consider factors such as: - Percentage of employees covered - Relative compensation levels - Ability of participants to influence or negotiate plan terms

Top-hat plans are exempt from most ERISA requirements but must comply with limited reporting and disclosure obligations.

Social Security and Employment Taxes

Deferred compensation may be subject to FICA and Medicare taxes when it vests, rather than when it is paid, depending on plan design. These rules are complex and should be reviewed carefully during plan implementation.

Eligible Employers

NQDC plans are most appropriate for financially stable employers with predictable cash flow. C corporations are the most common sponsors. Partnerships, sole proprietorships, and S corporations may offer NQDC plans to non-owner employees, but owners generally cannot defer taxation on their own income through these arrangements.

Governmental and tax-exempt employers are subject to separate rules under IRC Section 457.

Advantages

- Supplements qualified plan benefits
- Flexible and customizable
- Can be offered selectively
- Helps attract and retain key executives
- Lower administrative burden than qualified plans

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Disadvantages

- Benefits are generally unsecured
- Employer deductions are delayed
- Potential exposure to employer insolvency
- Greater after-tax cost compared to current compensation

Common Types of NQDC Plans

- Elective deferral plans
- Supplemental Executive Retirement Plans (SERPs)
- Mirror or wraparound 401(k) plans
- Excess benefit plans

Benefit Payment Events

Benefits may be payable upon: - Retirement or separation from service - Disability or death - A specified future date - Change in control (subject to special tax rules)

Payments may be structured as lump sums or installment payments, subject to Section 409A requirements.

Benefit Security Options

Employers may use various methods to provide participants with confidence in future payments, including: - Rabbi trusts - Secular trusts or annuities - Corporate-owned life insurance - Third-party guarantees or insurance products

Each approach involves trade-offs among security, taxation, and regulatory compliance.

Final Considerations

NQDC plans are powerful executive compensation tools when properly designed and administered. Because tax, legal, and accounting rules are complex and evolving, employers should work closely with qualified advisors to ensure compliance and alignment with long-term business objectives.

IMPORTANT DISCLOSURES

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