Overview: What is a nonqualified deferred compensation plan?

Nonqualified deferred compensation plans (NQDC) are contractual agreements between an employer and an eligible employee (key, executive, or highly paid) to defer a portion of their compensation. Employers can leverage this tool to attract, retain, and reward top talent in their field of work. Navigating the complexities of NQDC plans requires careful planning and adherence to regulations. NQDC plans do not fall under ERISA guidelines, they are governed by Section 409A of the Internal Revenue Code, which allows employers to have greater flexibility in designing the terms and features of the plan. This article will explore the construction of nonqualified agreements and identify best practices. Plan design, regulatory compliance, and risk management strategies are important elements to consider when developing nonqualified plans. By following these guidelines, organizations can establish robust deferred compensation plans that attract and retain top talent and adhere to the industry's highest standards of excellence.

Click here for the NQDC “Getting Started” guide.

Potential Benefits and Considerations of an NQDC Plan

There are multiple benefits and considerations both for the employer and the executive to think about in developing and participating in the plan.

Benefits For the Employer:

- Attract and retain talent
- Employer defines and controls eligibility
- Reward key contributors
- Flexibility in contributions and vesting schedules, if applicable
- NQDC plans are not subject to ERISA compliance testing, form 5500, or audit requirements.

Considerations for the Employer:

- Debt obligation of the plan
- Administration of plan
- Cost benefit of offering additional plan
- Loss of current deduction on income deferred
- Plan financing strategy

Benefits For the Executive:

- Enhanced wealth accumulation, fill the gaps created by ERISA limits
- Reach savings goals more quickly
    a. College education
    b. Dream vacation
    c. Supporting elderly parents
    d. Retirement
- Defers income tax on contributions and earnings until distributions are made
- Choose source of compensation (e.g. salary or bonus) to defer from
- Potentially reduce taxable income
- Opportunity to take penalty free distributions prior to retirement
- No required minimum distributions

Considerations for the Executive:

- Tax implications that should be discussed with a tax or financial advisor before making any elections
- Elections are binding and remain in effect for the entire plan year
- Deferred amount subject to claims of creditors in the event of Bankruptcy of the company
- Rollovers to another NQDC plan or IRA are not permitted

Tax Considerations for the Participants

One of the benefits of nonqualified deferred compensation plans is the deferred tax savings for highly compensated employees. When the participant defers a portion of their salary (pre-tax), it reduces their current taxable income for that year. However, that money will be taxable income once distributed. Even though income tax is deferred, participants are still subject to FICA taxes on the deferred amounts. This means FICA taxes are withheld from the participant's paychecks in the year compensation is deferred.

Tax Considerations for the Employer

Tax deductions are allowed once the participant recognizes the income at distribution, which defers from contributions in qualified plans where the tax deduction for contributions to the plan is immediate. As mentioned, NQDC plans must comply with Section 409A of the Internal Revenue Code to maintain "tax-deferred status." Failure to comply with 409A can result in significant tax and interest penalties for the participants on the deferrals. Given the complex tax rules surrounding NQDC plans, employers and participants should seek tax professionals or legal advisors experienced in executive compensation to ensure compliance with applicable laws and regulations.

Click here for more detail on state source taxes.

Risks Associated with NQDC Plans

NQDC plans offer advantages to the employer and the employee but have certain risks. Since these plans can be unfunded or informally funded, the assets in the NQDC plan are a part of the employer's general assets. Therefore, participants are exposed to the employer's financial instability. These assets would be subject to the claims of the creditors in the event of bankruptcy. Employers and participants should carefully evaluate NQDC plans and consider potential alternatives or additional risk mitigation strategies.

Best Practices

Employers need to establish eligibility criteria, contribution limits, and distribution schedules. They should prioritize educating participants and have open communication to make informed decisions and fully maximize the plan's benefits. Regarding regulatory requirements, staying up to date with IRS Section 409A is imperative to maintain the tax-deferred status of their NQDC plans. Plan sponsors wanting to safeguard participant assets should seek counsel on rabbi trusts. These trusts protect assets in the of mergers and changes in control. Lastly, employers should regularly review plan operations and consult with specialists to meet legal and tax obligations.
Navigating nonqualified deferred compensation plans with caution and foresight is essential. Adherence to best practices can mitigate risks and optimize the effectiveness of these arrangements. With ongoing monitoring and evaluation of plan performance and strategic vesting schedules, employers can expect meaningful financial benefits to their participants while attracting and retaining industry talent.

Plan Design Considerations

Before implementing a deferred compensation plan in the organization, there must be clearly defined objectives. Is the goal to attract and retain key executives? Provide additional retirement benefits? Or align compensation with company performance? Identifying goals will smooth out the plan design process. Plan design consists of five basic parameters - eligibility, contribution

limits, vesting schedules, funding options, and distributions. Plan sponsors should also establish governance frameworks to ensure effective management and oversight of these plans. Defining governance will help establish clear accountability and responsibility, which includes outlining rules and obligations for administrators, trustees, and other fiduciaries involved in plan management.

Eligibility

Nonqualified deferred compensation plans are limited to a select group of executives or key employees. Factors to consider in determining who is eligible to participate are job role, tenure, and contribution to the organization's success. At most, 15 percent of the organization should be allowed to participate in the plan. The company should have strict criteria for eligibility.

Contributions

Consider types of compensation eligible for deferral – base salary, bonuses, commissions, RSU's, directors fees or other forms of compensation such as a sign-on bonus. NQDC plans also allow for participants to defer 401(k) refunds resulting from qualified plan contribution limits and nondiscrimination testing. Establish contribution limits and whether there will be employer-funded contributions. It's essential to create a deferral strategy and have flexibility in contribution amounts to accommodate for varying financial circumstances and objectives.

Funding

After defining the "who, what, and why," determining which funding vehicle (if any) to utilize is essential, because participant balances are considered a corporate liability. Employers can leave the plans unfunded or informally fund through corporate cash, mutual funds, Corporate Owned Life Insurance, or a mix of the three.

- A nonqualified deferred compensation plan is a contractual arrangement between an employer and an employee, whereby the employer promises to pay an executive a specific benefit at some point in the future, usually at a life event or retirement.

- A primary difference between a qualified and a nonqualified plan is the type of funding used to support the payment of benefits.   Unlike qualified benefit plans, which have plan assets secured in an ERISA trust; nonqualified plans have no specific assets formally set aside for the payment of benefits.
- That said, many Plan Sponsors choose to informally fund their nonqualified plans:
    - To match plan liabilities with a pool of assets to minimize the impact of equity market volatility which can have a negative impact on corporate P&L
    - To reduce plan costs through tax advantaged pre-funding
    - Provide a source of dedicated liquid funds from which to pay future participant benefits.

Vesting

Organizations can utilize NQDC plans to retain participants. Gradual vesting of employer contributions over time rewards long-term commitment and discourages departure. For example, organizations can leverage their vesting schedules to align with individual employees. For recruiting purposes, a sign-on bonus can follow a separate vesting schedule.

Investments

Selecting the investment options for NQDC plans presents unique challenges for plan sponsors. While it may seem convenient to mirror the fund lineup of a 401(k) plan, this approach is not always optimal. Plan sponsors must carefully evaluate the specific goals, regulatory environment, and participant needs of the NQDC plan to ensure appropriate fund selection and oversight.

Click here for more information on NQDC investments.

Distributions

To finalize your plan, determine distribution options such as lump-sum payments or annual installments. Establish clear rules regarding distribution timing – retirement, separation from service, disability, or death. You can also allow participants to take distributions from the plan while still actively working – commonly referred to as “in-service” distributions. It will allow the company and participants to be on the same page if unforeseen circumstances arise.

Click here for more information about distribution options.

Plan Administration

Once the decision to implement a plan has been completed and board approval has been granted, plan sponsors are faced with the important task of appointing a Plan Administrator and a Recordkeeper_ to administer and carry out the provisions of the plan. The Plan Sponsor must make a decision to determine who is best suited to administer their plan. Working with an advisor or consultant, the Plan Sponsor can gain valuable insight on Recordkeepers through a request for proposal (RFP). The RFP process allows the Plan Sponsor to assess and evaluate recordkeeping platforms, vendors and their service offerings for competitiveness and comprehensiveness.

The Plan Administrators role includes design, amending, interpreting, and enforcing all appropriate rules and regulations to keep the plan in compliance. The Plan Sponsor should consider if establishment of an irrevocable trust is in order to trust the assets of the plan or will the plan set up be an unfunded arrangement. It is also important to consider whether to bundle the plan with the existing qualified plan provider or have a separate Plan administrator. Benefits exist on both sides of the equation and must be vetted.

Below are some additional services to consider in determining the plan administrator:

Advisory: An advisor can play an important in the role determining or assisting with the search for a Plan Administrator. If you have an advisor in your qualified plan, review your services agreement as you may find language supporting and participating in the RFP process. Consider what role, if any, should the plan advisor play for the nonqualified plan? Outline with your advisor, the intended investment lineup and tax strategies to assist employees develop a deferral strategy. Your advisor can also play a role with educational assistance, communications and reviewing tax strategies with participants.

Recordkeeper: A recordkeeping solution should deliver results that meet your current needs, anticipates future opportunities, can leverage innovation and quality while proactively taking more of the daily workload from your plate. Having an experienced service team can assist in building a market-competitive benefit program. Ensure the recordkeeping system is dynamic while supporting the plans features. Critical elements to the success of the plan include source creation, class year elections, compensation tracking, and distribution options. Your recordkeeping solution should mitigate risk and optimize return on your investment. Performance standards keep your recordkeeper striving to enhance the overall participant experience.

Consider reporting outputs and the ease of getting data from the recordkeeping system. Depending on the role the recordkeeper plays, a robust set of reports would include, plan assets, liabilities, census, deferral source allocations, distributions payment methods, etc. Review internal needs along with the capabilities of the plan administrator to ensure all needs are met.

Education / Communications: Design, produce and distribute a customized multiple functioning communication program for employees. Easy to interpret communications are vital for a successful and rewarding plan.

Click here for more information on communication your NQDC plan to employees.

Leverage the plan advisor and communications teams, develop robust communications, including Brainshark's, plan rules and overviews for eligible employees. New hire documents or brochures can aide in the attraction of hiring new talent. Understanding the role of your communications team plays will provide future wealth building opportunities for your plan participants.

Call Center: Who is responsible for the first line of defense? Engaging your Advisor, the plan's recordkeeper and the human resources team are all valuable resources for the success of the plan. Arming your team with plan materials, rules, videos or recorded presentations, plan documents enhance the participant experience.

Payment and Tax services: Distribution process is key to the success of the plan. Deferral sources, in addition to complex distribution options require precise tax reporting. Federal and state withholding and remittance, tax reporting for the participant are specific needs for every plan. Getting payment and tax service right makes the lives of the Plan Sponsor, administrator and employee much simpler.

Are these services your recordkeeper or internal payroll team can provide for the plan? If not, consider hiring a third-party provider to handle on behalf of the plan. Remember to check your Advisor's service agreement as these may be included as part of service package.