Nonqualified Deferred Compensation Plan: Where to Start

Ten steps to design and deliver a quality benefit to attract and retain key talent.

By Erik Speed for PSCA's NQDC committee, originally published in the Spring 2025 edition of Insights magazine.

As a corporate leader, and especially for an HR manager, one of your key responsibilities is designing compensation strategies that attract, retain, and reward top talent. A nonqualified deferred compensation (NQDC) plan is an excellent tool for providing executives and highly compensated employees with additional financial security while simultaneously aligning their interests with the company's long-term success.

However, it's not unusual for those in HR roles, particularly at smaller companies, to be unfamiliar with nonqualified plans, and, frankly, a little intimidated by them.

Unlike qualified plans (such as 401(k) plans), NQDC plans offer greater flexibility in contributions, funding, and distribution structures. However, they also come with unique legal requirements, most particularly under Section 409A of the Internal Revenue Code (IRC).

This article will attempt to demystify NQDC plans and provide a step-by-step guide for getting started on evaluating and implementing a plan successfully.

Step 1: Understand the Basics

A NQDC plan is a plan designed to supplement your 401(k) plan. Key characteristics of a NQDC plan are:

- Eligibility is limited to a select group of management or highly paid employees
- Employees can elect to defer receipt of up to 100 percent of their eligible compensation (i.e., no pretax maximums) to a later date, thereby delaying federal and state income taxation until a future date.
- No 5500 reporting or nondiscrimination testing
- Participant balances are subject to the claims of the general creditors of the company in the event of the company's bankruptcy or insolvency.

Step 2: Outline Your Objectives

Before implementing an NQDC plan, it's crucial to define the goals behind it. Common reasons companies establish such plans include:

- **Maintaining a Competitive Compensation & Benefits Program to Attract and Retain Key Employees**: High-level executives often look for companies that offer competitive compensation structures beyond base salary and bonuses.
- **Providing a Tax-Planning Tool and Enhancing Executive Compensation:** By deferring receipt of their compensation until a later date, participants can manage their current federal and state tax obligations to their own personal financial situation. Providing this tool enhances the value of your company's existing compensation strategy without increasing your cash outlay.
- **Encouraging Long-Term Commitment:** As noted previously, an executive that defers compensation puts that compensation at risk in the event of the company's bankruptcy, so they have a vested interest in the long-term financial stability and success of the company. Also, many plans include customized vesting schedules or performance-based incentives that encourage executives to stay with the company.
- **Restoring Company Match**: IRS rules limit the amount of compensation that can be eligible for employer matching contributions in the 401(k). NQDC plans are frequently used to extend the 401(k)-matching formula to an executive's full compensation amount.
- **Targeted Company Contributions:** Because nonqualified plans are exempt from ERISA's (Employee Retirement Income Security Act) coverage requirements, the plans can be used to make special, targeted employer contributions to specific employees or groups of employees for retention or recruitment or incentive purposes.

Once the objectives are clear, the next steps are socializing the plan with leadership and talking to someone that can help you get started.

Step 3: Solicit Management Buy-In

Ultimately, implementation of an NQDC plan requires board approval as it shifts current compensation expenses to the future, and the board will need to assess the impact on cash flow and financial statements. Reviewing project scope and obtaining pre-approval from senior leadership helps ensure a smooth and timely plan rollout.

Step 4: Engage an Expert

Engaging a consultant that specializes in NQDC plans can provide significant benefits, ensuring that your plan is strategically designed, compliant, and effectively and efficiently administered. You can also inquire of your current 401(k) providers - plan recordkeeper, investment manager, attorney – as to what level of NQDC support they can provide. Keep in mind, however, that while 401(k) and NQDC plans share some basic fundamentals, there are specific design, compliance, funding, and servicing requirements of an NQDC plan that may merit a specialist.

Step 5: Design the Plan

Designing an NQDC plan requires making key decisions about deferrals, employer contributions and vesting, and distributions.

Determine Your Eligible Population

The IRS provides no "bright-line test" for determining eligibility. Working with your plan partners (NQDC consultant, plan recordkeeper, or benefits counsel), along with your internal compensation group will help you determine an appropriate eligibility metric. Frequently this can be:

- Compensation level (e.g., annual salary of $200,000 or more, or total compensation of $260,000 or more)
- Title/Position (e.g., VP and above, or payroll grade six or higher)
- Fixed percentage of workforce (e.g., top 10 percent of employees based on total compensation, or 130 percent of 401(k) annual highly compensated employee definition)
- A combination of criteria

Employee Deferrals

Participants must elect to defer compensation before the beginning of the year in which the income will be earned. Common deferral options include base salary, bonus pay, commissions, and equity compensation (RSUs).

Employer Contributions & Vesting Schedules

Employers can also offer matching or discretionary contributions. Employer contributions can take the form of matching contributions, similar in structure to those in 401(k) plans, but with no IRS-imposed limits, or they may be customized contributions specific to company retention, recruitment, or incentive needs.

You can set vesting rules based on company retention strategies and may customize them based on circumstances.

Distribution Triggers

Section 409A restricts when employees can receive their deferred compensation. Permissible distribution triggers include:

- Separation from service (retirement or termination)
- A pre-determined date (e.g., on January 1, 2030)
- Death or disability
- Change in company ownership
- Unforeseeable emergency (as defined by IRS regulations)

Part of the design process will be to evaluate which distribution triggers you wish to incorporate into the plan, as well as the payment methods to be offered (e.g., lump sum or annual installments). Participants must make a "distribution election" concurrent with their deferral election and once elected, distribution schedules may only be changed if they meet specific Section 409A change requirements.

Step 6: Drafting the Plan Document

The NQDC plan document serves as the official agreement outlining the plan's terms and conditions. It should include:

- Eligibility (although determination of specific criteria is best omitted from the plan document and instead left to the discretion of the Committee)
- Deferral options
- Employer contributions and vesting schedule
- Distribution rules
- Funding arrangements
- Plan termination conditions
- Legal and tax provisions

Engaging legal experts to draft or review the document is highly recommended to avoid compliance risks. An NQDC consultant or plan recordkeeper should be able to provide this support or provide you with a referral.

Step 7: Determine the Funding Approach

NQDC plans are technically unfunded, however, most companies choose to set aside assets which *informally* cover future obligations. The most common way they do this is through a rabbi trust. A rabbi trust is a grantor trust that segregates and earmarks assets for future payouts. However, despite being segregated, funds in a rabbi trust remain subject to creditors' claims in case of the company's bankruptcy.

Trust assets are either invested in mutuals funds or Corporate-Owned Life Insurance (COLI). Each funding method has pros and cons, so consulting a NQDC consultant or financial expert is advisable.

Step 8: Choose a Plan Recordkeeper

Choosing the right recordkeeper for your nonqualified deferred compensation plan (NQDCP) is critical to ensuring accurate administration, compliance, and a seamless participant experience. A NQDC consultant or benefits consulting firm can help manage the selection process – following are a few key factors to evaluate when selecting a recordkeeper.

Experience and Expertise in NQDC Plans

Since NQDCPs are subject to specific regulations, it's important to choose a recordkeeper with:

- Proven expertise in nonqualified plans
- A strong track record of compliance and administration
- Experience with companies of similar size and industry

  Ask:

  - How many NQDC plans do they currently administer?
  - Do they specialize in nonqualified plans, or is it a secondary service?
  - Will they administer just the NQDC plan, or must they also administer the 401(k) plan?

Technology and System Capabilities

A user-friendly, secure, and efficient platform is essential for both HR administrators and plan participants:

- Request a demo of their platform

  Ask:

  - Is their platform cloud-based or on-premises? Proprietary or leased? NQ-specific or capable of handling both 401(k) and NQDC?

Participant Experience & Communication

Since executives rely on NQDC plans for tax-efficient savings, the recordkeeper should provide:

- Personalized account dashboards with clear deferral and payout options.
- Frequently accessed data points should be prominently displayed and easy to access.
- Bespoke customer support for plan participants.

  Ask:

  - Are participant calls fielded by call center representatives or the operations team that handles the plan?
  - What tools and resources do they provide for participants?
  - Do they offer one-on-one education or plan support?

Service & Support for HR Teams

You need a recordkeeper that reduces administrative burden on company staff by handling day-to-day plan management. Look for:

- Dedicated account management with a service team responsive to company inquiries
- Custom reporting for HR and finance teams

  Ask:

  - Will we have a dedicated account manager?
  - How quickly do they respond to HR inquiries?

Cost

NQDC recordkeeping fees can vary based on services, plan size, and funding strategy.

  Ask:

  - What are the total costs of administration?
  - Are there additional fees for services like customized communications or special reporting?

Finally, a recordkeeper's industry reputation and client feedback can provide valuable insights. While references can be valuable, they are also self-selected. Be sure to ask related professionals (attorneys, NQDC consultants, investment advisors and trust providers) what their experience with recordkeepers has been

Step 9: Communicate and Implement the Plan

Once the plan is designed and documented, the next step is raising awareness and ensuring employees understand this new benefit and their options. HR should collaborate with legal, finance, and benefits administration teams to ensure a seamless rollout. Key actions include:

- Developing clear communication materials=
- Conducting employee education sessions
- Providing detailed enrollment instructions and due dates

Because your new NQDC plan is available to a limited number of highly paid or management employees, one-on-one meetings are often the most effective and appreciated way of communicating plan benefits. Your new plan recordkeeper and/or NQDC consultant will usually coordinate education and enrollment process.

Step 10: File Top-Hat Exemption Letter

Within 120 days of the NQDC plan's effective date, complete the brief, one-time, online filing at the Department of Labor's Online Filing System. Doing so exempts the NQDC plan from ERISA's annual reporting requirements.

Conclusion

Implementing a nonqualified deferred compensation plan can provide significant benefits for both employers and employees, positioning the company to be more competitive in the market for executive talent. However, plan success is dependent upon proper plan design, legal compliance, and effective administration. By following the steps outlined in this article, HR professionals can create a valuable executive benefit that supports long-term retention and financial planning goals. Knowing what and who to ask is crucial to avoiding pitfalls and enabling plan success.

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