

## Maximizing Deferred Compensation Plan Distributions

Distribution elections are a critical decision for NQDC plan participants, and one they need to make when enrolling in the plan.

*By Monte Harrick for PSCA's NQDC committee, originally published in the Summer 2024 edition of Insights*

Nonqualified Deferred Compensation Plans (NQDCPs) are important vehicles in developing retirement and wealth. Participants in NQDCPs set aside a portion of their compensation, electing to receive it at retirement or a future date. Payouts from NQDCPs, if properly structured, can be used to mitigate tax and enhance account balance accumulation.

The decision on when and how to take plan distributions is critical in determining how participants receive cash distributions in the future. It involves assessing potential cash flow needs and tax liabilities many years – or even decades – into the future. Participants need a clear picture of the role a NQDCP will play in achieving a comfortable retirement or other financial goals. Providing information to participants before they enroll in your NQDCP can help employees make more informed distribution decisions and enhance the value of the plan.

### Planning Retirement Distributions

NQDCPs must provide for when and how deferred compensation, and any applicable earning, will be distributed. Still, distribution rules for deferred compensation are considerably different from those governing distributions from other retirement plans, such as 401(k)s or IRAs.

For example, the Internal Revenue Code (IRC) allows for 401(k) withdrawals to begin penalty-free after age 59½ – but the IRC also requires that you start taking distributions at age 73. By contrast, there are no IRC age restrictions on distributions from a deferred compensation plan.

Deferred compensation plans don't have required minimum distributions either. Plans generally provide for one of two distribution options – a lump-sum payment or installment payments. Based on those two options, participants should carefully consider how they should take future distributions by considering the following options.

#### Separation of Service/Retirement – Lump Sum

Choosing a lump-sum distribution gives participants immediate access to all their deferred compensation once it is distributed, usually at retirement or separation from service. Once participants receive a lump sum, they have the option of reinvesting that money at their discretion, but they will pay ordinary income tax on the entire lump sum. There is no capital gains treatment on NQDCP distributions nor are there options to roll the account balance into an IRA. The lump sum distribution could result in a larger tax bill than if participants were to choose installment distributions (see below), in part because it may push them into a higher tax bracket. They also lose the benefit of tax-deferred compounding when they withdraw money from the plan.

### **Separation of Service/Retirement – Installment distributions:**

Electing installment distributions allows participants to spread out the payment of their account balance thus, potentially, minimizing their tax bill, especially if personal income tax rates decline. More importantly, the unpaid balance continues to accrue on a tax deferred basis. The spreading of the payments from the NQDCP account will significantly increase future payments, provided the investment returns are positive. With an installment plan, smaller distributions are taken over time – typically on a yearly schedule. The remainder of the deferred compensation remains in the account, where it can continue to grow tax deferred. Spacing distributions over several years may reduce participants’ overall tax bill, especially if their personal income tax rate declines.

#### **Source Tax Rule:**

For those living and working in high income tax states and participating in NQDCPs, they should be familiar with the Source Tax Rule. This rule allows anyone who elects a distribution 10 years or longer to take advantage of a special state tax benefit. Under this specific 10-year-plus election, if a participant moves from the state of employment to another state in retirement, their payouts are not subject to tax in the state of employment. In short, payments structured this way are taxed in the state of residence when paid, not in the state in which the income was earned. This is a tax benefit for those planning to move to a state with lower income tax rates. Whatever form of distribution chosen, participants should consider the timing of those distributions relative to other company benefits, such as the vesting of restricted stock and the exercise of stock options, as well as income from other retirement plans.

### **In-Service Distributions**

Some NQDCPs allow you to schedule distributions based on a specific date—also known as an “in-service” distribution. For some participants, this flexibility is one of the biggest benefits of a deferred compensation plan. It offers a tax-advantaged way to save for a child’s education, a new house, or other short- and mid-term goals.

In-service distributions also can help partially mitigate the risk that a company could default on its obligations. Scheduling in-service distributions requires more up-front work than simply deferring all compensation until retirement. Here is a strategy for scheduling preretirement distributions:

**The class-year approach:** This strategy – also known as "laddering" – involves scheduling distributions for specific years and establishing separate accounts and investment portfolios for each one. For example, if a child will be starting college in 2024, participants could schedule distributions for 2024, 2025, 2026, and 2027 (the years they'll need to pay tuition). They can also schedule a distribution for their anticipated retirement date. If participants elect to defer part of their compensation each year and the plan tracks that deferred compensation for each class year, they may be eligible to schedule a different payment for each year. For example, if the plan allows for installments as a form of payment, participants could elect for one class year to be paid as a 4-year installment payment beginning in 2024. The other class years can be paid at separation from the employer. Depending on the plan's provisions, the payment of the deferred compensation can also be structured to reduce participants' tax liability based on a series of installment payments or lump sum payments based on a specified time. By spreading out the payments, participants can potentially reduce their taxable income for each applicable year.

## Distribution Strategies and Tax Planning

Questions typically arise as to whether a participant can change a previous distribution election. The answer is, yes, but there are restrictions.

A subsequent distribution election, if allowed by the plan, cannot permit the payment to be paid earlier than originally elected except in cases of extreme hardship, death, or disability – so participants can't change their minds and ask for their deferred compensation a year or two earlier than the scheduled distribution date.

However, participants can postpone a distribution as long as they follow strict "redeferral" rules: The request to push back a distribution must be made at least 12 months before the planned date, and you must defer the compensation for at least five additional years beyond the original distribution date.

For example, a participant may have scheduled a distribution for May 2029 to help pay for college costs. Then their child receives a scholarship or chooses to postpone college plans, and they decide they'd rather put the money toward retirement. They must make the change before May 2028, and then can't receive the money until May 2034 or later.

These restrictions on changing distribution schedules are another reason why careful, up-front planning is essential to help participants get the most out of their deferred compensation plan. Providing access to education and professional advice can increase the value of the plan.

NQDCPs are powerful tools for growing wealth and preparing for retirement. How elections are made about eventual payouts from these plans are critical to maximizing return.

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