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Nonqualified Deferred Compensation Plans: The Employee Perspective

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What is it?

A nonqualified deferred compensation (NQDC) plan is an arrangement between an employer and employee that defers the receipt of currently earned compensation. A NQDC plan doesn't need to comply with the discrimination and administrative rules that govern qualified plans, such as Section 401 of the Internal Revenue Code. And if the NQDC plan is "unfunded" (most are) the plan avoids the burdensome requirements of the Employee Retirement Income Security Act of 1974 (ERISA). Since an NQDC plan doesn't have to comply with these regulatory requirements, it's a flexible form of employee compensation that allows your employer to tailor the benefit amounts, payment terms, and conditions of the plan to your needs. In addition to its flexibility, an unfunded NQDC plan can provide you with significant tax benefits: Unlike cash compensation, which the IRS taxes currently, deferred compensation generally isn't subject to federal income taxes until you begin receiving distributions from the NQDC plan.

Tip: For a more detailed discussion of NQDC plans, see Nonqualified Deferred Compensation Plans.

Funded versus unfunded plans

In general

It is important for you to understand whether your employer's NQDC plan is "funded" or "unfunded" in order to understand how the federal tax laws and ERISA apply to the plan. Most NQDC plans are unfunded. The reason is that employers usually adopt NQDC plans in order to provide their employees with the benefit of tax deferral while at the same time avoiding the often burdensome requirements of ERISA.

Tip: ERISA does not apply if your employer is a church or a state or local government. If you're employed by a state or local government your NQDC plan is subject to a special set of rules, and this article does not generally apply. For more information, see 457 Plans.

Unfunded plans

An unfunded plan avoids most ERISA requirements, and your benefits are usually not subject to federal income tax until you receive them. A NQDC plan is unfunded if either assets have not been set aside by your employer to pay plan benefits (that is, your employer pays benefits from its general assets on a "pay as you go" basis), or assets have been set aside but those assets remain subject to the claims of your employer's creditors (often referred to as an "informally funded" plan). In general, when a plan is unfunded you must rely solely on your employer's unsecured promise to pay benefits at a later date. As a result, you may be fearful that when it comes time for you to receive the deferred compensation, your employer may be unwilling or unable to pay the deferred compensation or that a creditor may seize the funds through foreclosure, bankruptcy, or litigation. Unfunded plans must generally be limited to a select group of management or highly compensated employees, and are often called "top-hat" plans.

Tip: Although there is no formal legal definition of "select group of management or highly compensated employees," it generally means a small percentage of the employee population who are key management employees or earning a salary substantially higher than the average salary for all management employees. Generally, courts will look at the number of employees in the firm versus the number of employees covered under the top-hat plan, the average salaries of the select group versus the average salaries of other employees, and the extent to which the select group can negotiate salary and compensation packages.

Funded plans

If you fear losing your deferred compensation benefits (for example, if your employer becomes insolvent or declares bankruptcy) your employer may want to consider offering a funded NQDC plan. These are unusual, because funded NQDC plans generally must comply with all of ERISA's requirements, and your plan benefits are subject to federal income tax as soon as they are vested. In general, a plan is considered "funded" if assets have been irrevocably set aside with a third party (for example, in a trust) by your employer for the payment of your NQDC plan benefits, and those assets are beyond the reach of your employer and your employer's creditors. In other words, if you are guaranteed to receive your 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. But again, unfunded plans are far more common than funded plans.

Informally funded plans

While most employers want to avoid formally funding their NQDC plans in order to avoid ERISA while providing the benefit of tax deferral, employers often want to accumulate assets in order to ensure they can meet their benefit obligations when they come due. This is called 'informally funding" a NQDC plan. Even though your employer sets aside funds, the NQDC plan is not considered formally funded because the assets remain part of your employer's general assets, and can be reached by your employer's creditors. Informal funding allows your employer to match assets to future benefit liabilities, and provides you with psychological assurance (at least) that your benefits will be paid when due. The most common method of informally funding a NQDC plan is the rabbi trust, discussed more fully below. An irrevocable rabbi trust, adequately funded, can provide you with the assurance that your benefits will be paid in all events other than the insolvency or bankruptcy of your employer.

Tax treatment--unfunded plan

In general

Any amount your employer promises to pay you from an unfunded NQDC plan is generally not subject to federal income tax until you actually receive payment of your benefits from the plan. This is true whether or not your employer chooses to informally fund the NQDC plan (for example, through contributions to a rabbi trust). However, there are instances in which your NQDC plan benefits may be taxed prior to your actual receipt of the funds.

Constructive receipt

Under the doctrine of constructive receipt, the IRS can tax you prior to your "hands-on" receipt of funds if the funds are credited to your account, set aside, or otherwise made available to you without substantial restriction. In other words, once the funds have been earned and are payable to you on demand, you must report the income even if you choose not to actually accept current payment of the funds. The constructive receipt doctrine has been codified in part by Internal Revenue Code (IRC) Section 409A.

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. If your employer's NQDC plan fails to follow these rules, your NQDC plan benefits for that year and all prior years may become immediately taxable, and subject to penalties and interest charges. It is very important that your employer be aware of, and follow the rules in, IRC Section 409A, when establishing a NQDC plan. For additional information, see Internal Revenue Code Section 409A.

Tax treatment-- funded plan

Your employer's contributions to a funded NQDC plan are generally taxable to you once you become vested in the contributions--that is, when the benefits are no longer subject to a substantial risk of forfeiture. This is true even if you don't yet have a right to receive payment from the plan. If the plan is funded with a secular trust you may be entitled to a distribution from the trust to pay the taxes. Or your employer may decide to pay you a cash

bonus that covers your tax liability. The tax treatment of benefits paid from a NQDC plan funded with a secular trust can be quite complex.

NQDC plan issues that concern key employees

Dollar limitations on contributions to and benefits payable from qualified plans

Sometimes, highly compensated employees are adversely affected by the dollar limitations on contributions to and benefits payable from qualified plans. As a result, they don't receive as high a percentage of their compensation as do lower-paid employees under a qualified plan. A NQDC plan can help solve this problem.

> **Example(s):** Hal and Jane work at BCD Corporation. Hal earns $300,000 in 2008, while Jane earns $100,000. They both participate in a defined benefit plan that provides a general benefit of 50 percent of salary. Although the plan formula dictates that Hal should get a benefit of $150,000 (50 percent of $300,000), he actually is only allowed to receive $115,000 (50 percent of $230,000) because $230,000 is the maximum compensation amount that may be used in calculating the benefit in 2008. Conversely, Jane is entitled to $50,000 (50 percent of $100,000) because her entire annual salary can be taken into account, since it is below $230,000. As a result, Hal may only receive approximately 38.3 percent of his pay, while Jane may receive the 50 percent as dictated by the plan formula. Hal is adversely impacted by the $230,000 maximum, while Jane isn't.
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> **Tip:** The compensation limit (which is indexed for inflation) is $230,000 for 2008 (up from $225,000 for 2007).

Tax benefits

Generally, a key employee is subject to a higher income tax rate. As a result, a key employee can benefit from deferring compensation, since he or she is likely to be in a lower tax bracket during retirement, when the deferred compensation is finally received.

> **Example(s):** Hal works at XYZ Company. Hal is given the option of receiving as earned or deferring until retirement a $100,000 bonus. His current marginal tax rate is 35 percent, and his marginal tax rate at retirement will be 25 percent under today's rules. Assuming no other variables, if Hal decides to receive the $100,000 bonus this year, he will be taxed $35,000 (35 percent of $100,000), but if he defers the income until retirement, he will only be taxed $25,000 (25 percent of $100,000).

Rabbi trusts

In general

A rabbi trust is a trust that your employer establishes in order to satisfy its obligation to provide you with benefits under an NQDC plan. It's called a rabbi trust because a rabbi was the beneficiary of the first such trust to receive a favorable IRS ruling. The primary reasons for establishing a rabbi trust are for your employer to provide you with assurance that assets will be available, and that payment of your deferred compensation will be made when due under the terms of the NQDC plan (except in the event of your employer's insolvency or bankruptcy).

> **Tip:** Although the rabbi trust assets are held apart from your employer's other assets, the funds are still subject to the claims of your employer's general creditors. For this reason the NQDC plan is considered unfunded (or informally funded) for tax and ERISA purposes.
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> **Tip:** A rabbi trust can be in the form of either a revocable or irrevocable trust. If a rabbi trust is irrevocable, your employer gives up the use of the NQDC plan assets and can't get them back until all plan benefits have been paid. The assets are there to cover you, except in the case of your employer's bankruptcy or insolvency. If bankruptcy or insolvency occurs, the assets become accessible to your employer's general creditors (including you), and your NQDC plan benefits may be lost.

Why would you want your employer to establish a rabbi trust?

The rabbi trust is a major step forward in providing benefit security for plan participants. An irrevocable rabbi trust, adequately funded, can largely eliminate the risk of nonpayment for every reason but your employer's bankruptcy or insolvency. For employees who worry about nonpayment primarily by reason of a hostile takeover or a similar occurrence whereby the employer refuses to pay, the rabbi trust is an ideal device.

IRS tax treatment

A NQDC plan informally funded with a rabbi trust is considered "unfunded" for federal income tax purposes. Even though your NQDC plan benefits may be payable from rabbi trust assets your benefits are generally not subject to income tax until they are actually paid to you. See "Tax treatment--unfunded plan," above.

> **Caution:** IRC Section 409A provides specific rules that govern rabbi trusts. For example if your employer funds a rabbi trust while maintaining an at-risk defined benefit plan, or your employer invests rabbi trust assets off-shore, you could be subject to immediate taxation and penalties. For additional information, see Internal Revenue Code Section 409A.

NQDC plans and corporate-owned life insurance (COLI)

In general

Corporate-owned life insurance (COLI) is a life insurance policy that your employer takes out on your life. Your employer is both the owner and the beneficiary of the policy. As owner of the policy, your employer is responsible for paying the premiums. As beneficiary of the policy, your employer retains all rights to the benefits under the policy. Other than being named as the insured, you have no interest in the policy. COLI can be used for a variety of reasons, and the use of COLI may or may not bear any relationship to the actual financial loss your employer may anticipate incurring upon your death. For example, COLI is commonly used as a funding vehicle for NQDC plans. When used as a funding mechanism for an NQDC plan, your employer can borrow against the cash value that accumulates under the policy. Your employer can then use the borrowed funds to pay the COLI premium payments or to fund the NQDC plan.

> **Tip:** The Pension Protection Act of 2006 requires your employer to notify you: (a) that you may be insured under a COLI policy, (b) of the maximum amount of coverage your employer may take out on your life, and (c) that your employer will be the beneficiary of the death proceeds. The Act also requires that your employer get your written consent to being insured. If your employer fails to comply with these rules, the amount your employer can exclude from income as a tax-free death benefit will generally be limited to the premiums your employer paid for the contract. Some state laws may also require your consent before you can be insured under a COLI contract. For additional information, see Corporate-Owned Life Insurance (COLI).

Why would you want your employer to purchase COLI?

As an informal funding mechanism for NQDC plans, the COLI policy provides you with psychological the assurance that your employer will have assets available when benefit payments are due under the plan.

Risks associated with COLI

A number of risks are associated with using COLI to fund an NQDC plan. First, if the insurance company experiences severe financial difficulties, your employer may be unable to access the policy's cash value to pay the plan benefits. In addition, the disparity between the estimated earnings (earnings projected when the policy is issued) and the actual earnings may leave your employer with insufficient cash value to pay plan benefits when due. Also, the COLI policy remains part of your employer's general assets, and therefore is subject to the claims of your employer's creditors in the event of your employer's bankruptcy or insolvency. And if the COLI policy is held directly by your employer the policy could be cashed out at any time.

NQDC plans and split dollar life insurance

Another informal funding vehicle for NQDC plans is split dollar life insurance. In general, split dollar is an arrangement whereby you and your employer share the premium cost and/or death benefits of a life insurance policy issued on your life. Split dollar life insurance allows your employer to fund NQDC plan benefits with the proceeds your employer receives from the life insurance policy. While there are a number of variations, one way your employer can accomplish this is by establishing an unfunded nonqualified plan to provide you with a promised level of deferred compensation benefits. Your employer then purchases a life insurance policy on your life. The premiums may be split between you and your employer in any way desired. Typically you are entitled to a death benefit from the policy equal to some multiple of your compensation, for example 3 times pay. The face amount of the policy, however, is usually greater than that amount. Each year, your employer credits your nonqualified plan account with an amount specified in the NQDC plan. When distribution is scheduled to occur, your employer pays you the NQDC plan benefits from his or her general assets. Upon your death, your beneficiary receives the promised level of death benefits from the life insurance policy, and your employer receives the balance of the policy proceeds. The life insurance benefits are tax-free. By funding an NQDC plan with split dollar life insurance, you can receive death benefit protection under the life insurance policy along with deferred compensation under the NQDC plan, and your employer can recoup all or part of the cost of providing these benefits.

> **Caution:** Be sure to consult your legal and financial advisors before implementing a split dollar plan. The IRS has issued regulations that have significantly changed the tax treatment of split dollar life insurance. Also, in some cases, the Sarbanes-Oxley act may prohibit public companies from implementing certain forms of split dollar plans. For more information, see Split Dollar Life Insurance, Including Nonqualified Deferred Compensation Plans.

Secular trusts

In general

A secular trust is an irrevocable trust that your employer establishes with a third party to hold assets for the exclusive purpose of paying for your NQDC plan benefits. A significant feature of the secular trust is that participants generally have a nonforfeitable and exclusive right to the contributions made to the trust and to the earnings on those contributions. This stands in contrast to the rabbi trust, where plan assets remain subject to the claims of your employer's general creditors, and your benefits may be lost in the event of your employer's insolvency or bankruptcy.

> **Tip:** Although your employer establishes the secular trust for your benefit, you may be treated, for tax purposes, as having established the trust.

Why would you want your employer to establish a secular trust?

A secular trust can provide you with the assurance that your NQDC plan benefits will not be at risk as a result of your employer's unwillingness or financial inability to pay the benefits at a future time. Unlike assets that are within a rabbi trust, secular trust assets are not subject to your employer's creditors' claims. The secular trust assets must be used for the exclusive purpose of paying benefits due under the NQDC plan.

Disadvantages of a secular trust

The IRS taxes you each year on what could be sizable income. Unfortunately, you don't receive the cash to pay the tax on that money until NQDC plan distributions are scheduled to occur. However, the plan may be designed so that you may receive a distribution from the trust to pay the taxes. Alternatively, your employer may pay you a bonus that covers your tax liability.

Types of secular trusts

There are two types of secular trusts: an employer secular trust and an employee secular trust. An employee secular trust arrangement allows you to choose to receive cash compensation or contributions to an irrevocable trust that your employer establishes for your exclusive benefit. The trust is not subject to your employer's creditors, and your employer's role is as administrator of the trust. An employer secular trust is similar, but you don't have the choice to receive cash instead of your employer's contribution to the irrevocable trust. In both cases the trust assets are placed beyond the reach of your employer and your employer's creditors.

IRS tax treatment

The use of a secular trust creates a funded plan for tax purposes. In general, this means that your employer's contributions to a secular trust are includable in your income in the year they're made to the trust or, if later, in the year you become vested in the contributions. The taxation of secular trusts is complex.

Secular annuities

A secular annuity may be used in lieu of a secular trust, or in conjunction with a secular trust. A secular annuity is an annuity your employer purchases in your name that that is either a standalone benefit, or secures the benefit promised by your employer under a related NQDC plan. While there are a number of variations, typically you own and control the annuity contract, and your employer must rely on the premature withdrawal tax and the policy surrender charges to deter you from surrendering the contract for its cash value. If your employer wants more control over when you can receive the annuity proceeds, your employer might place the secular annuity inside a secular trust. By doing this you would generally not be entitled to distributions until the time specified in the plan and trust documents.

A secular annuity creates a funded plan for tax and ERISA purposes. The use of a secular annuity places the NQDC plan assets beyond the reach of your employer's creditors and provides full security to you that your NQDC plan benefits will be paid (subject to the solvency of the insurer). However, placing the assets beyond the reach of your employer's creditors generally causes you to be immediately subject to federal income tax on your employer's premium payments. Any increase in the cash surrender value is generally tax deferred until you begin receiving payments from the annuity contract.

> **Caution:** Distributions from a secular annuity may be subject to a 10 percent early distribution penalty if made before you reach age 59½, unless an exception applies.

What is a supplemental executive retirement plan (SERP) plan?

A supplemental executive retirement plan (SERP) is simply an unfunded NQDC plan that provides you with benefits that supplement benefits you are entitled to receive under your employer's qualified retirement plan. A SERP can be either a defined benefit plan or a defined contribution plan.

> **Tip:** The term SERP is also sometimes used more broadly to refer to any NQDC plan that provides unfunded deferred compensation benefits to a select group of management or highly compensated employees (i.e., a top-hat group).

What is an excess benefit plan?

An excess benefit plan is a special kind of NQDC plan. An excess benefit plan is designed solely to provide you with NQDC plan benefits in excess of the limits that apply to qualified plans under IRC Section 415. Section 415 limits contributions to defined contribution plans (like 401(k) plans and profit-sharing plans) for 2008 to the lesser of $46,000 ($45,000 in 2007) or 100 percent of pay (plus any age-50 pre-tax catch-up contributions). Section 415 limits benefits from defined benefit plans to the lesser of $185,000 (for 2008, $180,000 for 2007) or 100 percent of your average compensation for your high three years. Excess benefit plans are different from other NQDC plans because if unfunded they are entirely exempt from ERISA, and even if funded are exempt from most

ERISA requirements. Also, unlike other unfunded NQDC plans, an unfunded excess benefit plans does not need to limit participation to a select group of management or highly compensated employees even though typically only highly compensated employees will be impacted by the Section 415 limits.

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