Nonqualified Deferred Compensation

Are your clients looking for creative ways to attract, retain, motivate and reward key employees?

Would they be interested in implementing a plan to defer compensation and the tax on that compensation to a later date?

If so, a nonqualified deferred compensation plan might be the answer.

A well-designed nonqualified deferred compensation plan empowers a business owner to recruit, reward and retain key employees by extending to them financial benefits and incentives.

In addition, a business structured as a C corporation can design a nonqualified deferred compensation plan to allow the owners to defer compensation to a later date, when more advantageous. If a business is structured as a partnership, an LLC taxed as a partnership, or a corporation taxed under Subchapter S, an owner-employee or controlling shareholder generally will not benefit from a nonqualified deferred compensation plan.

What is a Nonqualified Deferred Compensation Arrangement?

The arrangement is a contractual promise between the employer and a select employee or a group of highly compensated employees. The agreement specifies when and under what circumstances future compensation is paid. When done properly, the participant or their heirs will be able to postpone federal income tax on the amounts until the benefits are paid. The promised amounts can be stated as a specific amount, ("defined benefit"); or as an account balance that is growing at a specified rate, ("defined contribution"). Either way, it is critical that these amounts are subject to a substantial risk of forfeiture or they become immediately taxable, even if the participants are not currently receiving benefits.

Design Considerations

The American Jobs Creation Act of 2004 enacted new Section 409A of the Internal Revenue Code. This new code section significantly changed nonqualified deferred compensation rules. If a plan fails to meet the new rules, compensation deferred under the plan becomes immediately taxable, and penalties and interest apply. All plans had to comply with the final regulations under IRC Sec. 409A as of January 1, 2009. Therefore, it is crucial for your clients to work with trusted advisors. In addition to complying with these new regulations, your clients should consider the following design considerations:

- Eligibility of key employees, while considering that the plan must restrict benefits to upper management and highly compensated employees;
- The conditions that would forfeit future benefits;
- Incentives that the benefits are based upon; and
- Vesting of benefits

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The preceding summary is intended to be a general discussion of the topic presented, and is based on our current understanding of applicable tax laws, regulations and rulings. In actual practice, the transaction discussed may be more complex and will require the attention and expertise of professional advisors. In no way should this summary be construed to constitute tax or legal advice. For Advisor Use Only.

Funding of Arrangements

Plans can either be classified as a funded or unfunded arrangement. As the name implies, an unfunded plan has no specific reserve set aside to fund the plan. It is an unsecured promise, and the assets targeted to fund the plan are general assets of the business and subject to creditors. If the plan is funded with a specific reserve, deferral of taxation is more complicated because the plan must demonstrate a substantial risk of forfeiture. For this reason most plans are considered unfunded arrangements.

Meeting the Employer's Obligation

A deferred compensation plan will create a deferred liability to the business, and most will choose to set aside funds to meet these obligations. It is important to remember that the plan will, in most instances, be an unfunded plan and the assets set aside are a general asset of the business, subject to creditors. Also, the business should hold all rights to the fund and should not grant any vesting rights in any of the assets to the participants before benefits are paid.

Because of its unique characteristics, life insurance is the most commonly used asset to "informally fund" an unfunded deferred compensation plan. The cash values grow tax deferred, tax-free death benefits create an immediate fund to pay survivor benefits to heirs, and cash values can be accessed tax free to pay retirement benefits via withdrawals and policy loans if the policy is not a Modified Endowment Contract. It is important to note that if life insurance is used to informally fund the plan, the employer must comply with the notice and consent requirements of IRC Sec. 101(j). If not, the employer would lose many of the tax advantages life insurance can offer. Remember, the life insurance policy is not the plan; it's a general asset of the business.

Participant Taxation

The amounts in an unfunded arrangement are generally includible in the participant's gross income for the year they are actually or constructively received. A funded plan must make sure there is a risk of forfeiture or the plan becomes taxable immediately.

In addition to adhering to the new 409A rules, nonqualified deferred compensation plans must meet three conditions in order to avoid immediate taxation:

1. The income deferral was agreed upon before compensation was earned;
2. The deferred amounts were not unconditionally placed in escrow or trust; and
3. The employer's promise to pay was merely a contractual obligation and was unsecured.

The new IRC Sec. 409A may be a little intimidating to some employers, however with the help of trusted advisors, it should not present any hurdles to accomplishing the objectives of most small employers whose stock is not traded publicly. If the objective is to tie the key employee to the owner's business, nothing in the marketplace can accomplish this as effectively as nonqualified deferred compensation. The future payments are the "carrot," and the plan and the conditions of the plan are the "golden handcuffs" keeping the key employee as a valuable member of the operating team.

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