Non-Qualified Deferred Compensation Plans

Why Establish a Non-Qualified Deferred Compensation Plan?

- Shelter current compensation from federal and state income taxation.
- Shelter earnings on assets in plan from current taxation at individual rates.
- Realized gains are taxed as received to the sponsoring employer.
- Shelter over and above the amount allowed by limits on qualified 401(k), profit sharing and pension plans.
- Shelter income from current income taxation in hopes of lower tax rates at retirement.
- Plans not subject to most ERISA rules, IRS nondiscrimination or coverage rules, vesting rules, funding rules, distribution or minimum required distribution rules.
- Individual plans with differing features and design can be established for each executive.

What Are The Mechanics?

- The employee signs agreement to defer a portion of income not yet earned.
- Alternatively, the employer can set aside assets for selected employees and promise to pay them at a later time, or upon the satisfaction of defined criteria.
- The employer contractually promises to pay the income to the employee at a later date, next year, a number of years in the future, at retirement or some other chosen date. The date must be indicated at the time of the deferral or specified by the plan.
- The employer retains the compensation deferred by the employee or contributed by the employer and normally agrees to credit it with interest or the gain that might be achieved if the money had been invested in mutual funds. The employer can also invest the assets and credit the return to the plan or fund the plan with employer stock.
- The employer can set up a trust, known as a rabbi trust, to hold assets and even allow participants the right to control the investment of the assets to achieve a desired return. The rabbi trust provides some protection from a change in

management or even change in control of the employer.

- At the date chosen by the employee to receive the deferred compensation or specified by the employer in the plan document, the employer will pay the compensation (and earnings) and withhold appropriate federal and state income taxes just as would be done for wages.

What Are the Rules?

- Must comply with IRS "constructive receipt" and "economic benefit rules" and the new rules of Internal Revenue Code Section 409A.
    - Constructive receipt requires deferral of income "before" it is earned and within the control of the executive to determine when and how to receive it.
        - Code Section 409A translates this to a requirement to execute an agreement to defer income before the commencement of the tax year in which the income is to be earned.
        - In the case of an employer funded plan, the employee may be given the choice of the time and/or manner in which the funds are to be paid out. An election governing both must be made in the tax year before the tax year when the compensation will be paid or the employer will make the contribution. Alternatively, the plan can specify the manner of payment.
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        - In the case of a bonus based on performance, the election to defer must be executed at least six months before the end of the performance measurement period for which the bonus will be paid.
        - IRS rules allow newly eligible executives to execute an agreement within 30 days of first becoming eligible.
    - Economic benefit arises when the executive derives some value from the deferred compensation even though the income has not been constructively or actually received, i.e. pledging the account for loan collateral, investing the assets in mutual funds chosen by the executive.
        - Seldom arises.

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- Plan must be unfunded, remain an asset of the employer until paid and subject to the demands of general creditors in the event of insolvency of the business.
  - An employer can invest in mutual funds or any other asset to pay the obligation arising later.
  - Executive can buy, if available, private insurance to protect deferred compensation benefits.
  - Some employers place assets in a "rabbi" trust. This trust remains an asset of the employer subject to the demands of general creditors but it protects the assets in change of control or change of management situations. The rabbi trust does not violate the unfunded nature of the plan.
- Executive retains an unsecured promise to pay from the employer for the amount of benefits due.
- Plan must cover no more than a "select" group of "management" or "highly compensated" employees.
- Plans subject to state fiduciary and contract laws.

How Is Deferred Compensation Taxed?

- Amounts contributed are subject to FICA taxes and Medicare taxes when contributed, or if later, when vested.
- Amounts distributed are subject to ordinary federal and state income taxes when received.
- The employer is entitled to a deduction when the deferred compensation is paid to the executive.
- If the employer invests to defray the later expense, any realized gains on the invested assets will be taxed to the employer in the year realized.
- Distributions are not eligible for any special tax benefits and cannot be rolled over to any retirement plan or IRA.

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Are There Reporting and Disclosure Requirements?

- Within 120 days of adoption of the Plan, a one page filing must be made with the Department of Labor containing the name and address of the employer, the employer's EIN, a statement that the employer is maintaining a plan primarily for providing deferred compensation for a select group of management or highly compensated employees, a statement of the number of such plans maintained the number of employees in each. If this statement is not timely filed, the plan is required to file annually Form 5500 with the Department of Labor.

- No other federal reporting requirements are applicable to the plan.

- There is no requirement for summary plan descriptions (SPDs) to be distributed to employees, but many employers draft and distribute SPDs.