Nonqualified Deferred Compensation Plans 101

Benefits and pitfalls to offering a NQDC to participants.

By Matt Maier (Lead Writer), with Colleen Houlihan, Eric Green, and Lee Nunn

PSCA Foreword

In mid-2015, PSCA's leadership approved the formation of the Non-Qualified Deferred Compensation (NQDC) Committee. This committee is led by Bruce McNeil, Partner at Littler and Committee Chair, and Matt Maier, Managing Director at SageView Advisory Group and Committee Vice Chair.

The committee includes plan sponsor representatives from Microsoft, ExxonMobil, Ingredion, National Grid, and Rexnord, as well as subject matter experts from King & Spalding, AonHewitt, and Principal Financial Group.

The NQDC Committee is currently working on several projects that are valued by PSCA's members, including a beginner's workshop for NQDC Plans and Executive Comp. The present article is the product of collaboration between: Matt Maier, SageView Advisory Group (team leader); Colleen Houlihan, Ingredion; Eric Green, Rexnord; and Lee Nunn, AonHewitt.

With people living longer and retiring earlier to more active lifestyles, 401(k) plans and social security payments cannot provide enough retirement savings for the highly compensated. Nonqualified plans offer a tax efficient way to fill the retirement gap.

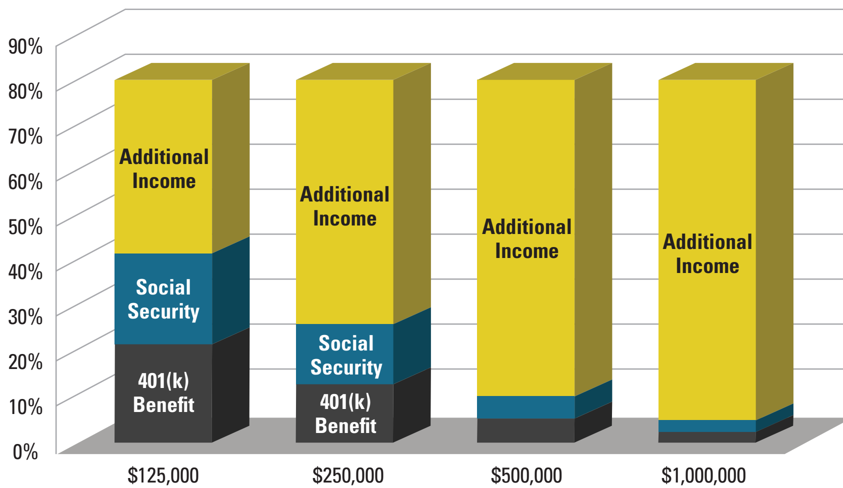
Nonqualified deferred compensation ("NQDC") plans were developed to offer highly-compensated employees a pre-tax savings opportunity commensurate to their income. NQDC plans are exempt from most provisions of ERISA (the Employee Retirement Income Security Act of 1974) because they are only available to a select group of management and/or highly-compensated employees and are not "qualified" employee benefit plans.

Overview of Benefits

Benefits to Employer	Benefits to Employee
• Plan sponsor defines and controls eligibility to participate • Not subject to ERISA compliance testing, form 5500 or audit requirements • Most plans are designed to attract, retain and reward key employees • Align corporate and executive interests by connecting performance and accountability to compensation • Ability to restore benefits lost to an employee under a tax-qualified plan	• No deferral limit — up to 100% of compensation can be deferred • Ability to reduce current income tax liability • Contributions grow tax deferred • Investment Flexibility • Access to funds prior to age 59½ without IRS early withdrawal penalty • No minimum distributions required at age 70½

Why NQDC Plans Make Sense for the Highly Compensated

- Qualified retirement plan regulations restrict contributions and distributions:
  - 401(k) contribution cap for 2015 is $18,000 ($24,000 for those age 50 and over)
  - Pre-age 59½ distribution penalties
- Personal investment alternatives cannot replicate the economics and tax- efficiencies of employer-sponsored benefit plans. A variety of factors prevent the accumulation of adequate savings:
  - Increasing State Income Tax rates: 5 percent to 11 percent or more (New York, Illinois, California, etc.)
  - High Federal income tax rates: top marginal income tax bracket is 39.5 percent.
  - A 3.8 percent (began in 2013) investment tax for joint filers with more than $250,000 of income.
  - The capital gains tax rates rose to 20 percent in 2013 for joint filers with more than $250,000 of income.
  - These combined taxes could make the total marginal rate approximately 52 percent, depending on the state of residence.



- A 401(k) plan and social security will likely provide only a small fraction of the income replacement needs for highly-compensated professionals. If the target for retirement income is 80 percent of final compensation, the need for supplemental savings increases dramatically with income. NQDC plans are tax-deferred ways to fill the "Additional Income" gap.

Pitfalls and Considerations

While there are numerous benefits for both the employee and employer, careful consideration should be given to avoid needless pitfalls.

For the Participant:

- Rollovers to IRAs are not permitted
- Subject to Section 409A regulations (Participant must make annual deferral and distributions elections. Distribution elections cannot be accelerated)
- Limited ERISA Protection — assets financing the plan, including employee salary deferrals, are owned by the company and are subject to the company's creditors. This means a participant's interest in their account balance is equivalent to that of a general unsecured creditor.

For the Employer:

- The company does not receive a current tax deduction on income deferred; the deduction is delayed until the deferred income is distributed.
- Generally, deferred compensation plans are informally funded through corporate assets, corporately owned insurance contracts, or both.
- If the plan is informally funded with taxable investments (i.e., mutual funds), the company recognizes taxable gains on those assets in the period they occur.

Plan Eligibility

ERISA rules stipulate that the highly compensated are not allowed to contribute any more than $18,000 into the company's 401(k) ($24,000 if you are over 50) in 2016. NQDC plans can be offered only to those the company deems eligible. ERISA clearly states that the plan must be intended for a "select group of highly compensated and/or management employees."

As a rule of thumb, highly compensated is defined as employees who earn in excess of $120,000 in annual salary. To be safe, companies should consider only making these plans available to those employees who are deemed to be highly compensated and are considered to hold a management role or title.

How are Rabbi Trusts Used to Fund Nonqualified Deferred Compensation?

A rabbi trust is intended to provide a degree of security that accumulated deferred compensation benefits will actually be paid. In short, companies make cash contributions to such a trust to fund their future obligations and pay deferred compensation benefits as they come due. Typically, amounts may be invested by the trustee in accordance with participant investment direction.

Amounts contributed to an irrevocable rabbi trust may not revert to the employer until all nonqualified deferred compensation benefits have been paid to eligible participants. This feature protects participants against the employer reneging on its promise to pay deferred compensation benefits, which is often considered especially important in the context of a hostile change in control. Nonqualified deferred compensation plans frequently provide that, upon a change in control, the employer will fully fund its deferred compensation obligations through the rabbi trust.

The assets of a rabbi trust are subject to the claims of creditors. If the employer establishing the trust becomes insolvent or bankrupt, the assets of the trust are available to satisfy claims of general creditors.

Conclusion

A successfully-designed nonqualified deferred compensation plan is based upon clearly-defined corporate goals prior to plan design and implementation. NQDC plans can play an important role in an organization's compensation and benefit program by improving their ability to recruit, motivate, and retain top-notch talent. These plans offer companies a flexible, less restrictive way to provide highly-compensated employees with an additional opportunity to save for retirement and other life goals.