

# INTRODUCTION TO NON-QUALIFIED DEFERRED COMPENSATION PLANS<sup>1</sup>

By: Willms, S.C.

## Why Deferred Compensation?

Simply stated, a non-qualified deferred compensation plan is an arrangement whereby compensation earned by an employee in one year is paid to him or her in a later year. Because non-qualified deferred compensation plans are not subject to the complex and burdensome rules imposed on qualified retirement plans, such plans offer an employer a unique opportunity to provide a benefit that is tailored to meet its specific objectives.

## Advantages of Non-Qualified Plans

Both employers and employees have much to gain from a properly structured "pay me later rather than pay me now" plan. The advantages associated with non-qualified deferred compensation plans include:

- \*The employer can pick and choose which employees are to be covered by the plan.
- \*The plan can provide supplemental retirement income to highly paid employees.
- \*Employers can offer greater compensation packages and thereby compete for "top performers."
- \*The plan can act as a "golden handcuff" for key employees by tying retirement benefits to continued employment.
- \*The plan can protect existing management in the event of an unfriendly takeover (sometimes referred to as a "golden parachute").
- \*The plan can be structured to allow the employer to recoup its investment in the plan.
- \*Plan assets are corporate assets, remaining on the balance sheet.
- \*The plan may reduce the need for additional personal life insurance, which the employee must otherwise pay for with after-tax dollars.
- \*The plan can help the employee avoid a variety of penalty taxes, which may be imposed on qualified retirement benefits.

---

<sup>1</sup> We cannot guarantee that this information is consistent with current law. Please contact Willms, S.C. for current information on this topic.

## **Taxation of Non-Qualified Deferred Compensation Benefits**

Employers are entitled to an income tax deduction in the year the benefits are includable in the employee's income, so long as the amounts contributed represent "reasonable compensation."

Employees must include deferred compensation benefits in income in the year the benefits are either actually or constructively received. (Constructive receipt is avoided by limiting the employee's access to those assets held in the plan, and subjecting those assets to the claims of the employer's general creditors.) If the employee has lower taxable income when the benefits are received, as is normally the case during retirement, they may be taxed at lower rates.

The advent of lower tax rates and fewer tax brackets has mitigated this traditional income tax advantage in some cases. As a result, some employers have enacted deferred compensation arrangements where income is recognized currently, accelerating the deduction to the employers.

Amounts received after the employee's death must generally be included in the designated beneficiaries' taxable income. However if the employee's benefits were not vested, up to \$5,000 can be excluded from income.

### **Determining the Plan Benefit**

Perhaps the most common method used to determine the amount of benefits to be paid under a deferred compensation plan is to tie those benefits to salary. There are two types of salary-based plans.

The first, known as a Salary Reduction Plan, involves a voluntary reduction in the employee's compensation in order to fund contributions to the plan. The second, known as a Salary Continuation Plan, entails the employer making a contribution calculated to provide the employee with a specific benefit upon retirement.

A stock-based plan can motivate employees by tying retirement benefits to the employer's success. Under such plans, the employer can either sell the employee stock at a bargain price (known as a Stock Restriction Plan) or grant the employee the right to purchase stock at a given price at a given time (known as a Stock Option Plan). In either event, the benefit is subject to certain conditions, such as continued employment with the company. If the condition is not satisfied, the benefit is forfeited.

Under a stock based plan the employee owns corporate stock and, therefore, will be entitled to look at corporate records, attend shareholder meetings, etc. However, a non-qualified deferred compensation plan can be tied to the value of the employer's stock without the employee actually receiving stock.

For example, under a phantom stock plan, the employer credits the employee's account with hypothetical shares of its stock. Upon retirement, the employee receives cash equal to the then value of the stock and any dividends, which may have been credited to his other account, provided certain requirements are met (such as continued employment with the company).

### **Securing the Promise**

A non-qualified plan can be either "funded" or "unfunded." A "funded" plan is one where the employer has set aside money or property for the employee's account in ways that protect the fund from the employer and the employer's creditors. If a non-qualified plan is funded, the contributions will be taxable to the employee when made, unless the employee's rights are subject to a substantial risk of forfeiture. Funded plans are also subject to the same vesting and fiduciary requirements imposed on qualified plans.

Most non-qualified retirement plans are "unfunded"; that is, plan assets continue to be subject to the discretion of the employer and to the claims of the employer's general creditors. Unfunded plans offer the least security to employees because the employer may lack the funds necessary to meet its obligations under the plan, or may simply refuse to make the payments because of a change in policy or management.

If a funded plan is inappropriate but additional security is desired, a "Rabbi Trust" should be considered. A Rabbi Trust is an irrevocable trust established to receive employer contributions. Amounts contributed to the trust can be utilized only to pay the promised benefits or to pay claims of creditors.

### **Conclusion**

Non-qualified deferred compensation plans provide a unique opportunity for employers to provide additional benefits to key employees on a tax-favored basis. Offering such benefits can be essential to the recruitment, motivation and retention of key employees.