

# Nonqualified Deferred Compensation in a Nutshell

The following is a review of nonqualified deferred compensation – what it is, how it works and the benefits to employers and employees.

## **What Nonqualified Deferred Compensation is:**

A nonqualified deferred compensation (NQDC) arrangement is simply a means of supplementing an executive's retirement income and providing survivor benefits. It is a contractual fringe benefit arrangement under which an employer promises to pay specified benefits to an executive in the event of disability, retirement or other future separation from service.

In other words, NQDC is an arrangement where an employer promises to pay an employee in the future for services rendered currently. Should the executive die prior to retirement, specified amounts would be paid to the executive's beneficiaries.

Employers use this selective fringe benefit as part of an overall compensation package to attract, motivate and retain key executives.

Since an NQDC arrangement is simply a "substitute" for, or supplement to, current compensation, it is possible to obtain a better balance between present earnings and future retirement income. The deferred benefits, instead of being paid and taxed now, are received after retirement. This maximizes the value of the executive's chief asset, his or her earning power, and lessens the need to personally accumulate retirement funds.

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**The information provided is not written or intended as specific tax or legal advice. Individuals are encouraged to seek advice from their own tax or legal counsel. Individuals involved in the estate planning process should work with an estate planning team, including their own personal legal or tax counsel.**



Once an NQDC arrangement is adopted for one or more selected executives and implemented by a written agreement, the employer incurs a future liability to make specified payments. It is a sound business practice to hedge this liability by establishing some type of reserve fund from which the payments can be made.

Although they must be “unfunded” and employees receive only an unsecured promise from the employer, the benefit obligation may be “financed” through a planned investment strategy.

Life insurance is ideally suited for this purpose and is recognized as one of the most practical and economical methods of ensuring the funds for such arrangements. Further, since they provide pre-retirement salary-continuation death benefits to the executive’s family, life insurance can fully and instantly create the funds necessary to complete the arrangement. The income tax-free death proceeds received by the corporation will offset its after-tax cost of providing these benefits. (In some cases, the alternative minimum tax may apply.)

### **NQDC in Action**

Here is an example of how an arrangement would work:

Wishing to retain the services of one or more valued executives, ABC corporation establishes an NQDC arrangement under which it agrees to pay \$50,000 per year for 10 years beginning at age 65, provided the executive remains with the corporation until retirement. If death occurs before retirement, \$50,000 will be paid each year for 10 years to the executive’s family, and in the event of death during the retirement pay-out period, any remaining payments will be continued to the family or estate.

To help meet its obligation, ABC purchases a life insurance policy on the executive’s life. ABC will be the owner and beneficiary of the policy. While ABC cannot deduct the premiums it pays, the income benefits eventually paid to the executive or his or her family can be tax deductible as

payment of reasonable compensation. Benefits received by the executive or family are taxable as ordinary income. Meanwhile, the executive can feel secure knowing that ABC corporation has a means to help pay for future benefit payments.

### **Advantages to the Employer**

For an employer, an NQDC arrangement:

- **Attracts talented people** – High-caliber employees are always in demand. To compete successfully for new employees, employers must offer attractive compensation packages;
- **Retains key employees** – The payment of NQDC benefits is usually contingent upon performance. For example, the employee will receive the promised retirement and death benefits only if actively employed at the time payments commence;
- **Is a selective fringe benefit** – The employer is not required to include all employees in this program. The executives know they are among the “chosen few” selected to participate in the program;
- **Is a flexible fringe benefit** – An NQDC arrangement can be individually tailored to complement other salary and benefit programs. Special consideration may be given to the employee’s objectives when designing an arrangement;
- **Has a cost that may be predictable;** and
- **Offers simple administration** – These arrangements do not require Treasury Department approval. When established for select management or highly compensated employees, they are not subject to many of the requirements of the Employee Retirement Income Security Act of 1974 (ERISA). A one-time notification to the Department of Labor is required when it is first established.

## Advantages to the Employee

For an employee, an NQDC arrangement offers:

- **Pre-retirement death benefits** – An NQDC arrangement can be set up so that all or part of an employee's salary will continue in the event of pre-retirement death. The death benefit provided for the employee's family may be paid in the form of a lump sum or as salary continuation over a period of years;
- **Increased retirement income** – The living benefits provided usually entail payments for a number of years after retirement, although it is possible to continue the payments for the lifetime of both the employee and the surviving spouse. The "ceiling" imposed on qualified plan benefits make NQDC, used to supplement other retirement and Social Security benefits, particularly attractive to highly-compensated employees; and
- **Greater net income** – Net income from a deferred arrangement will often be greater than alternative planning methods.

## Recent Tax Changes Affecting NQDC Arrangements

Internal Revenue Code (IRC) § 409A was enacted to govern the structure and taxation of NQDC. This code section sets forth requirements that must be met in order to receive current tax deferrals. While this fairly new tax code section in no way should deter or reduce the value of establishing a deferred compensation program, it is critical that the client (employer) work with their tax and legal advisors to ensure complete compliance with IRC § 409A.

Due to some fairly wrongful practices by some large corporations in deceiving their employees with respect to employer-owned life insurance, the Internal Revenue Service (IRS) introduced IRC § 101(j).

The code provides that the death proceeds paid on an employer-owned life insurance contract will remain income tax free if certain conditions are met:

- The insured (employee) must be notified and consent to having the company own the life insurance on his or her life; and
  - The employee must be working with the company during the 12-month period before the insured's death; or
  - At the time the life contract was issued, the insured was a director or highly compensated employee with the employer (thus an owner, shareholder, officer, etc.).

Furthermore, each year, IRS Form 8925 must be completed by the employer's tax or legal advisor on behalf of the employer stating amongst other things:

- How many people work for the employer;
- The number of employees covered by life insurance policies owned by the employer; and
- The total amount of insurance in force.

As with IRC § 409A, 101(j) and Form 8925 should not be a deterrent in establishing a well-drafted NQDC arrangement that will help the employer to attract, reward and retain talented employees. Rather, the federal government is trying to ensure that all arrangements are fairly and properly established under a more defined system and that there is fairness and transparency toward all parties involved in the arrangement. With the help of their tax and legal advisors, each employer interested in designing an NQDC arrangement can still achieve success while complying with all the guidelines without too much extra effort.

**Conclusion:** *Of the array of nonqualified executive fringe benefit plans, an NQDC arrangement can provide significant advantages for both the employer and the employee.*



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