StatonWalsh

Financial Clarity Through Transparency

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Table of Contents

Nonqualified Deferred Compensation Plan

	Employer	Key Employee
Agreement	Agrees to pay compensation for a set period after a stated date or death.	Agrees to continue service until specified date (e.g., normal retirement age). Optional: After separation, agrees not to compete and/or to provide consultation services.
Advantages	Employer retains key employee.	Employee (or heirs) receives extra retirement benefit when tax bracket may be lower.
Taxation	Benefits paid to employee (or heirs) are deductible to employer when paid or constructively received.	Benefits are taxed when payments are made or constructively received.

How It Works

General Comments[1]

- Deferral must generally be agreed upon before the compensation is earned.
- If the plan is unfunded, the compensation is not taxable until received.
- If the plan is funded, the employee's rights must be subject to substantial risk of forfeiture and they must be nontransferable. If they are not subject to such risk or are transferable, the payments become currently taxable.
- Employer can pick and choose which employees to benefit. However, if they are not highly compensated, the plan may be subject to ERISA requirements.
- A cash value life insurance contract can be used to informally fund an agreement. It can provide the necessary funds at either death or distribution.[2]
- Nonqualified plans are not subject to the pre-age 59½ distribution penalties or the age-based mandatory distribution rules imposed on qualified plans, IRAs, etc.

[1] The AJCA of 2004 significantly changed nonqualified deferred compensation plan rules. If a plan fails to meet the new requirements, compensation deferred under the plan becomes currently taxable and penalties and interest apply.

[2] Under the provisions of IRC Sec. 101(j), added by the Pension Protection Act of 2006, death proceeds from a life insurance policy owned by an employer on the life of an employee are generally includable in income unless certain requirements are met. State or local law may vary. Professional legal and tax guidance is strongly recommended.

Protecting Deferred Compensation

Many employers seek to attract and retain executives and other key employees using a variety of employee benefit programs. Nonqualified[1] deferred compensation programs are one such employee benefit. In these plans, typically, compensation currently payable to an employee is "deferred" to a future point in time when the employee anticipates being in a lower marginal income-tax bracket.

In general, the compensation is deductible to the employer, and taxable to the employee, in the year the funds are received (or "constructively" received) by the employee.

From the employee's perspective, the key dilemma is balancing the value of tax deferral against the risk that the promised benefits might not be paid. In the future, when the payments are due, the employer may be either unwilling or unable to make them. If the employer sets assets aside in a manner which effectively secures future payment, the compensation is taxable to the employee in the year those funds are no longer at risk.

The "Rabbi" Trust – A Partial Answer

One partial answer to this problem is for the employer to set up a "rabbi" [2] trust in conjunction with the nonqualified deferred compensation plan. A rabbi trust is typically irrevocable and is commonly designed to hold assets to pay the future, promised benefits.

To preserve the tax-deferred nature of the arrangement, and avoid "constructive" receipt (the funds become currently taxable to the employee, received or not), assets in the trust must remain subject to the employer's creditors. The employer may not use the assets in the trust for its general business purposes and must include trust earnings in its taxable income.

Implemented correctly, the rabbi trust approach provides some protection against the employer being <u>unwilling</u> to pay the promised benefits; it provides no protection if the employer is <u>unable</u>, because of insolvency, bankruptcy, or creditor problems, to meet its obligations.

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[1] "Nonqualified" plans do not have to meet the same strict federal tax and other legal requirements as" qualified" plans. The fact that a benefit program is "nonqualified" frequently allows an employer to favor a few, selected employees.

[2] So called because the first such arrangement approved by the IRS was established for a rabbi.

IRC Sec. 409A

The American Jobs Creation Act of 2004 included new IRC Sec. 409A, which added to federal income tax law numerous requirements that a nonqualified deferred compensation plan must meet to avoid having deferred amounts treated as being constructively received in the current year. If these requirements are not met, all current and past-deferred compensation, plus any earnings, are included in the employee's gross income for the current tax year. Further, an additional 20% tax is levied, plus an underpayment interest penalty. State or local law may differ.

While the full scope of IRC Sec. 409A is complex, several of its provisions target efforts to protect the future payment of promised benefits. These include:

- **Offshore trusts:** Use of an offshore trust, either directly or indirectly, to fund future benefits will cause the income tax penalties in IRC Sec. 409A to apply.
- **Financial "triggers":** Efforts to distribute or secure benefits in the event the employer's financial health declines, known as financial "triggers," are similarly penalized.
- **"At-risk" qualified plans:** The Pension Protection Act of 2006 added a notable restriction, aimed at firms with under-funded qualified retirement plans. Generally, for any period in which a qualified retirement plan is "at-risk," any funds set aside in a nonqualified deferred compensation plan for high-level executives will become taxable and the 20% penalty tax and special underpayment interest penalty apply.

Seek Professional Guidance

Given the complexities involved, and because the income tax penalties for not meeting the requirements of the Internal Revenue Code are significant, competent, professional guidance is strongly recommended.

Secular Trust

Protecting Deferred Compensation

Nonqualified deferred compensation plans are often used as a fringe benefit to recruit and retain key executives.

Even if funds are set aside by the employer to meet its future obligation, the company's creditors may reach the funds if there is financial difficulty.

To protect these funds, an irrevocable arrangement commonly known as a "secular" trust can be used. The employer pays the agreed-upon contributions to the trust, which invests the funds until the executive's retirement, disability, or death.

Use of a secular trust effectively shelters the funds from a number of potential threats. Unlike the popular "rabbi" trust, funds in a secular trust are not available to the company's creditors in the event of bankruptcy. Secular trust assets are also protected against a "hostile" takeover or a management decision to use the funds for other corporate purposes. For the employee, a secular trust is more secure than a rabbi trust.

General Tax Consequences

Unlike a rabbi trust, a secular trust does not provide tax deferral. In general, the income tax[1] consequences of a secular trust are as follows:

- Funds are taxable to the employee during the year they are contributed to the plan, if substantially vested.
- The contributions are deductible to the employer in the same year they are includable in the employee's income; no employer deduction is allowed for any growth or earnings inside the trust.

Many advisors feel that future tax rates will be higher; thus, paying the tax today, at lower rates, will result in a larger fund later on. One disadvantage, however, is that the employee's present tax burden increases, but his or her currently available income does not. The employer may wish to provide an additional cash bonus to pay the extra taxes.

[1] The discussion here concerns federal income tax law; state and/or local tax law may vary.

The possible tax advantage, combined with the separation of the funds from potential corporate creditors, makes the secular trust attractive to many executives.

Form of Trust

There are two principal forms of secular trust, the "employee-funded" secular trust and the "employer-funded" secular trust. The federal income-tax ramifications of each type of trust are quite different:

- **Employee-funded secular trust:** An employee-funded trust is generally considered to be an employee-grantor trust, with the employee taxable on both trust contributions and trust earnings each year. To the extent that contributions and earnings are currently taxed, future distributions should be received free of income tax.
- **Employer-funded secular trust:** In an employer-funded trust, the employee is taxable each year on trust contributions. In certain situations, highly-compensated employees are taxed on yearly earnings, including unrealized capital gains, municipal bond income, or even the inside build-up of life insurance. Further, because the IRS considers the trust itself to be a separately taxable entity, the earnings are taxed twice, once to the employee and once to the trust. To the extent that contributions and earnings have been previously taxed to the employee, distributions should be received free of income tax.

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Assumed rates of return are not in any way to be taken as guaranteed projections of actual returns from any recommended investment opportunity. The actual application of some of these concepts may be the practice of law and is the proper responsibility of your attorney.

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