Why a Nonqualified Deferred Comp Plan may be Right for You

04.06.16

What if a nonqualified deferred compensation plan (NQDCP) enabled your senior managers to replace a higher proportion of their current income when they retire? While NQDCPs often are perceived as only for top executives, they may also be right for your upper-level staff.

Some Considerations

The issue boils down to how much your senior managers are paid, and the extent of their willingness to set aside current income for future use. NQDCPs make sense when enough employees are prepared to defer more of their income than is allowed in a 401(k) plan. “Enough” requires an assessment of how motivational this program could be for prospective participants, weighed against administrative costs involved.

One catch for both parties to consider: Compensation deferred in an NQDCP isn’t segregated from general corporate assets. Rather, it’s a number on the balance sheet. If the company goes bust, NQDCP participants will be waiting in line along with other creditors to claim benefits, if any.

Key Features

So what are some NQDCP rules? Here are some key factors to consider with this type of plan:

You decide who’s eligible. NQDCPs aren’t subject to antidiscrimination rules, so you can limit participation to the highest earners. In practice, these plans aren’t available to rank-and-file employees who don’t fall within the definition of a select group of management or highly compensated employees.

You can attach strings. Employers can establish certain grounds under which employees must forfeit accumulated NQDCP funds. For example, if you terminate an employee for cause or an employee quits and goes to work for a competitor, the plan can specify that the employee must forfeit NQDCP funds. You can also establish vesting requirements, as you can in a qualified plan.

You can grant flexibility. These plans don’t have to be used exclusively for retirement savings purposes. For example, employees can take “in-service distributions” for specified purposes — such as paying children’s college tuition bills — if the distributions are set up properly through the plan.

Corporate tax deduction deferred. The company cannot expense compensation dollars that NQDCP participants squirrel away in the plan until the employee withdraws those funds. Any earnings on deferred compensation are taxed to the corporation; however, they become deductible when paid to the participant.

Stiff penalties for premature withdrawal. If an employee opts to claim any accumulated funds before the normal retirement age (or other approved plan purpose), he or she can get hit by a 20% tax penalty, on top of a regular income tax hit, on the entire value of the deferred account — not just the amount of the withdrawal.

Balance sheet implications. Depending on whether, and the degree to which, the company earmarks dollars to nominally “fund” accruing benefits, the amount of accruing benefits may appear as a balance sheet liability. The degree of reserves set aside to cover the liability would counterbalance the balance sheet liability.

Limited funding opportunity. As noted, accumulated NQDCP benefits aren’t sealed off in a distinct trust for the benefit of plan participants, as they are in qualified plans. However, a commonly used vehicle known as a “rabbi trust” offers limited protection. Dollars assigned to that trust are no longer subject to the employer’s ability to alter the terms of the NQDCP, yet are still considered general corporate assets and subject to creditor claims in a bankruptcy.

Investment features. In some NQDCPs, the company establishes a formula that determines how deferred earnings will grow, such as pegging the rate to the yield on a 10-year Treasury bond, or a stock market index, like the S&P 500. Other plans actually set aside the deferred compensation and allow participants to select from a menu of mutual funds — mirroring the investment options in the company’s 401(k) plan.

Change in Control

Executive compensation plans typically feature change-in-control protections for covered executives, locking in certain pay features to secure promised benefits if the company is sold. NQDCPs typically have similar provisions.

However, these provisions can be troublesome to prospective purchasers of the company, knowing that their hands will be tied. A “double-trigger” change-in-control provision can alleviate that concern, providing, for example, that accrued benefits are guaranteed only for employees who leave within 18 months of the acquisition. That motivates the acquirer to give employees a chance to prove themselves before deciding whether to terminate them.

Is it Right For You?
NQDCPs are worth considering for employers seeking ways to give highly paid employees additional tools to save for retirement on a tax-deferred basis. Ask your benefits consultant or attorney about them. Because these plans are subject to strict regulations, it’s important to make sure that both your written plan and the operation of the plan comply with the regulations.

For more information on BPM’s Employee Benefit Plan services, please visit our website or contact Jenise Gaskin at (925) 296-1040