

## Nonqualified Deferred Compensation

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### Practice Areas

• Taxation - Federal, State & Local

Nonqualified deferred compensation ("NQDC") arrangements for executives have become very popular due to federal pension law ("ERISA") limits on the amount of contributions and benefits available under traditional qualified retirement plans. For example, it is common for total retirement income from a combination of tax-qualified plans and Social Security to constitute 70%-75% of pre-retirement income for non-executive employees but only 30%-35% of pre-retirement income for executives. Additionally, certain NQDC plans can avoid ERISA minimum coverage and nondiscrimination rules, vesting and funding rules and reporting requirements. NQDC plans can be limited to selected employees rather than the entire workforce and benefits may vary among covered employees.

The two primary goals of most NQDC plans are to defer tax on benefits payable to covered employees and to avoid coverage under ERISA rules and regulations. A "top-hat" or supplemental executive retirement plan can achieve both objectives if properly drafted and implemented. Generally, a top-hat plan is in the form of a defined benefit plan in which the employer promises to pay on an unsecured and unfunded basis a benefit equal to a specified dollar amount or a percentage of final compensation (or of final 3 or 5-year average compensation). Typically, the benefit is subject to a vesting schedule and may be 100% forfeited if the executive terminates employment prior to a designated age for reasons other than death, disability or change of corporate control.

A top-hat plan is not subject to ERISA (except reporting and disclosure requirements) if it is unfunded and is limited to management or highly compensated employees. A funded top-hat plan or an unfunded top-hat plan which covers one or more employees who do not qualify as management or highly compensated employees is subject to ERISA's participation, vesting, funding, reporting and other rules.

Although a top-hat plan may qualify for exemption from most of ERISA rules, an unfunded top-hat plan is required to file an annual report on Form 5500. In addition to IRS penalties, failure to file can result in DOL penalties as high as \$300 per delinquent day per plan, up to \$30,000. Top-hat plans are eligible for a full exemption from filing Form 5500 if they file a simple statement with DOL within 120 days after the adoption of the plan disclosing the name, address and IRS identification number of the employer, a declaration that the employer maintains the plan primarily for the purpose of providing deferred compensation for a select group of management or highly compensated employees and the number of employees in the plan.

In most cases, executives really don't want to defer compensation; they want to defer the tax on compensation. Deferring the receipt of compensation is the price paid to achieve tax deferral. Normally, an employer's unsecured promise to pay an employee compensation at some future time does not result in taxable income to the employee until the compensation is actually received. The IRS can tax compensation to the employee before it is actually received if it is credited to his account, or otherwise made available so that he may draw upon it at any time, that is, if the employee's interest is substantially vested when payment by the employer is made. An interest is substantially vested if it is freely transferrable or not subject to a substantial risk of forfeiture. However, the IRS has ruled that even though an employee's rights may be or become nonforfeitable, the employee will not be currently taxable if the deferred compensation agreement is entered into before the compensation is earned, the employer's promise to pay is not secured in any way and the employee's rights to benefits under the plan are non-alienable and non-transferrable. Thus, a typical unfunded top-hat plan should accomplish tax deferral for the employee. Non-qualified plan deferrals after December 31, 2004 are subject to special requirements which, if not satisfied, can result in current income inclusion as well as interest and penalties under new Section 409A of the Internal Revenue Code. All existing deferred compensation plans need to be reviewed that they either comply with new Section 409A or to determine what remedial changes may be necessary.

Unlike the tax treatment under qualified retirement plans, the employer is not entitled to a tax deduction

until the year the employee includes the payment in his income. However, to be deductible, the benefit payments must represent reasonable compensation and constitute an ordinary and necessary business expense. Hefty deferred compensation benefits to a shareholder-employee could be construed by the IRS as a nondeductible dividend to the shareholder rather than compensation, especially if the NQDC plan is instituted just prior to the shareholder-employee's retirement. What is "reasonable" is a question of fact in each case.

Executives covered by NQDC plans, especially unfunded plans, face the risk that the employer may refuse to pay benefits (for example, a change of heart or following a corporate change of control) or that the employer may be unable to pay benefits due to a change in financial conditions. Accordingly, there is a growing trend to attempt to "informally fund" or secure the promise to pay NQDC without jeopardizing the tax deferral to the employee or ERISA exemption.

Permanent cash value life insurance is a popular method of informally funding NQDC. The employer is the owner and beneficiary of a policy on the executive's life and pays the premiums. The Department of Labor (DOL) has indicated such an arrangement is not a "funded" plan for ERISA purposes. If the employee dies while employed, the employer receives the insurance proceeds to pay any death benefit due to the executive's beneficiary. The cash surrender value of the policy is available to the employer to pay lifetime benefits to the former executive. Assuming the executive has no vested right to receive payment from the policy, the premium payments should not be taxable to the employee nor deductible by the employer. However, benefit payments should be deductible by the employer but taxable to the recipient when paid.

Nonqualified trusts are being used with frequency to help executives enforce payment in the event of a refusal to pay or inability to pay by the employer. These trusts may be designed as unfunded or funded for tax and ERISA purposes, with the degree of security varying accordingly. The trusts may be revocable or irrevocable. The executive's interest may be subject to substantial risk of forfeiture. There are three basic types of trusts being used - the Rabbi trust, the Secular trust and the Rabbicular trust.

A Rabbi trust is usually an irrevocable trust created by the employer in which assets are irrevocably segregated by the employer in a separate trust administered by an independent Trustee. The trust assets remain the property of the employer and can be seized by the employer's creditors and applied to pay claims if the employer becomes bankrupt. However, the assets are not available to the employer for its general use. A properly drafted Rabbi trust is not a "funded" plan for ERISA purposes. These trusts have become so popular that the IRS has released a model trust instrument to aid taxpayers and expedite IRS ruling requests. Although the Rabbi trust does not shield plan benefits from the employer's creditors, it does protect the executive from nonpayment due to a change of control in the employer's management or ownership or a "change of heart" on the employer's part as to its promise to pay benefits.

A Secular trust is a trust in which the executive's interest vests either immediately or upon the happening of one or more events, such as the attainment of a stated age, change of control, termination of employment, death, disability, etc. The trust assets are separate from the company's assets and cannot be seized by the employer's creditors. Thus, a Secular trust may provide protection to the executive against the company's nonpayment of benefits due to both a refusal to pay and an inability to pay. If the Secular trust provides full and immediate vesting, it is probably "funded" for tax and ERISA purposes and contributions by the employer would be currently deductible and taxable to the employee.

A Rabbicular trust is a hybrid of the Rabbi and Secular trusts. The trust is designed as a Rabbi trust until the occurrence of an event indicating financial difficulty of the employer (short of bankruptcy), such as a stipulated decline in debt-equity ratios, net worth, gross sales, earnings per share, etc., and when the event occurs, the trust becomes a Secular trust and the executive is given the right to withdraw benefits. The objective is to protect the assets from the claims of the employer's creditors if events occur which make insolvency likely, but to take advantage of the tax deferral and ERISA exemptions until that time. However, federal bankruptcy laws permit the bankruptcy Trustee to reclaim any transfer made within ninety (90) days of the employer's bankruptcy (or within one (1) year for transfers to insiders).

NQDC agreements provide opportunities to compensate executives without having to cover all other

employees. However, if the plan and its implementation are not handled properly, the goals of tax deferral and ERISA exemption may be jeopardized. NQDC agreements should be reviewed before implementation by competent legal counsel to assure the desired benefits.

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