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Nonqualified Deferred Compensation Plan

Pros and Cons for the Employee and Employer

A Nonqualified Deferred Compensation Plan (NQDCP) is an agreement between employer and employee to defer a portion of the employee's annual income until a specific date in the future or until a specific event occurs in the future. Many employers use a NQDCP to help attract, retain, and reward executives. When establishing a NQDCP there are few requirements that must be satisfied:

- Must only be available to a "top-hat" group of management or highly-compensated employees (HCE).
- This "top-hat" group should generally be no more than 15% of the total employee population.
- A statement must be filed with the Department of Labor within 120 days of plan adoption.

Pros and Cons for the Employee

The IRS imposes annual limitations on the amount an employee can contribute to a 401(k) plan. Beyond this annual limit, a traditional 401(k) plan must satisfy complex nondiscrimination testing requirements. When the nondiscrimination testing fails the HCE may receive taxable refunds of the contributions they made to the 401(k) plan thus increasing their tax exposure and decreasing their retirement savings.

Participating in a NQDCP will provide the HCE with the means to defer taxation of current income and grow retirement benefits on a tax-deferred basis where a 401(k) plan may be lacking. There are no IRS imposed limits and no nondiscrimination testing requirements. While this is appealing for many high-earners, and there are similarities to deferring compensation into a 401(k) plan, there are several important differences for the employee to consider:

- An election to defer compensation must generally be made prior to the beginning of the year and be irrevocable for the entire year;
- An election regarding the timing and form of distribution must be made at the same time as the compensation deferral election;
- NQDCP benefits are unfunded, although assets may be set aside in a trust; and
- Assets held in trust remain assets of the employer and are subject to claims of the employer's creditors.

Pros and Cons for the Employer

Unlike a qualified plan, a NQDCP is not subjected to the many rules imposed by ERISA and the Internal Revenue Code. This provides more flexibility to customize the plan to be unique to the organization and its "top-hat" employees. Benefits of this flexibility include:

- The plan can be a "golden handcuff" by offering deferred benefits that are subject to forfeiture unless certain conditions are met.
- The plan can provide highly-compensated employees an opportunity to defer compensation above and beyond that permitted in a 401(k) plan.
- Future benefits can be provided without a legal requirement to currently fund those benefits.

Although there is no requirement to do so, most employers choose to fund the benefits of a NQDCP by establishing a trust. Contributions made to a trust provide no current tax deduction for the employer as they remain assets of the employer. The tax deduction occurs when the benefits are distributed to the participant.

A NQDCP is often a cost-effective and flexible tool to provide incentives and encourage retention of valuable key employees. Through consultation with your financial advisors, accountants, and Benchmark Retirement Plan Services, Inc. representative, a NQDCP can help achieve many of your organizational objectives.