hooker & holcombe

The value of non-qualified deferred compensation plans

Most plan sponsors are familiar with qualified retirement plans – they are employer-sponsored 401(k), 403(b), and profit-sharing plans that meet guidelines set forth in the Employee Retirement Income Security Act (ERISA) of 1974.

Qualified plans enjoy attractive tax benefits that make them appealing for millions of American workers. Companies also prefer them because they receive tax breaks for contributions made on behalf of their employees. However, if you're looking to attract and retain high-ranking corporate executives and top-flight creative talent, you may want to consider a non-qualified defined contribution (NQDC) plan.

What is a non-qualified plan?

A non-qualified plan is a type of tax-deferred, employer-sponsored retirement plan that falls outside of the Employee Retirement Security Act (ERISA) guidelines. Non-qualified plans are designed to meet specialized retirement needs for key executives and other select employees and can also act as a recruitment or employee retention tool. A non-qualified deferred compensation plan is an arrangement under which an employer provides deferred compensation to an eligible employee or independent contractor. Unlike qualified plans that are subject to discriminatory and top-heavy testing, non-qualified plans are exempt from these requirements.

How does a non-qualified plan work?

The contributions made to these types of plans are usually non-deductible to the employer and taxable to the employee. However, they allow employees to defer taxes until retirement (when they are presumably in a lower tax bracket). Non-qualified plans are often used to provide specialized forms of compensation to key executives or employees in lieu of making them partners or part owners in the company or corporation. One of the other major goals of a non-qualified plan is to allow highly-compensated employees to contribute to another retirement plan after their qualified retirement plan contributions have been maxed out, which can happen quickly with highly-compensated employees.

NQDC plans vs. 401(k) plans

NQDC plans aren't like other workplace retirement plans that typically let employees defer a portion of their salary into a segregated account held in trust, and then invest these funds in a selection of investment options. Instead, an NQDC plan is more like an agreement between you and your employer either to receive an employer contribution or defer a portion of your annual income until a specific date in the future. Depending on the plan, the selected date could be in 5 or 10 years, or in retirement.

Employees have control over how much they choose to defer each year from their salary, bonuses, or other forms of compensation. Likewise, employers can make contributions to the plan on the employee's behalf. Deferring this income provides a strong tax advantage for highly-compensated employees: they don't pay income tax on the portion of their compensation in the year they defer it (they pay only Social Security and Medicare taxes for deferred income), so it has the potential to grow tax deferred until the employee receives it.

Most employers provide NQDC plans as an executive retirement benefit, simply because 401(k) plans often are inadequate for high earners to achieve their retirement goals.

Example of an executive earning $500,000 a year:

The $19,500 limit on annual 401(k) contributions represents only 3.9% of the executive's annual income. At that rate, the executive could never save enough (pretax) to make up the typical 70%–90% replacement income goal for retirement. By contrast, the executive could choose to set aside a much larger percentage of his or her salary or receive a contribution from their employer into an NQDC plan each year, creating an appropriate retirement cushion. Executives often have other after-tax savings opportunities, such as a taxable account and/or a tax-deferred annuity, but these are not considered employer plans.

Downsides of an NQDC plan

There are disadvantages of non-qualified defined contribution plans. For example, unlike 401(k) plans, an employee cannot take a loan from a NQDC plan, and they cannot roll the money over into an IRA or other retirement account when the compensation is paid to them. When an executive takes a distribution from the plan, the money is transferred from the trust to the employer and it is processed as a normal paycheck.

Unlike a qualified plan, where benefits are segregated from the employer's general assets, your deferred compensation deferred into the NQDC remains the employer's general assets and is subject to potential loss. The plan essentially represents a promise by the company to pay the executive back. At most, the company may set aside money in a trust (called a rabbi trust) to pay future benefits when they become payable. One of the key requirements of the rabbi trust is that its assets remain the assets of the employer, and that the participants in the plan do not have a priority interest in such assets as that would confer a current economic benefit on the participants. The funds in this trust are still part of the company's general assets, and would be subject to creditors' claims in a corporate bankruptcy.

NQDC plans aren't just for retirement savings. Many plans allow you to schedule distributions during the course of an executive's career, not just when they retire, so one can defer compensation to cover shorter-term goals like paying a child's college tuition. The deferral amount can also be changed by the executive on an annual basis.

Joining a NQDC plan is a personal decision, and emploiyees should weigh the advantages and disadvantages based on their individual circumstances.