PRIMARK
BENEFITS
RETIREMENT ♦ PLAN ♦ EXPERTS

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Non-Qualified Deferred Compensation Plans

A "Qualified Retirement Plan" means that the Plan meets requirement under Internal Revenue Code 401 and 501 which allows:

- Tax deductions for the sponsoring Employer when the contributions are made
- Tax deferral for the beneficiary until the beneficiary takes taxable distribution
- Rollover into IRAs
- Tax free (or deferred) investment earnings while the money is in the Trust
- Separation of the assets from the assets of the sponsoring Employer - making the funds secure from bankruptcy
- Oversight of beneficiary rights by the Department of Labor and the IRS

However, in order to achieve "Qualification" these plans must follow a lot of rules that employers can find onerous or unattractive. Chief among these rules is that the benefits must be offered on a relatively equivalent or "non-discriminatory" basis to both Highly Compensated Employees and Non-Highly Compensated Employees. In general, the benefits cannot be limited to owners, officers, and managers.

On the other hand, Non-Qualified Deferred Compensation Plans (NQDC Plans) do not have to follow non-discrimination rules, and in most cases are limited to officers and managers. Company owners will receive almost no favorable tax treatment through a Non-Qualified plan. Sole Proprietors and Partners will not benefit from NQDC plan because whatever is earned by the company is always taxed; there is no tax deferral at all.

In general NQDC plans are only a benefit for well paid non-owner employees.

NQDC Plans must still follow many rules in order to defer taxation for the beneficiaries. These rules are clarified in IRC § 409A and the resulting regulations. For example: distribution options (lump sum or annuity) must either be chosen by the plan, or must be determined before deferrals are earned or made.

NQDC Plans can also have formulas and limits that far exceed limits that are dictated by the qualified Plan rules. Since the NQDC Plans are technically not "funded," gains can be set at a theoretical rate, hooked to an index, or correspond to the actual gains experience of the "set-aside" fund. If assets are set aside to fund the benefit, these assets remain part of the company's assets, are subject to bankruptcy, and any gains or losses in the investment of these funds are taxed on the corporate level.

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Comparing the attributes of Qualified and Non-Qualified Plans

Attribute	Qualified Plans	Non-Qualified Plans
Eligibility	Must follow service and non-discrimination standards; a) cannot require more than 2 years of service, b) cannot eliminate participation of NHCEs	Eligibility may be limited to a small group of employees with no regard to service and non-discrimination rules
Funding	Employer must fund the plan by making contributions to a tax deferred Trust	Technically these plans are “un-funded”. However and employer may set aside assets for future funding
Trust Separate from Assets of Employer	Yes	No*
Gains of the Trust	Not Taxed	Gains in any set-aside fund are taxable to the Employer
Contribution Deductions	The Contributions are deductible for the Employer when made	Since the Plans are not “funded” there is no deduction for the employer until the benefits are “paid”
Employee/Beneficiary Taxation	Deferred until benefits are received	Deferred until the earlier of constructive receipt or payment*
Subject to Social Security Taxation	Generally No	Generally Yes
Tax Reporting Form	Form 1099-R	Form W-2
Transfers to IRAs or Other Tax Deferred Plans	Yes	No
Roth Treatment	Possible	Not-possible
Vesting Schedule	Must use approved schedules	Generally not vested until Termination of Employment
Contribution or Benefit Formulas	Strict limits apply	Do not need to follow Qualified Plan limits. These formulas may be very high

* Please note that any funding is not a “trust”, but a set aside that may be used for funding the benefit.

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Comparing Advantages and Disadvantages of Qualified and Non-Qualified Plans

Qualified Plan

ADVANTAGES:

- Contributions are fully deductible to the Employer
- Investment earnings are tax deferred
- Protected from Corporate bankruptcy
- Distributions may be rolled to IRAs for further tax deferral
- Good for Owners and Management Employees

DISADVANTAGES:

- Funding may be mandatory—and tends to be inflexible
- Benefits are limited by statute
- Must include a benefit to a reasonable number of Non-Highly Compensated Employees (Not an issue for Sole Proprietors with no employees)
- Limited Vesting options
- Cash Balance or Defined Benefit Plan Investments are pooled / no individual choice
  - The profit sharing/401(k) portion can have investment choice
- Rules are complicated and rigid

Non Qualified Plan

ADVANTAGES

- "Funding" is not mandatory
- Benefits are not limited by statute
- No need to include employees outside the preferred group
- May use much longer vesting requirement—"golden handcuffs"
- "Funded" plans may have individual investment choice
- Good for Non-Owner Management Employees

DISADVANTAGES

- No Tax deduction to Employer until the benefit is paid
- "Funded" investment gain is taxable to the Corporation
- Not protected from Employer bankruptcy
- Distributions may not be rolled over—taxable upon receipt
- No tax advantage for Owners

Questions for NQDC Plans

1. Name of Company/Employer:

2. Owners of Company (Reminder, Owners do not benefit from NQDC Plans):

3. Which employees do you wish to benefit through the NQDC? (Identify by name or job class)

4. What kind of contributions or benefit formula?

5. Will assets be set aside to fund the benefit?

6. Should employee/beneficiaries be allowed to "invest" the set-aside?

7. Will there be a minimum number of years to vest? Often vesting will be "100% at the later of X years of service or termination of employment"