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Nonqualified Deferred Compensation Plans Overview

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Nonqualified deferred compensation (NQDC) plans are company-sponsored benefit programs that allow participants to delay receiving income on a pre-tax basis. Since they are available only to a select group comprising senior management and other highly compensated employees, NQDC plans are exempt from most ERISA provisions.

Under NQDC plans, deferrals are not subject to statutory limits, and there is no penalty for taking scheduled distributions before age 59 1/2. (Plan balances, however, cannot be rolled over to an IRA or other qualified plan).

It is important to note that NDQC plans are informally funded contractual obligations to pay benefits. Consequently, they are not protected from creditors in the event of a company bankruptcy.

Plan Sponsor Benefits

* Powerful Motivator. Deferred compensation plans can offer additional distribution opportunities outside of retirement and, as a result, they can be a powerful "tool" in rewarding, retaining and recruiting highly desirable employees.

* Flexible. Because these plans are exempt from most ERISA requirements, companies can set eligibility to reward their most valued employees. In addition, vesting schedules can be designed to enhance retention, incorporate company stock to closely align participant and shareholder interests, match participant deferrals, or make additional contributions to specific participants.

* Cost Efficient. Companies can provide a valuable benefit to selected executives without having to increase the compensation participants otherwise would be paid. In addition, adopting informal strategies for funding a NQDC plan's liabilities can help support the promise to pay future benefits and to minimize corporate balance sheet and income statement volatility.

Plan Participants Benefits

* Tax Savings. Currently, 401(k) plans restrict pre-tax retirement savings for most participants to $18,500 ($24,500 for those over age 50). Certain NQDC plans may allow participants to defer up to 100% of their compensation, including salary and bonus.

* Increased Earnings. NQDC plans increase earnings power by taxing only deferred amounts as income at distribution. After-tax investments are taxed as income and any gains are taxed as investment returns. Consequently, both the amount that can be invested and ultimately, the after-tax earnings, assuming a positive rate of return, are greater in an NQDC plan.

* Lower Current Tax Liability. NQDC plans enable participants to defer current income taxes on compensation they place in the plan until it is distributed.

* Multiple Payout Options. Unlike 401(k) plans, NQDC plans allow participants to schedule penalty-free payouts while employed, at termination, or upon retirement, even prior to age 59 1/2. Payouts can also be made in installments, which allows the unpaid balance to continue to grow tax-deferred.

Note: Subject to maintaining IRC 409A compliance.

* Numerous Investment Options. A NQDC plan may offer a wide array of investment crediting choices. Participants can select multiple investment allocations for their balances, including different investments for different distribution timeframes.

Other Considerations

* Plan Design. NQDC plans should be customized as necessary to reflect the specific requirements and realities of the plan sponsor. In many instances, standardized solutions aren't appropriate.

* Grantor Trust Protection. Due to their unfunded nature, NQDC plans pose a greater degree of risk to participants than qualified plans. To help counter this, companies have the option of placing assets in a grantor trust.

When properly structured, such trusts can ensure that the assets will be used to pay deferral account balances, except in the event of the company's bankruptcy or insolvency, in which case assets would be subject to the claims of the company's creditors.

* "Informal" Funding. This means the company sets amounts aside as a hedge against the plan's future liabilities. Two investment vehicles often used for this purpose are corporate-owned life insurance (COLI) and taxable securities.

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