



## BUSINESS PLANNING

Nonqualified Deferred Compensation

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### NONQUALIFIED DEFERRED COMPENSATION

## SUMMARY

### WHAT IS NONQUALIFIED DEFERRED COMPENSATION?

Nonqualified deferred compensation is an arrangement established by employers to provide retirement income and often death and/or disability benefits to selected managers or highly compensated employees. When it's properly arranged, the employee can defer income taxation until the benefits are paid.

Deferred compensation arrangements are "nonqualified," which means they don't have to be preapproved by the IRS, and employers can favor selected employees without risking claims of discrimination. Also, when properly arranged, they are exempt from nearly all of ERISA's regulatory requirements.

### HOW DOES IT WORK?

A nonqualified deferred compensation arrangement typically provides that an employee will receive a stipulated sum for a fixed period of time—or for life—beginning at a future date, such as the employee's retirement. If an employee dies after payments have begun, the arrangement may direct that the remaining benefits be paid to the employee's beneficiary.

The arrangement may provide that the employee will receive future compensation as a result of a current salary reduction or in lieu of a bonus or salary increase. This is sometimes called a "true deferral arrangement."

An alternative is a "salary continuation arrangement." Here, the employer commits to pay future compensation to the employee in addition to current earnings, which aren't reduced by participation in the arrangement.

### WHAT'S THE TAX PICTURE?

Generally speaking, the deferred amounts in an unfunded plan are includible in the employee's gross income when they are actually or constructively received. The deferred amounts in a funded plan are currently includible in the employee's gross income unless they are subject to a substantial risk of forfeiture.



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The employee can lose income tax deferral if the arrangement doesn't follow the rules of IRC §409A (for example, if an employee has control over deferred amounts or has early access to them).

Amounts deferred under a deferred compensation plan will be includible in the employee's gross income for all tax years in which such amounts are not subject to a substantial risk of forfeiture if the plan fails to meet (1) distribution requirements, (2) no-acceleration-of-benefit requirements, and (3) election requirements.

The rules only permit distributions upon separation from service, death, disability, a fixed time specified in the plan, a change in ownership or control of the employer, or an unforeseeable emergency such as a severe financial hardship. Distributions at any other time will result in loss of income tax deferral.

The plan must not permit a prohibited acceleration of any payment or schedule of payments. Therefore, the plan administrator may not be given discretion over the timing of benefit payments that could result in an acceleration of payments

### WHEN SHOULD THE DEFERRAL ELECTION TAKE PLACE?

To achieve income tax deferral, the employee must generally make the election to defer compensation no later than the end of the preceding tax year.

In the first year of eligibility, the employee can make the initial deferral election within 30 days of becoming eligible and it will apply to compensation for services subsequently performed.

### WHAT'S THE CONCLUSION?

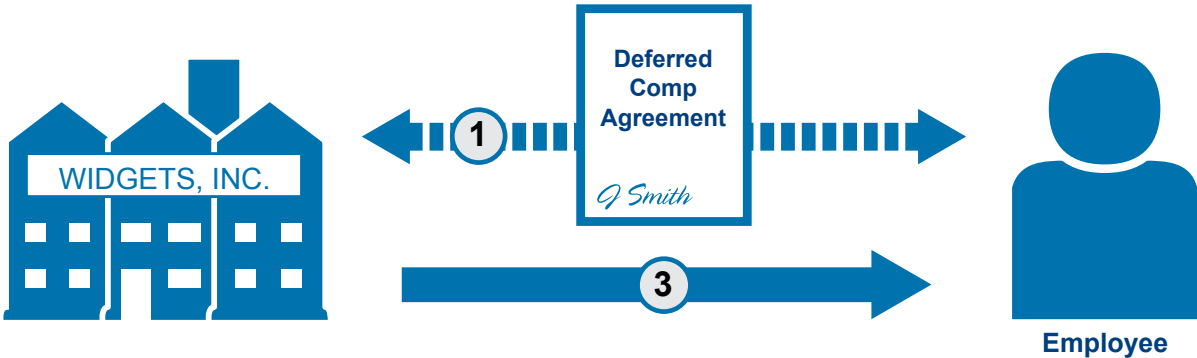
Even with the tax law placing restrictions on the distribution of benefits, nonqualified deferred compensation arrangements remain an effective way to reward and retain valuable, highly compensated employees on a selective basis.



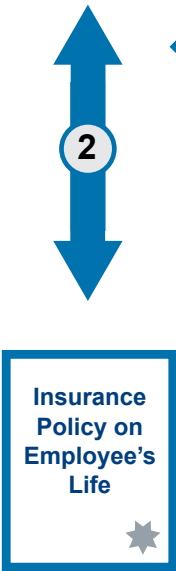
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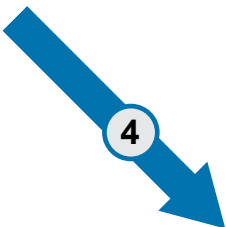
1. The employer and employee enter into an agreement specifying future compensation. A properly implemented agreement will defer taxation until a specified triggering event.



2. If the employer decides to informally fund the agreement, the employer may purchase an insurance policy on the employee's life.



3. When the employee retires (or otherwise meets the conditions of the agreement), the employer begins to pay benefits using the policy's cash value and/or other assets. These benefits are subject to the tax rules regarding policy withdrawals, loans and surrenders.



4. At the employee's death, the employer pays out remaining deferred compensation, per the terms of the written agreement, to the employee's named beneficiary. Death benefits received by the employer are received income tax free but payments paid to the beneficiary are income taxable.