Volume 29, Issue 2, August 2023

# Commco Comments

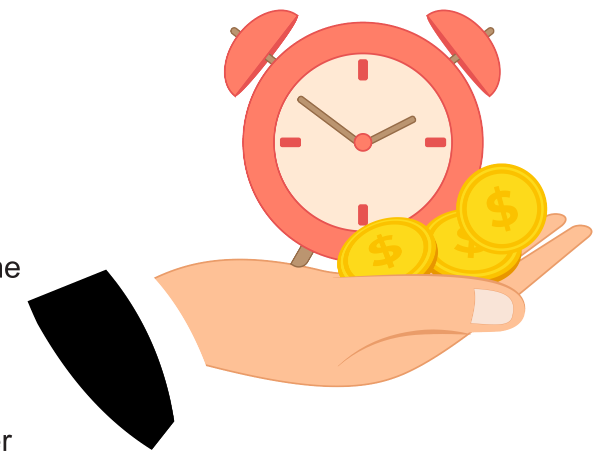
Timely Information and Updates for Employers and Retirement Plan Sponsors

## Nonqualified Deferred Compensation Plans

A nonqualified deferred compensation (NQDC) plan is an arrangement between an employer and one or more employees to defer the receipt of currently earned compensation. You might want to establish an NQDC plan to provide your employees with benefits in addition to those provided under your qualified retirement plan, or to provide benefits to particular employees without the expense of a qualified plan.

### NQDC plans vs. qualified plans

A qualified plan, such as a profit-sharing plan or a 401(k) plan, can be a valuable employee benefit. A qualified plan provides you with an immediate income tax deduction for the amount of money you contribute to the plan, while employees aren't required to pay income tax on your contributions until those amounts are distributed from the plan. However, a qualified plan must comply with strict and complex ERISA and IRS rules, and the plan must generally cover a large percentage of your employees.



In contrast, NQDC plans can be structured to provide the benefit of tax deferral while avoiding most ERISA requirements, with no annual dollar limits and no requirement to cover the rank-and-file along with highly compensated employees.

### Funded vs. unfunded NQDC plans

NQDC plans fall into two broad categories — funded and unfunded. An NQDC plan is considered funded if you have irrevocably and unconditionally set aside assets with a third party (e.g., in a trust or escrow account) for the payment of NQDC plan benefits, and those assets are beyond the reach of both you and your creditors. In other words, if participants are guaranteed to receive their benefits under the NQDC plan, the plan is considered funded. These plans provide employees with maximum security that their benefits will be paid. Funded plans are rare, though, because they provide only limited opportunity for tax deferral and may be subject to all ERISA requirements.

Unfunded plans are by far more common, because they can provide the benefit of tax deferral while avoiding most ERISA requirements. With an unfunded plan, you don't formally set aside assets to pay plan benefits. Instead, you either pay plan benefits out of current cash flow ("pay-as-you-go") or you earmark property to pay plan benefits ("informal funding"), with the property remaining part of your general assets and subject to the claims of your general creditors. In order to achieve the dual goals of tax deferral and avoidance of ERISA, your NQDC plan must be both unfunded and maintained solely for a select group of management or highly compensated employees. These unfunded NQDC plans are commonly referred to as "top-hat" plans.

### Income tax considerations

Generally, you can't take a tax deduction for amounts you contribute to an NQDC plan until your participating employees are taxed on those contributions (which

*Continued on page 2*

**WIN A $25 GIFT CARD**

*to your choice of REI or Powell's Books!*

*To be entered into the drawing, email quiz@thecommco.com with the correct answer to this question:*

*Which type of NQDC plan avoids more ERISA requirements: funded or unfunded?*

the commerce company

Retirement & Investment Services

the commerce company
Retirement & Investment Services

5440 SW Westgate Drive, Suite 110
Portland, OR 97221
thecommco.com

tel 503-203-8585
fax 503-203-8590
toll 800-203-8510

*Congratulations to our most recent gift card winner:*

*Michelle B. of Kaya HR, a division of Professional Business Solutions, Inc.*

*For answers to previous issues' questions, visit* [***https://thecommco.com/commco-comments/***](https://thecommco.com/commco-comments/)



*Continued from page 1*

can be years after your contributions have been made to the plan). Additionally, employees generally don't include your contributions to an unfunded NQDC plan (or plan earnings) in their taxable income until payments are actually received from the NQDC plan.

The taxation of funded NQDC plans is more complex. In general, your employees must include your contributions in taxable income as soon as they become nonforfeitable (i.e., as soon as they vest). The taxation of plan earnings depends on the structure of the plan; in some cases, employees must include earnings in current taxable income as accrued, and in some cases earnings aren't taxed until they're actually paid from the plan.

**Who can adopt an NQDC plan?**

Most NQDC plans are adopted by regular (C) corporations. In S corporations or unincorporated entities (partnerships or proprietorships), business owners generally can't defer taxes on their shares of business income. However, S corporations and unincorporated businesses can adopt NQDC plans solely for regular employees who have no ownership in the business.

NQDC plans are most suitable for employers that are financially sound and have a reasonable expectation of continuing profitable business operations in the future. In addition, since NQDC plans are more affordable to implement than qualified plans, they can be an attractive form of employee compensation for a growing business that has limited cash resources.

**How to implement an NQDC plan**

NQDC plans have many options for customization, which can make them complex to establish. They should be established and implemented under the combined guidance of an ERISA attorney and third party administrator. If you think an NQDC plan may be a good fit for your company's needs, email us at newsletter@thecommco.com to begin the conversation.