



## ADVANTAGES AND DISADVANTAGES OF NONQUALIFIED DEFERRED COMPENSATION PLANS

As a successful business owner, you realize that part of having a successful business is keeping your employees happy. Offering a competitive benefits package can help you accomplish just that. While retirement plans are a popular and successful means of achieving this goal, you may find that you need more to attract and retain executives and other key employees. Aside from a qualified plan, like a profit-sharing plan or a 401(k) plan, you may also choose to attract and retain these individuals with a nonqualified deferred compensation (NQDC) plan.

An NQDC plan is a contractual commitment made by an employer to an employee to pay currently earned compensation in a future year. As a flexible form of employee compensation, NQDC plans allow you to tailor the benefit amounts, payment terms, and conditions of the plan to both your and your employees' needs.

There are a number of reasons why an employer may want to consider establishing an NQDC plan (and why an employee might wish to consider participating in such a plan). These include:

- To supplement benefits provided by qualified plans
- To restore benefits that are limited by Internal Revenue Code provisions
- To attract, recruit, and retain qualified employees
- To provide retirement benefits to key employees while avoiding the administrative costs of qualified plans
- To provide incentives for early retirement
- To deter premature terminations
- To enable the employer to provide benefits to a select few, rather than being forced to cover nearly all employees (as would be required by a qualified plan)

### Advantages

NQDC plans offer a number of advantages. In particular:

- **They supplement an employee's qualified benefits.** Qualified plans are subject to a number of limitations on contributions and benefits. NQDC plans allow you to provide deferred compensation to your employees in excess of qualified plan limits.
- **They are easier and less expensive to administer than qualified benefit plans.** Because qualified benefit plans must follow complex IRS and ERISA rules, they're usually more expensive (and complicated) to implement and maintain than NQDC plans. If you can't afford to maintain a qualified plan but wish to

*Continued >*



Securities and Advisory Services offered through Commonwealth Financial Network®, Member FINRA/SIPC, a Registered Investment Adviser.

## Advantages and Disadvantages of Nonqualified Deferred Compensation Plans *continued*

offer your select group of management or highly compensated employees the ability to receive tax-deferrable retirement benefits, consider implementing an NQDC plan.

- **They can be offered on a discriminatory basis.** Qualified plans are subject to specific discrimination and participation rules that require you to provide proportionate benefits to non-highly compensated employees. An NQDC plan isn't subject to these same rules. As a result, you can decide to allow a few or even one highly compensated employee to participate in the NQDC plan. You're not obligated to cover anyone.
- **They can provide unlimited benefits.** Subject to the reasonable compensation requirement for deductibility, you can provide unlimited benefits to your employees.
- **They allow employers to control the timing and receipt of benefits.** Because ERISA's vesting rules don't apply to NQDC plans that aren't formally funded, you as the employer can control the timing and receipt of employee benefits payable under the plan.
- **They allow employers to attract and retain key employees.** For obvious reasons, many employers strive to attract, recruit, and retain executives and other qualified key employees. An NQDC plan that provides future retirement benefits, whether in lieu of or in addition to a qualified plan, can offer an added incentive for these key employees to come to work for and remain with an employer.
- **They offer increased deductions.** The business's deduction is based not on what the firm contributes to the plan but on what comes out of the plan. In other words, interest earned will make the deduction higher than the original investment. Moreover, if corporate tax rates increase between the time funds were contributed to the plan and the time benefits are paid out, the value of the corporation's deduction will be greater.

## Disadvantages

These plans are not without some drawbacks. Some disadvantages include:

- **Employees control the timing of the employer's tax deduction.** The employer generally can't deduct a contribution made to an NQDC plan until the year income is actually received from the plan by the participating employee. More often than not, this will occur several years in the future, particularly in the case of employees who choose to defer receipt of the income until retirement. In effect, employers have no control over when they will be entitled to take tax deductions.
- **There is a lack of security for employees.** From the standpoint of the participating employees, an NQDC plan isn't as secure as a qualified plan. Employees who participate in an NQDC plan generally have to rely on an employer's unsecured promise to pay benefits at a later time (except in the case of a formally funded NQDC plan). Most ERISA protections—such as participation, vesting, fiduciary responsibility, and funding standards—don't apply.

*Continued >*



Securities and Advisory Services offered through Commonwealth Financial Network®, Member FINRA/SIPC, a Registered Investment Adviser.

## Advantages and Disadvantages of Nonqualified Deferred Compensation Plans *continued*

- **They are generally not appropriate for partnerships, sole proprietorships, and S corporations.** Partnerships, sole proprietorships, and S corporations can certainly establish NQDC plans to benefit key employees. The plan will be of little benefit to the owners themselves, however, since income earned by the organization is immediately taxed to the business owner. In other words, the business owner can't defer taxation of amounts contributed to the NQDC plan on his or her own behalf.
- **They are generally more costly to the employer than paying current compensation.** An NQDC plan that provides for the deferral of income taxation to the executive also defers the employer's tax deduction on that compensation. The company must wait to take a tax deduction in the year the executive receives a distribution from his or her deferred compensation account. In addition, the deferred compensation amount typically increases through some type of interest or investment earnings. Until the payment to the employee is actually made, the employer may realize investment income (if the employer has chosen taxable investments as the informal funding vehicle for the plan) with respect to the deferred amount that is subject to tax. But since the employer's deduction for both the deferred amount and the investment earnings is deferred until the actual payment of benefits, the employer incurs a greater net after-tax cost for the NQDC plan than for a payment of current compensation. This additional employer cost should be taken into account as the terms for any NQDC plan or agreement are considered and agreed upon.

We will weigh the effects of these advantages and disadvantages on your business as we decide whether establishing an NQDC plan is the best strategy for you. When working with complex financial products, we often coordinate with outside professionals to develop a superlative financial plan. Since an NQDC plan involves complex tax matters, we will work with your tax professional to select the option that best fits your needs.

*Commonwealth Financial Network® does not offer tax or legal advice. You should consult a tax or legal professional regarding your individual situation.*

