Nonqualified Deferred Compensation:

Nonqualified Deferral Plans (NQDP's) are a particular form of nonqualified benefit plan that permits a company's key executives to defer substantial portions of their compensation, thereby delaying taxation on both the deferral amount, and subsequent growth until the balance is distributed, as long as some basic rules are followed.

Qualified Plan Limitations vs. Nonqualified Plan
Qualified plans are plans that *qualify* under Section 400 of the IRS Code, and therefore enjoy significant tax advantages for both the employee and employer. Some examples of these advantages are:

- The employer receives a current tax deduction for contributions to the plan.
- The employee is not taxed when contributions are made, but only when benefits are received.
- Plan assets accumulate free of taxes until distributed.
- Plan assets are secure - they are placed in trust beyond the reach of creditors, providing a high level of security for employees.

However, in exchange for these tax advantages, IRS rules and regulations must be strictly followed. These restrictions have the most severe impact on highly compensated executives. Some of the more restrictive rules are:

Benefits are Limited

- A qualified Defined Benefit Pension Plan must limit the annual benefit to $175,000 per year (for calendar year 2006).
- A qualified 401(k) plan may not permit employee deferrals in excess of $15,000 per year (for calendar year 2006), with a maximum combined employee/employer contribution of $44,000 per year (for calendar year 2006).
- A qualified plan must limit the amount of compensation when calculating benefits to $220,000 (for calendar year 2006).
- Qualified plan benefits must be non-discriminatory - there are strict rules with regard to the level of benefits that may be provided to a "highly compensated employee" in relation to the benefit provided to a rank and file employee.

A *nonqualified* plan has no statutory restrictions on the magnitude of the benefit that may be provided.

Coverage
Qualified plans must comply with strict coverage rules regarding which employees are permitted to enter the plan. For all practical purposes, all company employees are usually made participants in the plan after they meet a basic participation requirement, such as attaining age 21 and completing one year of service.

A *nonqualified* plan may cover as few as one employee, and generally must cover only a "select group of highly compensated employees".

Reporting
Qualified plans are required to provide a series of reports to the IRS, Department of Labor (DOL) and the participant. These reports include, but are not limited to: (a) IRS Annual Report (5500), (b) Summary Annual Report to the participant, (c) Summary Plan Description to the participant and the DOL. The labor involved in fulfilling these reporting requirement can be quite intense, and usually requires the services of a third party administrator.

A *nonqualified* plan has virtually no statutory reporting requirements, other that a short form to be filed with the Department of Labor.

Disadvantages of Nonqualified Plans
While nonqualified plans have no maximum benefit amount and the freedom to pick and choose plan participants, there are some limitations and drawbacks:

- The employer does not receive a tax deduction for contributions until the year the income is taxable to the covered employee. This can be a substantial number of years.
- The employee's benefit is not as secure as under a qualified plan. The employee must rely on the employer's unsecured promise to pay the benefits. Placing the assets in trust beyond the reach of creditors would incur adverse taxation.
- Not all companies are suited for a nonqualified plan. Non-profit organizations and governmental organizations are subject to special, highly restrictive rules. Partnership or S Corporation tax structure would not allow for the full benefits of a nonqualified plan.