Nationwide®
is on your side

Where is the Sale?

Nonqualified Deferred Compensation Plans

Anne L. Meagher, J.D. CLU, ChFC
Director, Advanced Consulting Group
Nationwide

Brought to you by the Advanced Consulting Group of Nationwide®

The Concept

Companies large and small often have a need and desire to provide special benefits to their key employees – after all, without them the company would not be as profitable or run as smoothly. A common method used to recruit, reward and retain key employees is through a nonqualified deferred compensation (NQDC) plan. This type of plan gives key employees the opportunity to defer a portion of their compensation on a pre-tax basis and only pay income tax on it when received in the future. These plans are often used to supplement a 401(k) plan for high earners who bump into the deferral limits of the 401(k) plan.

Companies will sometimes credit matching or discretionary amounts in addition to the employees' own deferrals. Quite often, an employer will credit a matching contribution to the employee's accounts if any match is "lost" in the 401(k) plan due to participation in the NQDC plan.

An employer has a great deal of flexibility in designing a NQDC plan, from choosing who will participate to dictating how and when distributions will occur. Typically, employees are allowed to defer salary and bonus compensation which is credited with earnings (and losses) based on a set of fund options chosen by the employer. (Earnings can also be credited based on other indices, but that is not usual in a plan in which employees are deferring compensation.) Employees are usually allowed to elect to receive their deferrals either at separation from service or on a date that is two or more years in the future while still employed by the company.

The majorities of tax-paying companies that have NQDC plans finance them with corporate-owned life insurance (COLI) and use the deferred amounts to pay premiums. COLI is the preferred asset to offset the plan liabilities because the increase in cash value is not currently taxed, the employer and employees have the ability to allocate deferrals to a wide variety of funds, and COLI cash values can be allocated to mirror the allocation of the plan liabilities among the funds.

Where's the sale?

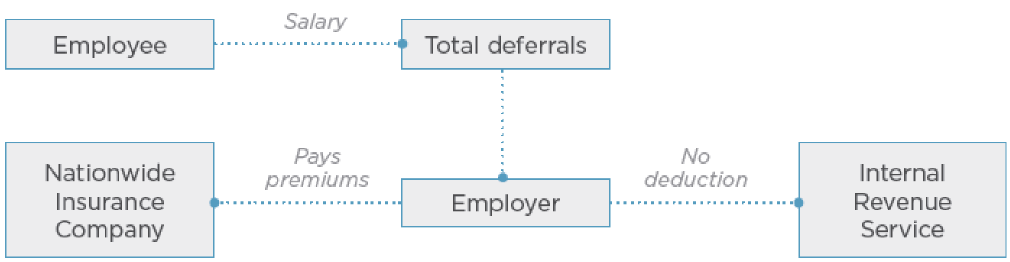
Typically, a company with these characteristics is a good candidate for establishing a NQDC plan:

- Stable, well-established with consistent profits

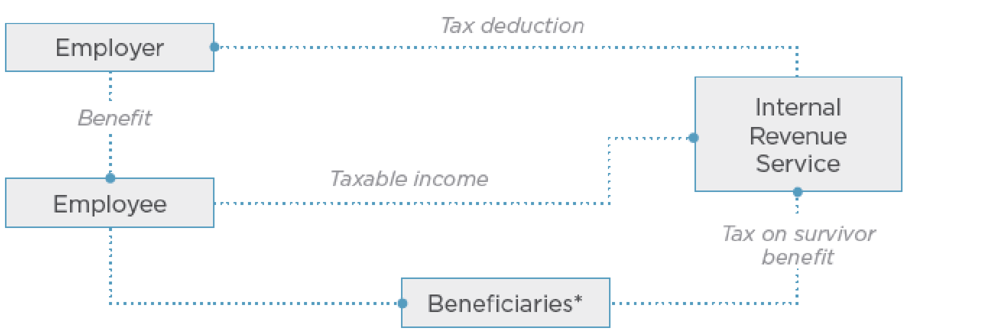
- Has highly paid executives who want to defer the receipt of compensation (in addition to what they contribute to a 401(k) plan), or
- Has to limit executives' deferrals to the 401(k) plan due to nondiscrimination testing results

Plan Mechanics

Pre-retirement deferral cash flow diagram



Post-retirement benefit cash flow diagram



* If the employee dies during post-retirement distribution (or pre-retirement employment) there may be distributions payable and taxed to the employee's beneficiaries.

Case Study

Take the case of Jen and Sara, owners of a local restaurant chain that has been in business for over 10 years and that continues to grow. Because the turn-over among the majority of the staff is high, Jen and Sara have never set up a 401(k) plan. Several of their long-term, key employees have asked for some type of retirement savings plan. Jen and Sara contacted their financial advisor who suggested they look into establishing a NQDC plan. The financial advisor suggested that the key employees be allowed to defer a portion of their base salary and annual profit sharing bonus into the plan. In addition, she suggested that the company also match the employees' deferrals, similar to what they would do in a 401(k) plan.

After reviewing several alternatives, Jen and Sara decide to take their advisor's advice and set up a NQDC plan. Because the key employees are familiar with the operation of a 401(k) plan, Jen and Sara design the NQDC plan to resemble a 401(k) plan, such as having the ability to allocate their deferrals among a variety of fund options, electing the number of installment payments they will receive when the account is paid, and having the ability to receive their account balance in the event of disability and death.

Jen and Sara also took their financial advisor's advice to informally fund the plan using COLI purchased on the lives of the key employees. Because the company is stable and profitable, Jen and Sara like the fact that taxes will not be due on cash value growth, plan liabilities can be "mirrored" by their investment in the COLI, and income tax-free death benefits will provide the company with a method to recoup the cost of the plan.

Federal income tax laws are complex and subject to change. The information in this memorandum is based on current interpretations of the law and is not guaranteed. Neither Nationwide, nor its employees, its agents, brokers or registered representatives gives legal or tax advice. You should consult an attorney or competent tax professional for answers to specific tax questions as they apply to your situation.

Nationwide®

NFM-14671AO (11/15)