Finseca Report
Marketplace

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What to Think About When Designing a Nonqualified Deferred Compensation Plan with Elective Deferrals

Market Trend: In a competitive labor market, a nonqualified deferred compensation plan that provides certain key employees with enhanced retirement savings opportunities can be a valuable added benefit to recruit and retain talent.

Synopsis: A nonqualified deferred compensation plan that permits elective deferrals must satisfy a number of legal requirements, including qualifying as an ERISA top hat plan and complying with the requirements of Internal Revenue Code Section 409A. Failure to comply with these legal requirements can have significant adverse impacts on both the employer and the participant, so care should be taken when designing and implementing the plan. Within these constraints, employers have a number of design choices to consider. This article explores those key design considerations and choices, such as identifying the eligible employees, choosing the eligible compensation and amounts that may be deferred, deciding what types of elections can be made as to time and form of payments, and deciding if and how to informally fund plan benefits.

Takeaways: Deciding among these design choices often requires an employer to balance the desire to provide participants with choices against the amount of plan administrative complexity that the employer is willing to bear. Employers looking to adopt a plan need to carefully consider these choices in light of their specific goals and business needs.

Background

This article explores the common design features and considerations for adopting a nonqualified deferred compensation ("NQDC") plan that includes elective deferrals of eligible compensation.

Elective NQDC plans can act as a tax-efficient retirement savings vehicle for highly-paid employees and can be designed to mirror the employer's tax-qualified 401(k) plan – subject to several important differences. Participants can use an elective NQDC plan to enhance their retirement savings which would otherwise be capped under a 401(k)plan due to various compensation and contribution limits applicable to tax-qualified plans.

While NQDC plans can be beneficial to employees and employers alike, they must be designed and operated to comply with Internal Revenue Code Section 409A ("409A"). In general, 409A imposes timing requirements on when deferral elections must be made and how and when deferrals must be paid. Once the applicable payment rules are established at the time of a participant's deferral election, 409A generally prohibits payments from being accelerated or further deferred, with limited exceptions. 409A also imposes a 6-month payment delay for deferred compensation payable due to a separation from service for certain "specified employees" of public companies (usually the top fifty most highly compensated officers).[1] A NQDC plan must satisfy these 409A requirements both in the form of the written plan document and in operation. A failure to comply with 409A, either in form or operation, can result in significant adverse tax consequences to participants, including accelerated recognition of income of the entire plan account balance (not just the part involved in the failure) plus a 20% additional tax and a potential penalty interest tax.[2]

While 409A imposes a number of rigid rules on deferral elections and timing of payments, there still remains a number of ways in which a NQDC plan can offer a participant choices if properly structured and timely made. As the following discussion illustrates, there can be trade-offs to consider when designing a NQDC plan between participant flexibility and administrative complexity. In general, greater flexibility results in greater administrative complexity. A good design process strikes the right balance for these trade-offs for a particular employer's business needs and circumstances.

Employers should also keep in mind some of the key differences between a NQDC plan and tax-qualified 401(k) plans. For example, the account balances under a NQDC plan must represent an unfunded, unsecured promise of the employer to pay the plan benefits, and a participant's claim to benefits can be no greater than the claim of a general creditor of the employer in case of the employer's insolvency. In other words, participants take on a benefit security risk with NQDC plans that they do not with a 401(k) plan, which funds benefits through a trust that is beyond the reach of the employer's creditors. Also, employers are not entitled to a tax deduction for compensation that is deferred to a NQDC plan until the benefits are actually paid. In contrast, an employer is able to claim a tax deduction on 401(k) plan contributions when they are made.

The following discussion highlights the key features to consider when designing an elective NQDC plan, and some of the available options employers may implement in compliance with 409A.

Eligible Employees

The group of eligible employees for the NQDC plan needs to be limited so that the NQDC can qualify as a "top hat" plan under ERISA. NQDC plans are generally treated as "pension plans" under the Employee Retirement Income Security Act of 1974, as amended ("ERISA"). In most cases, a NQDC plan will need to qualify as a "top hat" plan in order to avoid a number of ERISA requirements applicable to pension plans, including funding requirements, which could otherwise defeat the intended tax results.

[1] *See* Treas. Reg. § 1.409A-3(i)(2)(i); Treas. Reg. § 1.409A-1(i)(1)
[2] For information on how to correct a failure to comply with 409A, see our prior article titled "Whoops – What to Do When You Discover an Operational Error in a Non-Qualified Deferred Compensation Plan" in the Finseca Resource Library.

An ERISA "top hat" plan is an unfunded plan that is maintained primarily for the purpose of providing deferred compensation for a "select group of management or highly compensated employees." The Department of Labor ("DOL") has not established a bright-line test for determining what constitutes a "select group of management or highly compensated employees." The DOL has indicated that eligible employees should be limited to employees who, "by virtue of their position or compensation level, have the ability to affect or substantially influence the design and operation of the arrangement."

The courts, however, have generally not adopted this "bargaining power" principle. Rather, the courts generally apply an analysis based on both quantitative and qualitative factors, taking into account the facts and circumstances of the employer.

- **Quantitative factors** generally focus on the percentage of an employer's workforce that is eligible to participate. Typically, coverage less 10% of an employer's work force will satisfy the select group requirement.

- **Qualitative factors** generally focus on the positions, duties, and compensation of those eligible to participate. NQDC plans generally will satisfy the select group requirement if participation in the plan is limited to employees who have average compensation in excess of two times the average compensation of the entire workforce.[3]

An employee who is a "highly compensated employee" for 401(k) plan nondiscrimination testing is not necessarily a "highly compensated employee" for top hat plan purposes.

In establishing a NQDC plan, an employer must determine the eligibility criteria for participation in the plan and how the employees are chosen to participate in the plan. A common approach is for the board of directors or a designated committee (*e.g.*, the compensation committee) to select the eligible employees to participate. Alternatively, the employer can preemptively designate specified positions within the company that are eligible automatically upon the commencement of their employment. For example, participation could be limited to senior vice presidents and above. Under either approach, an employer should consider whether participation in the plan is limited to a select group of the employer's key management or highly compensated employees. The employer will also need to make a one-time top hat filing with the DOL.[4]

Eligible Compensation

NQDC plans permit eligible employees to defer compensation – and, therefore, defer the associated tax-consequences related to such compensation – until the deferred compensation is paid. Compensation eligible to be deferred will usually be limited to base salary and annual cash incentives compensation. In some cases, long-term cash incentives or certain equity-based compensation may be eligible for deferral. An employer must determine which compensation is eligible for deferral, as well as how much an employee is able to defer. The design choices related to the compensation eligible to defer should be based on the employer's overall business reasons for adopting the NQDC in the first place – *e.g.*, is the plan intended to make up for 401(k) plan limits, maximize retirement savings opportunities for cash bonuses, etc.

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[3] For more information on top hat plans, see our prior article titled, "Top Hat Plans – What Are They and How Do You Know If You Have One" in the Finseca Resource Library.

[4] For more information on top hat plan filings with the DOL, see our prior article titled "New Year Reminder: Have You Filed A Top Hat Plan Statement for Your Non-Qualified Deferred Compensation Plans?" in the Finseca Resource Library.

In determining which compensation can be deferred, employers should remain cognizant of the various tax implications associated with each respective type of compensation. Deferrals of cash compensation often prove to be the simplest form of compensation to defer under a NQDC plan, and thus impose lesser administrative burdens. Deferring payouts of equity compensation awards can prove trickier from an administrative perspective, but stock award deferrals are not uncommon among public companies, especially for non-employee directors. Deferral of gains from the exercise of stock options generally is not permitted due to certain 409A requirements applicable to stock options.

Maximum Deferral Rates

A NQDC plan must set forth the maximum amount of eligible compensation that may be deferred. However, the maximum amount is not subject to IRS limits that apply to a 401(k) plan, such as the Internal Revenue Code Section 402(g) limit on annual deferrals ($20,500 for 2022 before catch-up contributions, if eligible) or the Internal Revenue Code Section 401(a)(17) limit on compensation ($305,000 for 2022).

Typically, a NQDC plan will include a minimum and maximum percentage of eligible compensation that a participant may elect to defer each plan year. Sometimes the maximum deferral percentage will vary based on the type of eligible compensation being deferred, such as base salary versus cash bonuses, with separate deferral elections permitted for each category of eligible compensation. The plan may also give discretion to the board or a committee to set the minimum or maximum deferral amounts each plan year and include these amounts in the deferral election notice for that year.

In setting deferral limits, employers must take a number of factors into consideration, including certain payroll processing considerations. As a practical matter, if a very high percentage may be deferred (up to 100%), the payroll system will need to consider the order of processing the deferrals in conjunction with other payroll deductions. For example, there will also often be pre-tax contributions to a cafeteria plan to pay group medical premiums or to fund health savings accounts, required tax withholdings (including FICA on the NQDC plan deferrals), 401(k) plan deferrals (discussed further below), other after-tax payroll deductions, etc. The NQDC plan should include language giving the employer some flexibility in determining these administrative steps to establish the portion of the eligible compensation that is in fact deferrable.

Enrollment Periods

One of the key compliance requirements under 409A relates to the timing of deferral elections. As a general rule, an employee must make an irrevocable deferral election the year before the year in which the corresponding services are performed. For example, in the case of an annual cash bonus, the employee must make their deferral election by the end of 2022 for a bonus earned for performance during 2023 and payable in early 2024. Employers may require that employees make such an election on an annual basis, or have the election carry over year-to-year unless the employee affirmatively changes or revokes the election (often called an “evergreen” election).

For newly-eligible employees, 409A provides that the employee may make their initial deferral election within 30 days after the date they become eligible to participate in the plan, but only with respect to compensation for services to be performed subsequent to the election. Whether an employee is “newly eligible” to participate in a NQDC plan is determined on an aggregate plan basis (*i.e.*, an employee will not be considered “newly eligible” if they were previously eligible to participate in another plan of the same type, such as a separation pay arrangement or a nonaccount balance plan). [5]

[5] *See* I.R.C. §409A(a)(4)(B); Treas. Reg. §1.409A-2

While elections must typically occur the year prior to the year of service, special rules are in place for "performance-based compensation" as defined under 409A. 409A provides that deferral elections relating to performance-based compensation are allowed on or before the date that is six months before the end of the performance period, so long as (i) the performance period is twelve months long; (ii) the employee's performance period or the date the performance criteria are established through the date the election is made; and (iii) the election to defer is not made after the compensation becomes "readily ascertainable."[6] This performance-based compensation election rule can be helpful for plans that allow deferrals of annual cash bonuses or certain long-term cash or stock awards earned based on specified performance goals.

NQDC plans do not have to permit elections outside an annual enrollment window for newly eligible employees or for performance-based compensation. Such added enrollment opportunities can add administrative complexity. But the plan document should include the possibility of those special enrollment periods if needed, subject to the determination of the plan administrator.

Coordination with 401(k) Plan Deferrals

Employers should consider how the NQDC elective deferrals will impact their 401(k) plan. In most cases, annual compensation taken into account for contributions and testing for a 401(k) plan will need to exclude amounts deferred in the year to the NQDC plan.

A NQDC plan may be established as a "standalone" plan, such that the elective deferrals under the NQDC plan are independent from, and apply side-by-side with, the participant's elections under the 401(k) plan. For example, a participant may elect to defer 10% to the 401(k) plan and also elect a 10% deferral of base salary to the NQDC plan. Both elections would apply to the base salary earned in any given payroll period. The participant may make changes to the 401(k) deferral elections during the year (consistent with the 401(k) plan administrative platform), but the NQDC plan election must remain irrevocable for the year to satisfy 409A.

For a NQDC plan operating in this manner, the employer will need to make sure that its payroll system determines the correct order for processing these deferrals. If the 401(k) plan deferral is made on the gross amount of base salary (before the NQDC deferral), there can be a potential adverse impact to the 401(k) plan annual nondiscrimination testing because the NQDC plan deferral typically cannot be included as part of annual 401(k) testing compensation.

> **Example**. An employee has elected to defer 10% under both the 401(k) plan and NQDC plan. Base salary for a payroll period is $10,000. If the 401(k) and NQDC plan deferrals are both determined based on this gross amount, $1,000 will be deferred to each plan. But for year-end 401(k) plan testing purposes, only $9,000 will be taken into account (because the NQDC plan deferrals will usually not be included in annual testing compensation). For those testing purposes, the employee's contribution percentage will be 11% (*i.e*., $1,000 ÷ $9,000) rather than 10%, which could hurt the 401(k) testing results. As an alternative, if the 401(k) plan determined its deferrals based on the base salary for the payroll period after the NQDC deferrals, the amount deferred to the 401(k) plan would be $900 (*i.e*., 10% x $9,000), but there would be no adverse impact on annual 401(k) testing.

[6] *See* I.R.C. § 404A(a)(4)(B); Treas. Reg. §1.409A-2(a); Treas. Reg. §1.409A-1(e)

Some companies establish NQDC plans where the annual deferral election is made on a combined basis with the 401(k) plan deferral election, so that a single percentage applies which goes first to the 401(k) plan until an applicable IRS limit is reached, and the remainder then spills over to the NQDC plan after the limits are reached. This type of coordinated, combined election can sometimes be easy to communicate to participants, but adds additional administrative complexities. For example, under this coordinated approach, both the 401(k) and NQDC plan deferral elections must remain irrevocable for the plan year in order for the NQDC plan spillover to satisfy 409A. Making the 401(k) plan election irrevocable may require programming changes for the 401(k) plan administrative system. There can also be 409A compliance challenges as to how the election applies to annual bonuses that are earned for service in one plan year but not payable until the following year. For these reasons, we do not frequently see these types of coordinated plan elections.

Another approach we sometimes see to address potential 401(k) plan coordination is to provide that the NQDC plan eligible compensation is limited to the plan year compensation that exceeds the Internal Revenue Code Section 401(a)(17) compensation limit for the year. But this type of design likely makes sense only for employers with a number of high earners.

Whatever approach is taken, the employer should make sure that its advisors are comfortable that the arrangement does not violate the Internal Revenue Code Section 401(k) "contingent benefit rule" (which generally prohibits linking deferrals to a 401(k) plan based on whether the employee receives or does not receive benefits under another plan, but includes exceptions for deferrals to a NQDC plan based on exceeding 401(k) plan deferral limits).

Employer Contributions

Similar to a 401(k) plan, employers are able to make contributions on behalf of their employees under a NQDC plan. In determining whether to make such contributions, the employer will need to decide whether to make mandatory contributions, such as matching contributions based on the amount of each employee's elected deferral amounts, or if the employer would like to have discretion to make employer contributions.

In some cases, the NQDC plan may use a formula to "restore" matching or employer contributions that could not be made to the 401(k) plan due to IRS limits. These restoration contributions are usually calculated using an "A – B" formula, where "A" is the matching contribution or employer contribution that would have been made to the 401(k) plan had IRS limits (especially the Section 401(a)(17) compensation limit) not applied, and "B" is the amount of the 401(k) plan contribution actually made.

It is also usually advisable to include the ability to credit discretionary employer contributions, which may include vesting requirements. Including this feature can provide an employer flexibility for features such as retention awards or supplemental compensation payments to be made on a deferred basis.

Account Adjustments

In establishing a NQDC plan, employers must also determine how to handle account adjustments. Generally, under a NQDC plan, employers establish and maintain a separate "account" for each participant, which is to be adjusted for earnings or losses based on the performance of a deemed investment option. The account is "notional" in that it represents the employer's benefit obligation to make payments at a later date, but is not (and cannot be) formally funded with assets.

Many elective NDDC plans will set up a menu of deemed investment choices that mimic the investment choices available under the employer's 401(k) plan. Participants may then make elections as to how the participant's NQDC plan account is deemed invested. Alternatively, the employer can offer employees the choice of other types of deemed investments or provide fixed or variable interest rates.

Deferrals of stock awards are usually credited as "stock units" that are valued based on the value of the underlying shares, often with dividend equivalents reinvested as additional stock units. In some cases, the stock units will remain payable in shares of stock at the end of the deferral period, usually from the share pool under the employer's equity compensation plan. Employers considering including deferrals deemed invested in employer stock should be aware of potential securities law compliance considerations, including (for public companies) the requirements under Section 16 of the Securities Exchange Act of 1934. These additional requirements may result in increased administrative complexity.

Vesting

Amounts electively deferred are almost always fully vested upon deferral. Plans that include "restoration" matching or other employer contributions often link the NQDC plan vesting to the same vesting schedule that applies under the 401(k) plan to the corresponding contribution.

ERISA, however, does not impose any minimum vesting requirements on NQDC plans (unlike tax-qualified retirement plans). Accordingly, employers can establish vesting terms in NQDC plans to meet a particular purpose, especially for employer contributions. If executive retention is the goal, an employer could design the NQDC plan to include an extended vesting period for certain employer contributions.

Distribution Rules and Forms of Distribution

NQDC plans must abide by the strict 409A rules for permissible payment events and how and when payment elections can be made. In order to comply with 409A, employers must establish their plans to provide that deferred compensation can only be distributed to an employee on one of the following events:

- a fixed payment date or fixed payment schedule;
- an employee's separation from service;
- a change in control of the employer;
- an employee's disability or death; or
- an unforeseeable emergency.[7]

For an elective NQDC plan, there are typically three approaches to consider regarding rules for time and form of payment, ranging from least flexible/simplest to most flexible/complicated:

- include no participant choice and fix the payment event and form in the plan, *e.g.*, a lump sum payment on the first to occur of separation from service, death or disability;

[7] *See* Treas. Reg. §1.409A-3(a)

- give participants a one-time election when the participant first joins the plan to elect the form of payment upon separation from service, *e.g.*, a lump sum or annual installments over five or ten years; or

- give participants a new election with each year's deferral election as to the payment event and form for that year's deferrals – often referred to as "class year elections."

With class year elections, employers often allow the participant to schedule an in-service payment in a specified year for the year's deferrals (usually after a minimum deferral period of two years). A scheduled in-service payment can help a participant who anticipates a future expense before retirement, like college tuition for kids, but wants the benefit of current deferral. Once an in-service payment is scheduled, however, it generally cannot be changed other than certain further deferral elections discussed in the next section. The NQDC plan should also address whether a separation from service before the scheduled in-service payment date triggers payment, or whether payments can be scheduled for a number of years after separation from service. The range of choices needs to be clearly documented in the NQDC plan, and then clearly communicated to participants so that they can make informed elections at the time of their deferral election. Once the deferral election becomes irrevocable for a year, the related class year payment election attached to those deferrals generally also cannot be changed (other than the limited further deferral election noted below).

Employers choosing a class year election design should find a good third-party administrator for their NQDC plan to assist with the annual election process and to properly track the various payment rules applicable to a participant. The added complexity heightens the risk of 409A operational errors, so the employer needs to carefully consider the balance between desired participant flexibility and administrative complexity.

Employers should also consider whether the NQDC plan should have certain de minimis payment rules that would override any class year payment elections and instead require a lump sum payment on separation from service if a participant's account balance is below a specified amount.

Changes to Payment Elections

Generally, 409A requires the payment rules for a year's deferrals to become irrevocable when the related deferral election becomes irrevocable (generally by December 31 preceding the deferral year). Once the payment rule becomes fixed, 409A generally prohibits accelerations or further deferrals.

409A, however, includes an exception to this rule that can permit a change in the time and form of payment, often called "12/5" elections. This exception permits a participant to make a subsequent election to change the time and/or form of payment (e.g., lump sum versus installments) only if –

1. the subsequent election does not take effect until at least 12 months after the date on which the subsequent election is made;

2. the payment with respect to the subsequent election is deferred for a period of not less than five years from the date the payment would otherwise have been paid; and

3. the subsequent election is made not less than 12 months before the date on which the payment is scheduled to be paid.[8]

[8] *See* Treas. Reg. §1.409A-2(b)

Employers are not required to permit 12/5 elections as part of the NQDC plan, but the plan document often contemplates them. The implementation of 12/5 elections can be more administratively challenging than the rule would otherwise suggest. Special rules need to be considered if the initial payment rule is an “earlier of” or “later of” construct, such as a payment on the earlier of a fixed date or separation from service. In some cases, a 12/5 election may require payments to be delayed five or more years after separation from service. Some employers may want to limit how long after separation from service that benefits can be payable, especially since the related employer tax deduction is delayed until the payments are actually made.

Unforeseeable Emergency Withdrawals

An employer may also want to consider permitting participants to make certain in-service withdrawals. Generally, 409A limits an employee’s ability to take an in-service withdrawal from a NQDC plan, other than a scheduled in-service payment elected for a fixed date, as described above.

409A, however, permits employers to allow for payments if a participant experiences an “unforeseeable emergency.” 409A defines an “unforeseeable emergency” as a “severe financial hardship to the [employee] resulting from an illness or accident of the [participant, their spouse, beneficiary or dependent]; a loss of property due to casualty; or other similar extraordinary and unforeseeable circumstances” outside the control of the participant. This definition is different from, and more restrictive than, the hardship distribution triggers that can apply to a 401(k) plan.

The employer can design their NQDC plan to allow payments for an unforeseeable emergency, only select unforeseeable emergencies, or none at all. If allowed, the NQDC plan can also require a cancellation of deferral elections for the year of the withdrawal.

Financing

As an overarching rule, both ERISA and 409A require that a NQDC plan be “unfunded” and “unsecured,” such that an employee’s claims to benefits can be no greater than the claims of a general creditor. Formal funding such as with a 401(k) plan is not permitted.

However, in order to limit the risk associate with an unfunded plan, employers may wish to consider the use of “hedging strategies” to address market-to-market accounting impacts and to establish a disciplined approach to have the necessary cash to pay NQDC plan benefits when due. One common approach is to set aside amounts deferred in a type of grantor trust referred to as a “rabbi trust” (so named because the first such trust approved by the IRS was for a NQDC plan benefitting a rabbi). The rabbi trustee holds and invests the assets to be used to pay plan benefits. But if the employer becomes insolvent, the rabbi trust assets will be available to pay the employer’s creditors. The rabbi trust is not tax exempt, so taxable gains (*e.g.*, from investment dividends, sale of trust assets, etc.) will be passed through to the employer.

An employer may accomplish much of the same hedging benefit by simply investing the deferred compensation in a brokerage or other account in its own name. Or the employer could explore purchasing corporate-owned life insurance (“COLI”), which may be able to provide a more tax-advantaged hedging approach for the employer compared to a rabbi trust or self-investment, but also has certain costs associated with the insurance coverage.

The employer legally does not have to adopt any of these hedging strategies. Rather, the employer could choose a “pay as you go” approach in which NQDC plan payments are funded out of the employer’s cash reserves when due. Effectively, the deferred compensation is being reinvested and put to work as part of the employer’s working capital during the deferral period.

Decisions about whether to informally fund NQDC plan deferrals should be carefully reviewed with a team that includes finance, human resources, accounting, and legal at the time the NQDC plan is being established. These decisions can have important accounting and cash flow impacts on the employer over the life of the NQDC plan.

Claims Procedures

As discussed above, generally a NQDC plan must qualify as a top hat plan under ERISA. As a top hat plan under ERISA, NQDC plans do not have to comply with most of ERISA’s substantive requirements, such as minimum participation, vesting and accrual standards, funding requirements and fiduciary standards. That being said, employers sometimes overlook that a NQDC plan is subject to the ERISA claims procedures – a common pitfall that can result in costly errors in a plan’s administration.[9] As a best practice, employers should have NQDC plan claims procedures that mimic those included in their 401(k) plan. Claims procedures help employers mitigate the risks associated with offering plans, because in litigation the courts will generally give deference to a decision by a plan administrator to deny a claim.

The NQDC plan should therefore include a fulsome claims procedure, or incorporate a fulsome claims procedure by reference to the 401(k) plan claims procedures. The NQDC plan should also clearly designate a plan administrator (such as the board or a committee of the board, the employer’s benefits committee, or other body) to oversee claims.

Conclusion

When deciding whether to establish a NQDC plan that permits elective deferrals, the employer should consider how a NQDC plan will help the employer meet its business goals and fit into its overall compensation philosophy. As this article illustrates, NQDC plans provide employers with a number of fairly flexible and useful choices for attracting, retaining and incentivizing top employees. However, employers must balance the administrative burden of implementing a NQDC plan and its associated obligations against any desire to maximize flexibility of employee choice.

[9] For more information on claims procedures for top hat plans, see our prior article titled “The Importance of Claims Procedures in Nonqualified Deferred Compensation Plans” in the Finseca Resource Library.

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