Advanced Designs Professional Guide

# Non-Qualified Deferred Compensation Using Life Insurance

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# Introduction

Having enough retirement income continues to be one of the top concerns of executives. Due to limits on qualified plans and social security benefits, individuals earning high incomes may find that a diminishing percentage of their income can be replaced at retirement from these two sources. At the same time, businesses are faced with the challenge of attracting and retaining these key executives. Providing a supplemental retirement benefit to executives who have maximized their qualified plan benefits may meet the goals of both executives and the business.

Such an alternative is a ***nonqualified deferred compensation plan***.

A nonqualified deferred compensation (NQDC) plan can provide an attractive retirement benefit to the executive and act as a much-needed incentive through which a business can attract and retain these individuals. Because it is nonqualified, the plan can be designed to fill the unique needs of different executives and businesses. For example, a 401(k) Mirror Plan is a popular form of an NQDC plan that allows for matching contributions. Another possibility is using a split-dollar design in conjunction with an NQDC plan to provide the executive with a personal life insurance benefit.

## Terminology

NQDC plans can be offered to business owners, directors, independent contractors and other highly-compensated employees of a business. It is not appropriate to provide an NQDC benefit for rank-and-file employees.[1] For simplicity, "executive" will be used throughout this professional's guide to describe the participant in the NQDC plan. There are also many types of businesses that could offer such a plan (e.g., C-Corporations, partnerships, LLCs, etc.). Since NQDC plans of tax-exempt organizations are subject to different rules (as discussed on page 30), any reference to business and any discussion of the tax consequences of NQDC to the business in this guide shall refer to a for profit business unless otherwise indicated. Any variances from this terminology will be noted and explained. NQDC plans are comprised of either voluntary executive compensation deferrals, contributions made by the business, or both. Throughout this professional's guide, "deferrals" shall represent all contributions made to the NQDC plan, regardless of their source.

[1] See ERISA Issues on page 43

# What is an NQDC plan?

An NQDC plan is the systematic and administered deferral of compensation until retirement *without* using a qualified plan.

## Types of NQDC Plans

In general, there are three types of NQDC plans: Voluntary Deferral Plans, Supplemental Executive Retirement Plans (SERPs), and 401(k) Mirror Plans. A Voluntary Deferral Plan is comprised entirely of the executive's deferrals. In other words, the business is not making any contributions; it is merely providing the executive with the ability to defer his or her own compensation. In a SERP, however, the business promises to provide a supplemental retirement benefit. The executive's compensation is not reduced and the plan is funded solely with employer contributions. Combining these two designs provides us with the third NQDC design, the 401(k) Mirror Plan. A 401(k) Mirror Plan uses both voluntary executive compensation deferrals, like the Voluntary Deferral Plan, but it adds the business's promise to match these deferrals.

## NQDC Plans in General

Regardless of the design chosen, in many cases an NQDC plan, like a qualified plan, can be designed as either a defined contribution plan, or as a defined benefit plan. Voluntary Deferral Plans and 401(k) Mirror Plans, however, are almost always defined contribution plans, with the amount of the deferral (and any promise to match) determined as either a flat amount or a percentage of the executive's compensation.

In an NQDC plan, once the deferrals are made, the business controls if and where the funds are invested.[2] As a defined contribution NQDC plan, the agreement, entered into by the business and the executive, may promise the executive a fixed rate of return, an actual rate of return based on investment performance, or a rate of return based on an unrelated index (see Measuring the Account Balance on page 22). In any event, these deferrals and any gain or loss on them are referred to as the executive's *account balance*. On the other hand, if the plan is designed as a defined benefit plan, the NQDC agreement may promise a fixed dollar amount to the executive at retirement. This fixed dollar amount represents the executive's *account balance*. Whether the plan is structured as a defined contribution or a defined benefit plan, it is the account balance that can eventually be paid to the executive at separation of service, death, disability, at the occurrence of an unforeseeable emergency, a change of control, or at a specified time listed in the agreement (see Distribution of Benefits on page 25).

In general, NQDC plans have three major requirements:

- Any asset used to informally fund the executive's account balance must always be reachable by the business's creditors (see Income Tax Issues on page 38 and ERISA Issues page 43).
- All deferrals must be made before the executive is in actual or constructive receipt of them (see Deferral Election on page 20).

[2] See Informal Funding discussion on page 3.

- If ERISA (the Employee Retirement Income Security Act of 1974) applies, NQDC plan eligibility must be limited to the "top-hat" group (see ERISA Issues on page 43).

## Informal Funding

The requirement that the account balance must be reachable by the business's creditors means that the NQDC plan is *informally funded*.[3] Under the terms of the agreement, the business usually has a variety of investment choices. The choices can include stocks, bonds, mutual funds, annuities, money market accounts, certificates of deposit, life insurance and even real estate. The business may invest in any asset it deems appropriate, or it may choose to not fund the benefit at all. The business may choose to pay the executive's benefit out of future cash flows. Life insurance has long been an attractive informal funding choice for NQDC plans for reasons that will be discussed next. For purposes of this guide, all discussion of NQDC plans is under the assumption that life insurance is the informal funding choice. In any event, when it comes time to pay the executive his or her promised account balance, the business may use any asset to pay the promised benefit.

## Why Life Insurance?

A life insurance policy may provide the beneficiary with death benefit protection in the event of the insured's premature death. For those employers considering a nonqualified deferred compensation plan for their key employees, they may also consider using a life insurance policy to informally fund the plan and provide added protection in the event of a key employee's premature death.

In addition to death benefit protection, using deferrals to pay premiums on a life insurance policy makes life insurance an attractive informal funding choice for the following reasons:

- Policy death benefits may be received income tax-free by the business.[4]
- Life insurance policy cash value accumulates without current taxation to the business.[5]
- Through the proper combination of loans and withdrawals, policy cash surrender value can provide tax-free income to the business in order to pay promised benefits to the executive.[6]
- The policy can be designed (usually through the use of term riders) to provide for cost recovery scenarios such as return of premiums plus cost of money, and to perhaps recoup lost corporate tax deductions.

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[3] Rev. Rul. 68-99,1968-1 CB 193; Pvt. Ltr. Ruls. 89-01-041 & 85-09-023.

[4] For federal income tax purposes, life insurance death benefits generally pay income tax-free to beneficiaries pursuant to IRC Sec. 101(a)(1). In certain situations, however, life insurance death benefits may be partially or wholly taxable. Situations include, but are not limited to: the transfer of a life insurance policy for valuable consideration unless the transfer qualifies for an exception under IRC Sec. 101(a)(2)( i.e. the "transfer-for-value rule"); arrangements that lack an insurable interest based on state law; and an employer-owned policy unless the policy qualifies for an exception under IRC Sec. 101(j).

[5] IRC Sec. 7702(g); See *Cohen v. Comm.*, 39 TC 1055 (1963), acq 1964-1 CB 4.

[6] For federal income tax purposes, tax-free income assumes, among other things: (1) withdrawals do not exceed tax basis (generally, premiums paid less prior withdrawals); (2) policy remains in force until death (any outstanding policy debt at time of lapse or surrender that exceeds the tax basis will be subject to tax); (3) withdrawals taken during the first 15 policy years do not cause, occur at the time of, or during the two years prior to, any reduction in benefits; and (4) the policy does not become a modified endowment contract. See IRC §§ 72, 7702(f)(7)(B), 7702A. Any policy withdrawals, loans and loan interest will reduce policy values and may reduce benefits.

It is important to note that life insurance is subject to underwriting and approval of the application and will incur monthly policy charges.

## Drawbacks When Using Life Insurance

Life insurance is not a short term or liquid asset and generally should not be considered if the plan is designed to pay distributions in the first few years. Additionally, life insurance policies have loads (i.e., sales charges), other monthly charges, cost-of-insurance (COI) and surrender charges that reduce the available cash value. If life insurance is the informal funding choice then loads, other monthly charges, cost-of-insurance and surrender charges must be factored into the NQDC plan design.

### *Limited Access to Cash Value*

Accumulated value is the total accumulation within the life insurance policy. Cash surrender value refers to the portion of the policy's accumulated value that is net of surrender charges. The business, as policyowner, only has access to the cash surrender value which, depending on the life insurance policy being used, may be substantially less than the accumulated value. Therefore, when designing an NQDC plan this limited access must be taken into consideration when determining the account balance and the timing and availability of distributions.

### *Low Early Cash Surrender Value*

Certain types of life insurance policies may have little or no cash surrender value for the first few years. This can be caused either by sales loads and other monthly charges that reduce the amount of account value, cost of insurance that reduces the amount of account value, and, as discussed previously, surrender charges, or a combination of the three.

### *Possible Taxation of Living Distributions at Withdrawal, Loan, or Full Surrender*

To the extent a withdrawal (i.e., a "partial surrender") is taken from the policy or the policy is fully surrendered, any gain will be taxable to the business if the withdrawal amount[7] or the policy's cash surrender value upon full surrender exceeds the business's basis in the policy.

Switching to policy loans may avoid this taxation of gain provided the life insurance policy is not a modified endowment contract. If a life insurance policy loan, however, is still outstanding when a policy is surrendered or lapses, the loan is automatically repaid from the cash value of the policy. This will result in taxable income to the extent the net surrender value plus the amount of the repaid loan exceeds the cost basis of the policy. If a life insurance policy loan is still outstanding at the time of death, the loan is automatically repaid from the policy's death benefit. This use of the death benefit to repay a policy loan does not cause the recognition of taxable income.

### *Pro-Rata Interest Deduction Disallowance*

The pro-rata interest deduction disallowance means that a portion of a business's deductible interest (not the interest related to the life insurance policy but all otherwise deductible interest, e.g., mortgage interest, interest on lines of credit, etc.) will be disallowed equal to the ratio of life insurance cash value to total business assets. In numerical terms, if one-third of a business's assets is life insurance cash value, then

[7] Per IRC Sec. 7702(f)(7) after the first fifteen policy years a withdrawal will be taxed as basis first, gain second. A partial withdrawal in the first fifteen policy years may be taxed as a withdrawal of gain first, basis second if the withdrawal causes a "reduction in benefits."

one-third of all business interest deductions will be disallowed. The cash value of all business life insurance, wholly business-owned policies as well as policies used in split-dollar designs, is figured into the interest disallowance calculation.

This law applies to policies issued after June 8, 1997. Fortunately, however, included in this law are sufficient exceptions to preserve most of the uses of business life insurance without causing the pro-rata interest disallowance. Policies insuring 20% or more shareholders (and their spouses in survivor life policies), officers, directors and employees will not cause the disallowance.[8] At this time, only policies on less than 20% owners and persons otherwise unrelated to the business, such as customers, will cause the pro-rata disallowance.

A possible problem may arise, however, after an insured retires. In theory, since the insured is retired, he or she may no longer fall within these exceptions unless, of course, they own 20% or more of the business's stock (see Pro-Rata Interest Deduction Disallowance on page 40).[9]

## Employer-Owned Life Insurance

If, after considering all of the advantages and disadvantages, the business chooses to purchase life insurance, the life insurance policy should only insure a director or highly compensated executive. A highly compensated executive is defined as any one of the following:

- A shareholder who owned more than 5% of the business's stock at any time during the preceding year;
- An executive who earned at least $130,000 (in 2020, indexed for inflation) for the preceding year;
- One of the five highest paid officers; or
- Among the highest paid 35% of all employees.[10]

Additionally, the business, prior to issuance of the life insurance policy, must provide written notice to the executive that it intends to be the owner and beneficiary of a life insurance policy on the executive's life and may choose to continue the coverage beyond the executive's employment. The business must also notify the executive as to the maximum amount of life insurance that could be placed on the executive's life. The executive must give written consent to such life insurance coverage.[11]

If the business fails to provide written notification to the coverage and receive written consent, the life insurance death benefit (above the business's investment in the contract) will be income taxable to the business. In addition, death proceeds received by a business for an insured who was not a director or highly compensated employee at the time the policy was issued or who was not an employee of the business within 12 months or his or her death will be income taxable to the business to the extent they

[8] IRC Sec. 264(f)(4).
[9] For the 2013 budget, Treasury has proposed a change to the pro-rata interest deduction. Treasury's proposal would repeal the exception for life insurance policies covering employees, officers, or directors. If this budget proposal were to become law, only policies that insure a 20% owner would be exempt.
[10] IRC Secs. 101(j)(2)(A); 414(q); 105(h)(5).
[11] IRC Sec. 101(j)(4).

exceed the business' investment in the contract. It is therefore important that the business follow these requirements in order to preserve the income tax-free life insurance death benefit.[12]

## Assumptions When Using Life Insurance

To use life insurance successfully as the informal funding choice in an NQDC plan, the following assumptions are necessary:

- The life insurance policy is a life insurance contract as defined in IRC Sec. 7702 and the policy will remain in force until the insured's death.
- The life insurance policy insures an officer, shareholder, or highly compensated executive.
- Prior to policy issue, the business will provide written notice to the executive regarding the life insurance coverage and will receive written consent.
- The life insurance policy is not, nor will it become, a modified endowment contract as defined in IRC Sec. 7702A.
- Withdrawals by the business during the first fifteen policy years will not cause a reduction in benefits as defined in IRC Sec. 7702(f)(7). A withdrawal during the first fifteen policy years that causes a reduction in benefits could be taxable as gain first, basis second.
- Unless combined with a split-dollar agreement (see Split-Dollar Combinations on page 32), the business will be the owner and beneficiary of the life insurance policy being used to informally fund the plan.

[12] For federal income tax purposes, life insurance death benefits generally pay income tax-free to beneficiaries pursuant to IRC Sec. 101(a)(1). In certain situations, however, life insurance death benefits may be partially or wholly taxable. Situations include, but are not limited to: the transfer of a life insurance policy for valuable consideration unless the transfer qualifies for an exception under IRC Sec. 101(a)(2)( i.e. the "transfer-for-value rule"); arrangements that lack an insurable interest based on state law; and an employer-owned policy unless the policy qualifies for an exception under IRC Sec. 101(j).

# Why an NQDC plan?

In this economy, businesses must compete for top-quality executives. Qualified retirement plans are frequently used as an adjunct to compensation to attract these executives. Defined benefit plans, profit-sharing plans, 401(k) plans with generous business matching contributions are all added inducements to executive loyalty. Due to qualified plan limitations, however, qualified retirement plans may only partially satisfy the executive's retirement planning objectives.

## Qualified Plan Limitations

Federal legislative policy assures that qualified retirement plans are provided fairly to non-highly compensated employees (NHCEs). Qualified plan benefits, however, are limited and these limits effectively penalize highly compensated executives (HCEs)[13] by reducing their retirement benefits from a qualified plan to a smaller percentage of their pre-retirement income. Some of the qualified plan limitations affecting HCEs are:

- *Maximum Compensation Limit*: Although the Economic Growth Tax Relief Reconciliation Act of 2001 (EGTRRA) increased the compensation limit that can be used for calculating qualified retirement plan benefits, this amount only increased to $200,000. (This amount, however, is indexed for inflation and in 2020 is $285,000.) [14]
- *Maximum Contribution Limits*: The maximum annual per employee contribution to defined contribution retirement plans is the lesser of 100% of eligible compensation or $57,000 in 2020.[15] Employee contributions to 401(k) plans are even more severely limited to $19,500 in 2020.[16] An employee age 50 or older may defer an additional $6,500 (in 2020).[17]

Qualified plans have additional requirements which may make them less attractive for businesses who desire some flexibility and wish to target key executives:

- *Requirements of Title I of the Employee Retirement Income Security Act of 1974 (ERISA)*: Unless otherwise exempted, qualified retirement plans must comply with Parts 1-5 of Title I ERISA. These requirements include reporting and disclosure, participation and vesting, funding, fiduciary responsibility, and a claims procedure.
- *Non-Discrimination*: The benefits, features, and rights provided under qualified plans must not discriminate in favor of HCEs.[18] In addition, contributions or benefits must not discriminate in favor of HCEs.[19]

These qualified plan limitations and restrictions do not mean that businesses should offer only NQDC benefits to their key executives. Qualified plans do provide a meaningful retirement benefit for many

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[13] Highly Compensated Executives are defined as employees who either received $130,000 (in 2020, indexed for inflation) in compensation from the employer in the previous year, or were a 5% owner in the current year or previous year. IRC Sec. 414(q)(1).
[14] IRC Sec. 401(a)(17).
[15] IRC Sec. 415(c)(1). Adjusted for inflation in increments of $1,000.
[16] IRC Sec. 402(g)(1)(B). This amount is adjusted for inflation in increments of $500. IRC Sec. 402(g)(5).
[17] IRC Sec. 402(g)(1)(C).
[18] Treas. Regs. Secs. 1.401(a)(4)-1(b)(3), 1.401(a)(4)-4(a).
[19] IRC Sec. 401(a)(4).

employees. The business, however, may wish to consider an NQDC plan as a supplement to the benefits provided by the qualified plan.

## Supplemental Retirement Planning

The executive wants a supplemental retirement plan that will allow him or her to defer pre-tax compensation, in excess of the qualified plan limits, until retirement. The business, in order to attract and retain valuable executives, wants to provide the executive with an attractive compensation package. A properly structured NQDC plan can satisfy both objectives.

# Steps of an NQDC Plan

Suppose the business, with the help of their independent tax and legal counsel, has determined that an NQDC plan is an appropriate additional benefit to encourage the executive's loyalty and the executive has determined that an NQDC plan is necessary for his or her supplemental retirement planning, what next? The following is a step-by-step explanation of an NQDC plan. These steps are basic and are intended to impart a big picture of an NQDC plan. More in depth discussion of the components, design, legal and tax issues of an NQDC plan follow in this professional's guide.

***Step 1.*** *The executive enters into an agreement with the business to defer future compensation in return for the payment of supplemental retirement income.*

By executing this agreement, the parties agree as to the amount and timing of the deferrals. This agreement clarifies if the deferrals will consist of voluntary deferrals from the executive's compensation (as in a Voluntary Deferral Plan); the business's promise to pay a future benefit (as in a SERP); or a combination of the two (normally a 401(k) Mirror Plan). The agreement also determines how the account balance is calculated, and the methods and timing of distribution. This agreement is a legal document that must be prepared by qualified counsel.

***Step 2.*** *The business provides written notification of its intent to purchase a life insurance policy on the executive and the executive consents in writing.*

In order to preserve the income tax-free nature of the life insurance policy's death benefit, prior to the issuance of the life insurance policy, the business must provide written notification to the executive that it intends to be the owner and beneficiary of a life insurance policy on the executive's life and may choose to continue the coverage beyond the executive's employment.[20] The business also notifies the executive as to the maximum amount of life insurance that could be placed on the executive's life. The executive gives written consent to such life insurance coverage.

***Step 3.*** *The business purchases a life insurance policy on the executive's life, naming itself owner and sole beneficiary of this policy. The policy provides a death benefit and tax-deferred accumulation of cash value.*

As owner of the life insurance policy, the business must pay the premiums. If the executive defers any compensation (e.g. a Voluntary Deferral Plan) the business may use the deferrals to pay the premiums. If no deferrals are made, the business must use its own cash flows to pay the premiums. Each year the business must report the life insurance coverage to the IRS on Form 8925.

[20] For federal income tax purposes, life insurance death benefits generally pay income tax-free to beneficiaries pursuant to IRC Sec. 101(a)(1). In certain situations, however, life insurance death benefits may be partially or wholly taxable. Situations include, but are not limited to: the transfer of a life insurance policy for valuable consideration unless the transfer qualifies for an exception under IRC Sec. 101(a)(2)( i.e. the "transfer-for-value rule"); arrangements that lack an insurable interest based on state law; and an employer-owned policy unless the policy qualifies for an exception under IRC Sec. 101(j).

***Step 4.*** *At retirement, the executive receives his or her deferred compensation from the business and pays income tax on this compensation when received.*

Upon a distribution event the business can pay the distribution with any cash at its disposal. The business may choose to access the life insurance policy's available cash surrender value either through withdrawals or policy loans. When the distribution is paid to the executive it is taxable to the executive and may be deductible to the business.[21]

***Step 5.*** *In the event of the executives' death, his or her heirs may receive the executive's vested account balance.*

If the executive dies, the business generally receives the life insurance policy's death benefit income tax-free.[22] The business may then use part or all of the death benefit to distribute the vested account balance to the executive's survivors. As with Step 4, when the distribution is paid to the executive's survivors it is taxable and may be deductible to the business.[23]

## Grandfathered NQDC Plans

Where there is an NQDC plan that has been in existence as of December 31, 2004 or earlier and made a timely decision to elect grandfathering (a "grandfathered" NQDC plan), to which changes are being made, it is important to note that certain changes or events, or "material modifications", may eliminate the grandfathered treatment of the NQDC plan and create possible tax implications. A grandfathered NQDC plan is considered materially modified, and thus subject to IRC Section 409A, if a benefit or right existing as of October 3, 2004 is enhanced or a new benefit or right is added and such material enhancement or addition affects amounts earned and vested before January 1, 2005.[24] According to final regulations, the following events are not considered a material modification:

- A participant's exercise of discretion over the time and manner of payment of a benefit to the extent such discretion is provided under the terms of the plan as of October 3, 2004.[25]
- A participant's exercise of a right permitted under the plan as in effect on October 3, 2004.[26]
- The amendment of a plan to bring the plan into compliance with the provisions of IRC Section 409A.[27]
- The establishment of or contributions to a trust (e.g. a rabbi trust) or other arrangement from which benefits under than plan are to be paid, as long as the contribution to the trust or other

[21] Assuming it qualifies as an ordinary and necessary business expense under IRC Sec. 162.
[22] For federal income tax purposes, life insurance death benefits generally pay income tax-free to beneficiaries pursuant to IRC Sec. 101(a)(1). In certain situations, however, life insurance death benefits may be partially or wholly taxable. Situations include, but are not limited to: the transfer of a life insurance policy for valuable consideration unless the transfer qualifies for an exception under IRC Sec. 101(a)(2)( i.e. the "transfer-for-value rule"); arrangements that lack an insurable interest based on state law; and an employer-owned policy unless the policy qualifies for an exception under IRC Sec. 101(j)
[23] Assuming it qualifies as an ordinary and necessary business expense under IRC Sec. 162.
[24] Treas. Reg. Sec. 1.409A-6(a)(4).
[25] Treas. Reg. Sec. 1.409A-6(a)(4)(i).
[26] *Id.*
[27] *Id.*

arrangement would not otherwise cause an amount to be includible in the executive's gross income.[28]

- The reduction of an existing benefit (e.g. the removal of a haircut provision).[29]
- The change of the investment measure for an account balance plan.[30]

Please note that adding a right or enhancing a benefit, even if that right or benefit is allowable under IRC Section 409A, is considered a material modification. For example, adding a provision to an existing NQDC plan, which would allow for a distribution upon the occurrence of an unforeseeable emergency, would be considered a material modification.

[28] Treas. Reg. Sec. 1.409A-6(a)(4)(i)(A).
[29] Treas. Reg. Sec. 1.409A-6(a)(4)(i).
[30] Treas. Reg. Sec. 1.409A-6(a)(4)(iv).

# Issues Unique to Each NQDC Plan Design

Although NQDC plan designs may allow an executive to defer an otherwise taxable portion of his or her compensation until retirement or some other later date, each design has issues unique to that particular design.

## Voluntary Deferral Plan

A Voluntary Deferral Plan is a type of NQDC plan comprised entirely of an executive's compensation deferrals. The business does not make any contributions to the plan; it merely provides the executive with the ability to defer his or her own compensation. The business does control where any informal funding assets are invested and has promised the executive a rate of return the executive can expect to earn on his or her compensation deferrals. The deferrals plus any gain or loss represent the executive's account balance.

All executive deferrals in a Voluntary Deferral Plan must be 100% vested from the inception of the plan. Vesting, however, does not mean the executive is currently taxed. As long as any informal funding of the account balance is subject to the claims of the corporate creditors and the plan is unfunded, the executive may avoid income taxation until the account balance is actually distributed (see Constructive Receipt on page 38).

**Voluntary Deferral Plan**
**Using Life Insurance**

1. Agreement: With the help of an attorney, the employer enters into a written agreement with the executive, whereby the executive elects to defer a portion of his or her compensation. In return, the employer agrees to provide supplemental retirement income to the executive. The agreement will clearly explain the various distribution provisions (i.e. retirement, death, etc.). If the employer plans on informally funding the plan with life insurance, the employer must provide written notice to the executive that it intends to buy life insurance on the executive's life. The executive then provides the business with written consent to purchase the life insurance.
2. Contributions: The employer creates an accounting entry in its financial statements which represents the executive's account balance. The executive's account balance is an unsecured promise by the employer to the executive to pay a future benefit. The employer may or may not choose to informally fund the plan with an asset. If so, the asset is funded through executive deferrals.
3. Control: Any assets used by the employer to informally fund the promised benefit remain under the control of the employer. The executive does not have any control over his or her account balance or the assets used to informally fund the promised benefit until the benefit is actually paid by the employer.
4. Premiums, Cash Value/Death Benefit: The employer may choose to informally fund the arrangement using a life insurance policy. Please note that the life insurance policy is not the plan. It is merely an informal funding vehicle utilized by the employer to accumulate the funds necessary to pay the benefits due under the plan. The employer is the owner and beneficiary of the policy and the executive is the insured. The employer pays the premiums of the life insurance policy. The premiums are a non-deductible expense for the employer. The life insurance policy provides the employer with a death benefit and tax-deferred accumulation of the cash value and serves to informally fund the employer's liability for the plan benefits.
5. Distributions: At the executive's retirement, the employer starts the payment of the executive's account balance according to the plan agreement. The employer may fund these payments via a tax-free distribution of the cash value accumulated within the life insurance policy.[31] The payments from the plan are taxable income for the executive and may be tax-deductible for the employer.
6. Executive's Death: In the event of the executive's death, the employer will receive the tax-free life insurance death benefit.[32] If the employer has not completed the payments due to the executive under the terms of the agreement, the employer may use the death benefit to pay the executive's heirs the remainder value.

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[31] For federal income tax purposes, tax-free income assumes, among other things: (1) withdrawals do not exceed tax basis (generally, premiums paid less prior withdrawals); (2) policy remains in force until death (any outstanding policy debt at time of lapse or surrender that exceeds the tax basis will be subject to tax); (3) withdrawals taken during the first 15 policy years do not cause, occur at the time of, or during the two years prior to, any reduction in benefits; and (4) the policy does not become a modified endowment contract. See IRC §§ 72, 7702(f)(7)(B), 7702A. Any policy withdrawals, loans and loan interest will reduce policy values and may reduce benefits.

[32] For federal income tax purposes, life insurance death benefits generally pay income tax-free to beneficiaries pursuant to IRC Sec. 101(a)(1). In certain situations, however, life insurance death benefits may be partially or wholly taxable. Situations include, but are not limited to: the transfer of a life insurance policy for valuable consideration unless the transfer qualifies for an exception under IRC Sec. 101(a)(2) (i.e., the "transfer-for-value rule"); arrangements that lack an insurable interest based on state law; and an employer-owned policy unless the policy qualifies for an exception under IRC Sec. 101(j).

## SERP

Unlike a Voluntary Deferral Plan, a SERP is a type of supplemental NQDC plan that is not comprised of executive compensation deferrals. A SERP is simply the business's promise to pay a future benefit. The executive's current compensation is not impacted by the SERP.

While Voluntary Deferral Plans and 401(k) Mirror Plans are generally limited to a defined contribution structure, a SERP may be designed as either a defined contribution plan or a defined benefit plan. Under a defined benefit SERP, the amount of the retirement benefit is determined at the outset. The retirement benefit in a defined benefit SERP may be described as either a fixed amount or a percentage of the executive's salary. It is not conditioned upon the performance of any particular investment(s). In contrast, a defined contribution SERP specifies an amount the business will contribute on a yearly (or more regularly) basis.[33] These contributions, plus any earnings or loss, represent the executive's account balance.

Unlike a Voluntary Deferral Plan, a vesting schedule is often used with the SERP design. The employer is not bound by the same vesting schedule limitation of qualified plans. While employers may impose more restrictive vesting schedules than would be permissible under qualified plans, such as a 20-year vesting period, the primary purpose of many NQDC plans is to attract and retain key executives. A longer vesting schedule reduces the attractiveness of the plan to the executive (see Vesting on page 24).

### Supplemental Executive Retirement Plan
**Using Life Insurance**


[33] There is no requirement that the employer actually fund the promised benefit. The employer may choose to forego current contributions and instead pay the promised benefit from future cash flow.

1. Agreement: With the help of an attorney, the employer enters into a written agreement with the executive, whereby the employer promises to provide future income for the executive. The agreement will clearly explain the various distribution provisions (i.e. retirement, death, etc.) and if a vesting schedule will be applied to the promised benefit. If the employer wishes to informally fund the SERP with life insurance, the employer must provide written notice to the executive that it intends to buy life insurance on the executive's life. The executive then provides the business with written consent to purchase the life insurance.
2. Allocation: The employer creates an accounting entry in its financial statements which represents the executive's SERP balance. The executive's SERP balance is an unsecured promise by the employer to the executive. The employer may or may not choose to informally fund the arrangement with an asset. If so, the asset is acquired entirely through employer contributions.
3. Control: Any assets used by the employer to informally fund the promised benefit remain under the control of the employer. The executive does not have any control over his or her SERP balance or the assets used to informally fund the promised benefit until the benefit is actually paid by the employer.
4. Premiums, Cash Value/Death Benefit: The employer may choose to informally fund the arrangement using a life insurance policy. Please note that the life insurance policy is not the plan. It is merely an informal funding vehicle utilized by the employer to accumulate the funds necessary to pay the benefits due under the plan. The employer is considered the owner and beneficiary of the policy and the executive is the insured. The employer pays the premiums of the life insurance policy. The premiums are a non-deductible expense for the employer. The life insurance policy provides the employer with a death benefit and tax-deferred accumulation of the cash value and serves to informally fund the employer's liability for the plan benefits.
5. Distributions: At the executive's retirement, the employer starts the payment of the executive's account balance according to the plan agreement. The employer may fund these payments via a tax-free distribution of the cash value accumulated within the life insurance policy.[34] The payments from the plan are taxable income for the executive and may be tax-deductible for the employer.
6. Executive's Death: In the event of the executive's death, the employer will receive the tax-free life insurance death benefit.[35] If the employer has not completed the payments due to the executive under the terms of the agreement, the employer may use the death benefit to pay the executive's heirs the remainder value.

[34] For federal income tax purposes, tax-free income assumes, among other things: (1) withdrawals do not exceed tax basis (generally, premiums paid less prior withdrawals); (2) policy remains in force until death (any outstanding policy debt at time of lapse or surrender that exceeds the tax basis will be subject to tax); (3) withdrawals taken during the first 15 policy years do not cause, occur at the time of, or during the two years prior to, any reduction in benefits; and (4) the policy does not become a modified endowment contract. See IRC §§ 72, 7702(f)(7)(B), 7702A. Any policy withdrawals, loans and loan interest will reduce policy values and may reduce benefits.
[35] For federal income tax purposes, life insurance death benefits generally pay income tax-free to beneficiaries pursuant to IRC Sec. 101(a)(1). In certain situations, however, life insurance death benefits may be partially or wholly taxable. Situations include, but are not limited to: the transfer of a life insurance policy for valuable consideration unless the transfer qualifies for an exception under IRC Sec. 101(a)(2) (i.e., the "transfer-for-value rule"); arrangements that lack an insurable interest based on state law; and an employer-owned policy unless the policy qualifies for an exception under IRC Sec. 101(j).

## 401(k) Mirror Plan

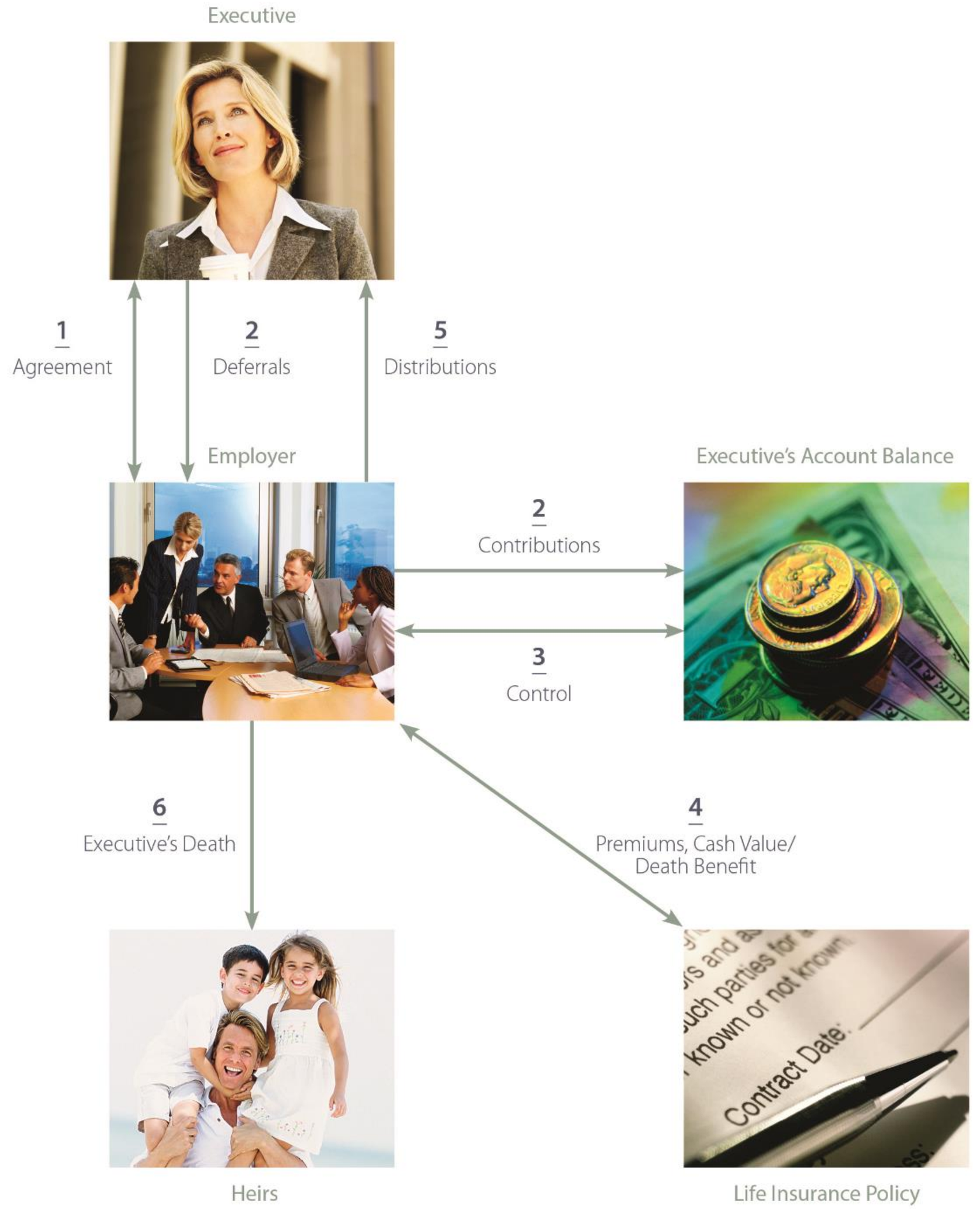
A 401(k) Mirror Plan is a combination of both voluntary executive compensation deferrals and the business's promise to match these deferrals. It emulates a qualified 401(k) plan with both executive deferrals and employer matching. A key difference between a nonqualified 401(k) Mirror Plan and the company qualified 401(k) plan is the size of the permitted deferrals. Under a qualified 401(k) plan, an executive can only defer $19,500 of his or her compensation in 2020.[36] If the executive is at least 50 years old the executive may defer an additional $6,500 in 2020.[37] The business may match this deferral but the total contribution to the qualified 401(k) plan must be no more than $57,000 per year or $63,500 per year if the employee is age 50 or older and is making catch-up elective deferrals.[38] There are no comparable limits on compensation deferrals or business matches in a nonqualified 401(k) Mirror plan. However, any business assets used to informally fund these executive benefits must be subject to the claims of the business's general creditors. Unlike qualified 401(k) plans, there is no federal bankruptcy protection for any business assets used to informally fund any nonqualified plan, including 401(k) Mirror Plans.

One of the rights enjoyed by participants of a qualified 401(k) plan is the ability to direct the investments of their individual account. The sponsoring employer of a nonqualified 401(k) Mirror Plan may confer a similar right to the executive. Unlike the qualified plan, however, these investment directions are merely suggested allocations. The business is not bound by the choices made by the executives. The account balance of any NQDC plan, including a 401(k) Mirror Plan, is informally funded. The business may invest the deferrals or contributions in any asset it deems appropriate, or it may choose to not fund the benefit at all, rather the business may choose to pay the future benefit out of future cash flows. When the business chooses to invest in assets that differ from the suggested allocation of the executive, the value of the assets may be more or less than the account balance.

Similar to a Voluntary Deferral Plan, the executive in a 401(k) Mirror Plan must be 100% vested in his or her voluntary salary deferrals. The business may, however, place a vesting schedule on the promised match (see Vesting on page 24).

[36] IRC Sec. 402(g)(1)(B). This amount is adjusted for inflation in $500 increments.
[37] IRC Sec. 402(g)(1)(C).
[38] IRC Sec. 415(c)(1). (as indexed for inflation in 2020).

# 401(k) Mirror Voluntary Deferral Plan
### Using Life Insurance




1. Agreement: With the help of an attorney, the executive enters into a written agreement with the employer to defer future compensation in return for post-retirement income or death benefits for his or her heirs, or both. The employer may agree to provide matching contributions to the executive's deferral. This arrangement is similar in design in some respects to the 401(k) qualified plan that is commonly provided by employers. If the employer chooses to informally fund the plan with life insurance, the employer must provide written notice to the executive that it

intends to buy life insurance on the executive's life. The executive then provides the business with written consent to purchase the life insurance.

2. Contributions: The employer creates an accounting entry in its financial statements which represents the executive's account balance. The executive's account balance is an unsecured promise by the employer to the executive a future benefit. The executive's account balance is comprised of the executive's deferrals and any matching contribution from the employer. The executive's account balance is considered a general asset of the employer and is fully subject to the claims of the employer's creditors. Assuming the arrangement is structured properly, the deferrals and company match are not currently taxed to the executive until they are paid.
3. Control: Any assets used by the employer to informally fund the promised benefit remain under the control of the employer. The executive does not have any control over his or her account balance or the assets used to informally fund the promised benefit until the benefit is actually paid by the employer.
4. Premiums, Cash Value/Death Benefit: The employer may choose to informally fund the arrangement using a life insurance policy. Please note that the life insurance policy is not the plan. The policy is merely an informal funding vehicle utilized by the employer to accumulate the funds necessary to pay the benefits due under the plan. The employer would be considered the owner and beneficiary of the policy and the executive would be the insured. The contributions to the executive's account balance may be used to pay the premiums of the life insurance policy. The premiums are a non-deductible expense for the employer. The life insurance policy provides the employer with a death benefit and tax-deferred accumulation of the cash value and serves to informally fund the employer's liability for plan benefits.
5. Distributions: At the executive's retirement, the employer will start the payment of the executive's account balance. The employer may fund these payments via tax-free distributions of the cash value accumulated within the life insurance policy.[39] The payments from the plan are taxable income for the executive and may be tax-deductible for the employer.
6. Executive's Death: In the event of the executive's death, the employer will receive the tax-free life insurance death benefit.[40] If the employer has not completed the payments due to the executive under the terms of the agreement, the employer may use the death benefit to pay the executive's heirs the remainder due.

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[39] For federal income tax purposes, tax-free income assumes, among other things: (1) withdrawals do not exceed tax basis (generally, premiums paid less prior withdrawals); (2) policy remains in force until death (any outstanding policy debt at time of lapse or surrender that exceeds the tax basis will be subject to tax); (3) withdrawals taken during the first 15 policy years do not cause, occur at the time of, or during the two years prior to, any reduction in benefits; and (4) the policy does not become a modified endowment contract. See IRC §§ 72, 7702(f)(7)(B), 7702A. Any policy withdrawals, loans and loan interest will reduce policy values and may reduce benefits.

[40] For federal income tax purposes, life insurance death benefits generally pay income tax-free to beneficiaries pursuant to IRC Sec. 101(a)(1). In certain situations, however, life insurance death benefits may be partially or wholly taxable. Situations include, but are not limited to: the transfer of a life insurance policy for valuable consideration unless the transfer qualifies for an exception under IRC Sec. 101(a)(2) (i.e., the "transfer-for-value rule"); arrangements that lack an insurable interest based on state law; and an employer-owned policy unless the policy qualifies for an exception under IRC Sec. 101(j).

# Features of an NQDC Plan

A properly structured NQDC plan includes the following features:

***For the Executive:***

- The ability to defer compensation, through salary deferrals; additional compensation promised by the employer; or both executive deferrals and employer additions, until separation of service, disability, unforeseeable hardship, death, a specified time, or a change of control.
- Earnings on the deferred compensation are not taxed to the executive until received.
- As a nonqualified plan, the executive can defer compensation in excess of the qualified plan limitations, thus ameliorating some of the impact of reverse discrimination.
- NQDC plans are not subject to the 10% premature withdrawal penalty imposed under IRC Sec. 72(t) for qualified plan distributions prior to age 59 ½.
- The plan can be structured to provide pre and post-retirement death benefits to the executive's survivors.
- Without the onerous requirements of ERISA, plan provisions such as vesting, survivorship benefits, measure of benefit and method of benefit payments are flexible and subject to negotiation between the business and executive.

***These benefits make NQDC plans an effective way for an executive to reduce current income taxes and accumulate funds for retirement.***

***For the Business:***

- NQDC plans avoid most of the cost and administrative requirements associated with establishing a qualified plan under ERISA.
- Without having to comply with the anti-discrimination provisions of qualified plans, as long as participation is limited to the "top-hat" group, as defined under ERISA, the business is able to pick and choose who will participate in the plan.
- The business, subject to reasonable compensation limits under IRC Sec. 162(a)(1), can provide a benefit to selected executives.
- Although the business cannot take an income tax deduction until the executive receives the benefits, this is offset by the fact that the benefit paid should be larger than the salary deferred. Assuming income tax rates remain relatively unchanged and there are earnings on the deferral, the business should be able to take larger deductions at the time benefits are paid than would have been available had it taken a current deduction.
- If employer contributions are contemplated, as with either a SERP, or the matching contributions in a 401(k) Mirror Plan, the employer could impose a vesting schedule to the account balance.

***These benefits make NQDC plans an attractive tool that engenders executive loyalty by facilitating retirement accumulation.***

# Deferral Election

If a NQDC plan consists of executive salary deferrals (such as the Voluntary Deferral Plan or 401(k) Mirror Plan), the executive must elect to defer his or her compensation on a yearly basis. The plan administrator's responsibility is to procedurally allow the executive to make timely deferral elections. Failure to do so may cause the executive to be in constructive receipt of potential deferrals under IRC Sec. 409A, thereby destroying the integrity of the plan. IRC Sec. 409A applies to all deferrals (and earnings) that are vested after January 1, 2005. In general, an election to defer compensation must be made in the taxable year preceding the year in which the services are performed giving rise to the compensation.[41] For example, in order to defer compensation for services performed in 2021, an executive must make the election to defer in 2020.

In the first year in which an executive becomes eligible to participate in the plan, the initial deferral election must be made within 30 days after the executive becomes eligible. This deferral election may be effective for any compensation earned for services performed subsequent to the election.[42] For example, if an executive becomes eligible to participate in an NQDC plan on June 30th, the executive may elect, by July 30$^{th}$, to defer a portion of his or her compensation earned for services performed after the election.

Finally, for "performance-based compensation" performed over a period of at least 12 months, the deferral election must be made no later than six months before the end of the period.[43] "Performance-based compensation" is compensation which would be variable and contingent on satisfaction of pre-established organizational or individual performance criteria and not readily ascertainable at the time of the election.[44]

In other words, deferral elections must be made within thirty days of eligibility for new plans and new executives, in the tax year preceding the year in which services are performed for existing plans and executives, and six months prior to the end of a measuring period for "performance-based compensation." The plan administrator must communicate these requirements to the executives and provide proper forms with sufficient advance notice for making deferral elections.

## Measure of Deferral

Deferrals are usually measured as a percentage of salary (e.g., 10%) or a flat dollar amount. If life insurance is the informal funding choice and the business intends to apply the deferral as premiums into the policy, it is important to keep the amount and timeliness of the deferral elections as consistent as possible so as to not threaten the integrity of the policy. Any suspension or drastic reduction in premium may cause the policy to under-perform or, in the worst case, lapse. Any excessive payment of premium may be rejected from the policy because it exceeds the maximum premium rules[45] or may be accepted by the policy but cause it to be taxed as a modified endowment contract.[46]

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[41] IRC Sec. 409A(a)(4)(B)(i).
[42] IRC Sec. 409A(a)(4)(B)(ii).
[43] IRC Sec. 409A(a)(4)(B)(iii). Treas. Reg. Sec. 1.409A-2(a)(8).
[44] Treas. Reg. Sec. 1.409A-1(e).
[45] IRC Sec. 7702.
[46] IRC Sec. 7702A.

In any case, the plan administrator should communicate to the executive what options are available for deferral elections and make sure the choices are timely made.

## Beneficiary Designations

Beneficiary designation in this context does not mean the beneficiary of the life insurance policy; it means the designation of who shall receive the NQDC/survivor benefits if the executive should die. The plan administrator must make these elections available. Generally, beneficiary designations can be done at any time prior to death.

# Measuring the Account Balance

In an NQDC plan, structured as a defined benefit plan, the executive's account balance is an amount stated in the agreement. This amount may be either a fixed dollar amount or an amount determinable by some formula established in the agreement. If the NQDC plan, however, is structured as a defined contribution plan, the executive's account balance is the amount of the deferrals increased by a growth index. This growth index may not reflect the value of the underlying asset used by the employer to informally fund the benefit.[47] If life insurance is used, the value of the policy is the cash surrender value. In the early years, this cash surrender value can be expected to be less than the deferrals made by the executives. This is due to the fact that the cash surrender value of a life insurance policy is reduced by various expenses such as loads, other monthly charges, cost-of-insurance, and possibly surrender charges. The cash value growth in a life insurance policy is tax deferred, however, and over time, the compounding effect of this tax-deferred growth could offset the reductions to the deferrals caused by the various expenses. Be that as it may, due to these reductions, in the early years the account balance may be less than the actual deferrals, making the NQDC plan unattractive to the executive. To counter this, an adjusted or alternative index is sometimes used.

With an adjusted index, the deferrals are not reduced by loads, other monthly charges, cost-of-insurance, or surrender charges. Further, the growth rate is the gross return credited to the life insurance policy's cash value, but adjusted at the business's tax rate. For example, assuming the use of variable universal life insurance, if in one year the gross return on the separate account is 7.5% and business's tax bracket for the same year is 21%, the executive's actual deferrals will increase by almost 6%.

An alternative index may be used independent of cash value. For instance, a plan balance may be calculated to equal what the deferrals would have grown to, after taxes, had they been invested in one-year Treasuries on each plan anniversary. The NQDC plan agreement may also specify adjustments to an independent index, such as an additional 1%.

It is important to note, however, that no matter how the account balance is determined; the life insurance policy's cash surrender value may or may not be sufficient to pay the promised benefit. If insufficient, any shortfall must come out of the business's treasury or other assets. If more than sufficient, the business can use the excess for other business purposes. This disconnect between the policy's cash surrender value and the account balance is all the more evident when the growth index is independent of the life insurance policy.

## Hypothetical Investment Options Allocations

An NQDC plan may allow the executive to suggest hypothetical investment options. The risk of constructive receipt may be less if these allocations are designed properly. Nevertheless, their availability should be limited and one allocation election per year is probably the safest. The IRS might view too frequent allocation election availability as giving the executive too much control over the value of his or her account balance. Control over the value confers upon the executive a taxable economic benefit (see

[47] The executive has no underlying interest in the asset used to informally fund the account balance. (In fact, there may not be an actual asset, rather, the employer may choose to fund the promised benefit from future cash flows.) Please see the discussion of Informal Funding on page 3.

Directing Hypothetical Investment Options on page 39). In any case, it is the plan administrator's responsibility to make sure that these elections are timely communicated to the executives.

Because the business will offer these hypothetical investment accounts to the executive, it makes sense that it should informally fund the plan with a choice that will closely mirror the performance of these accounts. For this reason, when using life insurance, variable universal life insurance with its separate account and numerous investment options is a logical choice. All or some of the investment options of the separate account can be chosen as the hypothetical investment accounts of the NQDC plan. As mentioned above, however, the policy’s cash surrender value in the early years may not be sufficient to fully support the account balance. The use of a policy’s cash surrender value to assist in paying the benefit is optimal when distributions are not contemplated for at least ten years.

## Phantom Stock Plans

Phantom stock plans utilize the stock value of the company to measure the executive’s account balance. The account balance is tied to the value of the employer’s stock. As the employer’s stock increases, so does the executive’s account balance. Conversely, the account balance decreases with decreases in the value of the employer’s stock. For the business, the phantom stock plan has the advantage of providing the executive with an additional benefit tied to the employer’s overall performance without having to actually dilute the company stock or give the executive the general benefits the stockholders have. For the executive, he or she receives a sense of ownership without the lack of marketability common with private company stock.

While linking the retirement benefit to the stock of the company can be an advantage, it can also be a disadvantage as well. If the company stock outperforms the actual assets used to informally fund the account balance, the employer may have to make up any shortfall. Conversely, if the assets used to informally fund the account balance were to outperform the company stock, the employer may enjoy a surplus.

# Vesting

An executive benefit is vested if it is no longer subject to a substantial risk of forfeiture. A substantial risk of forfeiture is not a requirement of NQDC plans[48]; that is, the requirement that any asset used to informally fund the account balance be reachable by the business's creditors is not the same as a substantial risk of forfeiture.[49]

A substantial risk of forfeiture is something, almost always within the executive's control, that may cause him or her to forfeit the benefit. Under IRC Sec. 409A, the rights of a person to compensation are subject to a substantial risk of forfeiture if such person's rights are conditioned upon the future performance of substantial services by any individual.[50] The typical substantial risk of forfeiture is satisfying a time period before being entitled to a retirement benefit. For example, the executive may have to work several years before the nonqualified retirement benefit is vested. Should he or she quit before vesting, the benefit is forfeited.

Vesting does not subject the executive to income taxation. An executive may be vested in his or her account balance and not pay income tax on this balance until the amounts are actually received.

Vesting schedules can vary in length and increments. There are no required vesting schedules with NQDC plans as there are with qualified plans. To be attractive to the executive the vesting schedule should be reasonable and attainable. Severe vesting schedules (e.g., cliff vesting after 20 years) can be meaningless and fail to garner their ultimate objective of executive loyalty.

Nevertheless, executive voluntary salary deferrals must be 100% vested from the inception of the plan. Vesting schedules are exclusively applied to SERPs and to matching contributions of a 401(k) Mirror Plan.

If the NQDC plan will benefit an executive that also owns a significant amount of the total voting power of the business, it may not be possible to have a substantial risk of forfeiture. Such a business owner must always be vested in his or her account balance, even in a SERP or a 401(k) Mirror Plan.[51] When determining whether or not a business owner owns a significant amount of the total voting power, the following factors will be considered:

- The owner's relationship to other equity holders (attribution rules of IRC Sec. 318 will apply) and the extent of their control, potential control and possible loss of control of the owner;
- The position of the owner in the business and the extent the owner is subordinate to any other business owner;
- The owner's relationship to the officers and directors of the business;
- The persons who must approve the owner's discharge; and
- Past actions of the business in enforcing the restrictions.[52]

[48] While a substantial risk of forfeiture is not a requirement of NQDC Plans offered by a taxable organization, it is a requirement of some NQDC Plans offered by tax-exempt organizations. Therefore, these plans, known as 457(f) plans generally do not use a vesting schedule (see Tax-Exempt Organizations on page 30).
[49] Further, the benefit must always be reachable by the corporation's creditors, whether or not it is vested.
[50] IRC Sec. 409A(d)(4).
[51] Treas. Reg. 1.409A-1(d)(3).
[52] *Id.*

# Distribution of Benefits

With a properly designed and administered NQDC plan, the executive should not recognize any taxable income until money is actually distributed to him or her upon the happening of a distribution event under IRC Sec. 409A. Retirement is not the only event leading to distribution. Among other things, distribution can be made to occur at separation of service, disability, death, a specified time (or pursuant to a fixed schedule) specified under the plan, a change in the ownership or effective control of the corporation, or at the occurrence of an unforeseeable emergency.[53] The conditions for each permissible distribution and a list of impermissible distributions are discussed below.

## Separation of Service

At termination of employment, whether due to retirement or otherwise, the executive may receive his or her vested account balance. A separation of service is based upon whether the facts and circumstances indicate that the business and executive reasonably anticipate that no further services would be performed by the executive after a certain date or that the level of services the executive would perform after such a date would permanently decrease to no more than 20% of the average level of services performed over the last 36 month period. An executive will be presumed to not have separated from service when the level of services is presumed to be 50% or more of the average level of services for the last 36 months. There is no presumption if future services are anticipated to be more than 20%, but less than 50%.[54]

If an executive separates service and receives a distribution based upon that separation of service, but is then later re-hired, the separation of service, and thus the distribution, is valid so long as at the time the executive left the business both the business and the executive reasonably anticipated that the executive would not provide services in the future. Therefore, an executive can quit, receive his or her vested account balance, and then later be re-hired by the company and the distribution of the account balance will not violate the rules under IRC Sec. 409A so long as the business and the executive did not reasonably anticipate that the executive would be re-hired.[55]

The NQDC plan agreement specifies the form of the distribution (lump-sum or installments). Key employees[56] of publicly traded companies may not receive distributions until six months after the date they separated from service, or the date of the key employee's death, if earlier.[57]

## Disability

Many NQDC plans do not offer disability benefits on the assumption that disability will be covered under the business's group or individual disability coverage. Those that do offer disability benefits may actually purchase a disability policy and do not intend to access the account balance for the payment of a disability benefit. It is possible, however, to have the account balance constitute the basis for a disability benefit above and beyond the benefit provided by the disability coverage. An executive will be considered disabled if, due to any medically determined physical or mental impairment, he or she is either; (1) unable

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[53] IRC Sec. 409A(a)(2)(A).
[54] Treas. Reg. Sec. 1.409-1(h)(1)(ii).
[55] *Id.*
[56] Officers with compensation over $185,000 (as indexed for 2020), 5% owners (owns more than 5% of the business), or 1% owners (owns more than 1% of the business) with compensation over $150,000. IRC Sec. 416(i).
[57] IRC Sec. 409A(a)(2)(B)(i).

to engage in any substantial gainful activity; or (2) has been receiving income replacement benefits from an accident and health plan of the employer's for at least 3 months, and under either (1) or (2), the medically determined physical or mental impairment can be expected to either result in death or last for a continuous period of not less than 12 months.[58]

## Death

At death, the executive's account balance is distributed to his or her survivor(s). The method of distribution (e.g., lump sum or installment) and to whom (i.e., the beneficiary(ies)) will have been established under the terms of the agreement. In certain circumstances, such as death before retirement, the plan may allow for an additional distribution. Assuming the use of life insurance, this additional distribution may come from the business's receipt of the policy's death benefit. The receipt of this additional death benefit is income taxable to the executive's survivor(s). In order to provide an income tax-free death benefit to the executive's beneficiary(ies),[59] a split-dollar arrangement may be used in connection with an NQDC plan. For a discussion of using both an NQDC plan and a split-dollar arrangement please see Split-Dollar Combinations on page 32.

If death occurs after retirement, while the executive is receiving his or her account balance in installments, usually the installments are continued in the same fashion to the survivors. In some cases, however, a plan may specify the remaining account balance is to be distributed in a lump sum if the executive dies after retirement.

## Specified Time

A distribution may be made prior to retirement if it is made pursuant to a fixed schedule specified under the plan. The specified time must be a date, rather than an event. For example, a distribution when the executive reaches age 65 is permissible, but a distribution when the executive's child begins college is not.[60]

## Change of Ownership or Effective Control

A distribution may be made due to one of the following three situations:[61]

1. *A change in the ownership of the company.* A change of ownership occurs when an individual or a group of individuals acquires more than 50% of the total fair market value, or total voting power, of the company.
2. *A change in effective control of the company.* A change of effective control occurs when either: (1) any individual, or a group of individuals, acquires (within the last twelve months) ownership

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[58] IRC Secs. 409A(a)(2)(C)(i)-(ii).

[59] For federal income tax purposes, life insurance death benefits generally pay income tax-free to beneficiaries pursuant to IRC Sec. 101(a)(1). In certain situations, however, life insurance death benefits may be partially or wholly taxable. Situations include, but are not limited to: the transfer of a life insurance policy for valuable consideration unless the transfer qualifies for an exception under IRC Sec. 101(a)(2) (i.e. the "transfer-for-value rule"); arrangements that lack an insurable interest based on state law; and an employer-owned policy unless the policy qualifies for an exception under IRC Sec. 101(j).

[60] The requirement of a specified time is listed under IRC Sec. 409A(a)(2)(A)(iv), however, the code does not give a detailed description of the requirement. The Conference Report issued with the American Jobs Creation Act of 2004, which established this code section, indicates that the distributions need to be based on a date rather than the occurrence of a specific event.

[61] Notice 2005-1, 2005-2 IRB 274, Q&A 11-14.

of 35% of the company voting stock; or (2) a majority of the company's board of directors is replaced during a twelve month period by directors whose appointment or election is not endorsed by a majority of the company's board of directors prior to the date of the appointment or election.

3. *A change in the ownership of a substantial portion of the assets of the company.* This occurs when an individual or a group of individuals acquires (within the last twelve months) assets of the company that has a total gross fair market value equal or greater than 40% of the total gross fair market value of all the assets of the company immediately prior to the acquisition.

An NQDC plan may provide for distributions upon the occurrence of one or more of these events.

## Unforeseeable Emergency

An unforeseeable emergency means a severe financial hardship to the executive resulting from an illness or accident of the executive, the executive's spouse, or a dependent (as defined in IRC Sec. 152(a)) of the executive, loss of the executive's property due to casualty, or other similar *extraordinary* and *unforeseeable* circumstances beyond the control of the executive.[62] The amount that may be distributed is limited to an amount necessary to compensate for the emergency plus an amount sufficient to pay the taxes generated by the distribution. In addition, amounts received by the executive from insurance or liquidation of other assets (if it does not cause severe financial hardship) must be taken into consideration when determining the amount that may be distributed for an unforeseeable emergency.

## Impermissible Distributions

### *Loans*

Loans are not permitted from NQDC plans without resulting in immediate taxation of the benefit. To permit loans could give the executive the possibility of accessing the account balance if he or she foresaw the business experiencing solvency problems. This would violate a basic fundamental rule of NQDC plans: keeping assets used to informally fund the account balance reachable by the business's creditors.

It has been argued that loans should be allowable so long as the executive pays interest[63] and provides collateral (e.g., the account balance). Further, the loan plus any unpaid interest would be accounts receivable to the business, thus allowing a creditor to pursue the executive, as a debtor of the business, for its recovery. If the executive were also insolvent, however, the business's creditors would have nothing to recover. This is why the IRS stated that NQDC plans could not be assigned or alienated.[64] A loan is an assignment or alienation of an NQDC plan and thus not permitted.

Finally, if the employer is a publicly traded company, the Sarbanes Oxley Act forbids any type of loans to the business's key executives.

### *Acceleration of NQDC Payments*

Generally, the NQDC plan may not allow the executive to accelerate the timing of his or her payments.[65] This rule is in response to a technique commonly referred to as a "haircut" provision, where the executive

[62] IRC Sec. 409A(a)(2)(B)(ii).
[63] IRC Sec. 7872 contains the tax requirements for employer loans.
[64] Rev. Rul. 60-31, 1960-1 CB 174.
[65] IRC Sec. 409A(a)(3).

was permitted to take an accelerated distribution, subject to a 10% penalty, of his or her account balance. This haircut provision was used by executives to remove the account balance from a company that may be experiencing financial difficulties. The use of this provision brings into question whether or not the assets used to informally fund the account benefit are really subject to the claims of the corporate creditors.

Some types of accelerated distributions, however, may be allowed. Permitted accelerated distributions include the following non-elective distributions: those distributions that are beyond the control of the executive (e.g., distributions to comply with federal conflict of interest or court orders pursuant to divorce); withholding of employment taxes; distributions necessary to pay income taxes due to vesting in a section 457(f) plan;[66] and distributions of minimal amounts ($10,000 or less) for "administrative convenience."[67]

### *Distributions Tied to the Financial Health of the Business*

Distributions tied to the financial health of the business are known as "financial triggers." This type of distribution trigger removes assets used to informally fund the account balance from the claim of the business's creditors. As such, all deferrals made to a plan that allows a distribution upon the change of the corporation's financial health will be immediately taxable to the executive and subject to additional penalties under IRC Sec. 409A.[68]

## Benefit Distribution Elections

The executive, with the help of the plan administrator (whether the employer or a third-party administrator), must make timely distribution elections under IRC Sec. 409A. There are two types of elections: *timing* and *form*.

*Timing* refers to the timing of the expected distribution event. For instance, an NQDC plan may specify that the normal retirement age is age 65 but allow for elections to take distribution after normal retirement. While a plan generally may not allow the executive to accelerate the timing of any payment, it may allow the executive to defer the payment date of the account balance. In order for an executive to defer the timing of any payment, the deferral election must be made one year prior to the original payment date.[69] If the distribution relates to a separation of service, a specified time, or a change of ownership control, the executive must defer payment for at least five years from the date the payment was originally scheduled.[70]

*Form* refers to the methods of distributing the benefit. The two most common forms of distribution are lump sum or installments. This election is made at the inception of the plan. Executives who wish to change the form of the distribution may do so but the election to change the form must be made at least one year prior to the original distribution date and the distribution must be deferred for at least five years from the originally scheduled date. For example, if the executive were scheduled to receive a lump-sum

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[66] Sec. 457(f) plans are discussed under the section titled Tax-Exempt Organizations on page 30.
[67] Notice 2005-1, 2005-2 IRB 274, Q&A-15.
[68] IRC Secs. 409A(b)(2), (3), (4).
[69] IRC Sec. 409A(a)(4)(C)(i).
[70] IRC Sec. 409A(a)(4)(C)(ii).

distribution at age 60, he or she could elect to instead receive installment payments, but the election must be made by age 59 and the installment payments must not begin until age 65.

Under the final regulations, elections to change to change the timing or form of payment of compensation from an NQDC are permitted under the following conditions (informally known as the "one and five rule"):

- The election to change the time or form of payment does not take effect until at least 12 months after the date of the election.[71]
- The payment is deferred for a period of at least 5 years after the election to change the timing or form.[72]
- If the payment was scheduled to be made on a specified date, the election to change the timing or form of payment must be made at least 12 months prior to that specified date.[73]

If the above requirements are met, the participant can re-defer their payments for a receipt at a later date or change the form of their payment.

If the executive wishes to change from installment payments to a lump sum the ability to do so would depend upon whether or not the installment payments are treated as a series of separate payments or are treated as a single payment spread out over time. If the NQDC plan agreement does not state how installment payments are to be treated, the default is that they are treated as a single payment made over time.[74] The difference between the two is best explained in the following example. Assume that an executive is scheduled to receive 10 annual installments beginning at age 60. If the installment payments were treated as a single payment made over time, the executive could elect, by age 59, to change to a lump-sum payment at age 65. If, however, the installment payments are treated as a series of separate payments, each installment payment stands on its own. If the executive is scheduled to receive 10 annual payments from age 60-69 he or she may not move the payments from age 66-69 to age 65. This would be an acceleration of the payments. If a lump-sum payment is truly desired, the executive would need to defer all payments until five years after the last scheduled distribution. The lump-sum benefit could not be paid until age 74.

There is, however, an obvious advantage to treating the installment payments as a series of separate payments. Each payment stands on its own, so the executive could elect to only defer some of the payments and still receive the others. For example, the executive in the above example, who is scheduled to receive 10 annual installments beginning at age 60, could defer the first five payments for five years. At age 65, the executive would then receive the original scheduled payment for age 65 plus the deferred payment from age 60. Treating the installments as separate payments gives the executive greater flexibility with each payment. This treatment, however, is not the default. If the executive wishes to have their installment payments treated as a series of separate payments, it must be clearly expressed in the NQDC plan agreement.

[71] Treas. Reg. 1.409A-2(b)(1)(i).
[72] Treas. Reg. 1.409A-2(b)(1)(ii).
[73] Treas. Reg. 1.409A-2(b)(1)(iii).
[74] Treas. Reg. 1.409A-2(b)(2)(iii).

# Tax-Exempt Organizations

A tax-exempt organization is any organization organized under Section 501 of the Internal Revenue Code. Examples include hospitals, state schools and universities, state or local governments, and unions and trade associations. NQDC plans can be done with tax-exempt organizations; however, because of their tax-exempt status, Congress enacted an additional layer of law, IRC Sec. 457, which regulates the NQDC plans of such tax-exempt organizations.[75] IRC Sec. 457 adds complexity and may affect the final design or even the applicability of NQDC plans with tax-exempt organizations. There are generally two types of 457 plans: 457(b) or *eligible* plans; and 457(f) or *ineligible* plans.

## Eligible 457(b) Plans

An eligible 457(b) plan is similar to other types of NQDC plans in many respects. First, the executive defers compensation on a pre-tax basis. Additionally, these deferred amounts must remain the property of the organization and any assets used to informally fund the benefit must remain subject to the claims of the organization's creditors. There are, however, differences between 457(b) plans and an NQDC plan offered by for-profit entities. The deferral amount, whether from executive salary deferrals or employer contributions, is limited to the lesser of 100% of compensation or $19,500 (in 2020).[76] NQDC plans offered by for-profit organizations do not have a comparable limitation. Furthermore, distributions from a 457(b) plan must meet certain requirements similar to qualified plans, such as the minimum required distribution rules.[77] One advantage of governmental 457(b) plans, over other NQDC plans, is the ability of the executive to rollover his or her account balance to an IRA. These governmental 457(b) plans, however, may not invest in life insurance. Eligible governmental plans must transfer all assets to a trust, custodial account, or an annuity contract for the sole benefit of the employee and their beneficiaries.[78]

All 457(b) plans, whether offered by a governmental entity or some other tax-exempt organization, may be designed as: a Voluntary Deferral Plan; a SERP; or a 401(k) Mirror Plan. Regardless of the source of these deferrals, the annual amount may not exceed the applicable limit of $19,500 discussed above. Additionally, the account balance of a 457(b) plan may be subjected to a vesting schedule. Like for-profit NQDC plans, vesting does not mean taxation. An executive may be vested in a 457(b) plan and not be taxed.

## Ineligible 457(f) Plans

An ineligible 457(f) plan is any 457 plan that has failed the requirements of a 457(b) plan. Typically, the requirement that is violated is a limitation on the deferral amount. Any plan that allows for deferrals in excess of the applicable limit ($19,500 in 2020) is a 457(f) plan. The deferrals are still made on a pre-tax basis to the executive, but there is the added requirement that the retirement benefit must be subject to a substantial risk of forfeiture. A "substantial risk of forfeiture" for a 457(f) plan means that not only are the funds always subject to the claims of the corporation's creditor (as with all NQDC plans, 457 or

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[75] Please note that despite their tax-exempt nature, churches and qualified church-controlled organizations are exempt from the limitations imposed by Section 457.
[76] Cost-of-living adjustments will be made in $500 increments. Treas. Reg. Sec. 1.457-4(c). Please note that pursuant to EGTRRA, this applicable dollar limit is no longer reduced for salary deferrals made to a qualified 401(k) or 403(b) plan.
[77] IRC Sec. 457(b)(5).
[78] IRC Sec. 457(g).

otherwise) but the executive may not be vested in any portion of his or her account balance. Unlike 457(b) plans, vesting in a 457(f) plan means income taxation to the executive. Once the substantial risk of forfeiture is eliminated, the executive is taxed on the entire vested account balance.[79]

Because of the substantial risk of forfeiture requirement for 457(f) plans, the account balance is typically paid as a lump-sum as opposed to an installment payment. Once the substantial risk of forfeiture no longer exists (e.g., retirement), the executive is taxed on the entire vested account balance. Additionally, since vesting triggers income taxation to the executive, a 457(f) plan is always designed as a SERP.

An organization may offer both an eligible 457(b) plan and an ineligible 457(f) plan.[80] An organization generally uses both an eligible plan and an ineligible plan when an executive seeks to defer a portion of their income via the 457 plan, but the total contributions would exceed the applicable dollar limit for the year.

[79] IRC Sec. 457(f)(1)(A); Treas. Reg. Sec. 1.457-11(a)(1).
[80] Priv. Let. Rul. 199916037.

# Split-Dollar Combinations

Combining an NQDC plan with a split-dollar arrangement provides a chassis through which the life insurance policy's cash value can be used to informally fund the plan. The net amount at risk (policy death benefit less the policy's accumulated value) can be used to provide a personal life insurance death benefit for the executive and his or her survivors. The death benefit may be able to serve two distinct functions: 1) to "self-complete" the retirement benefit in the event of an executive who dies prematurely; and 2) to provide an additional income tax-free death benefit post-retirement.[81] The latter can be done through either endorsement split-dollar or a collateral assignment split-dollar.

## Endorsement Split-Dollar

Endorsement split-dollar is a simple twist to the usual NQDC plan. With the basic NQDC plan, the business is the owner and beneficiary of the life insurance policy. If the executive needs personal life insurance protection, the business could endorse either a part of, or the entire, net amount at risk of the life insurance policy to the executive. So long as the executive includes the cost of current life insurance protection (also known as the reportable economic benefit or REB) on this endorsed portion in his or her gross income, or pays an equivalent amount into the policy,[82] the endorsed death benefit would be received by the executive's beneficiary(ies) income tax-free.[83]

It is important to note that if any policy cash value is endorsed to the executive it will be immediately taxable to him or her.[84]

## Collateral Assignment Split-Dollar

Collateral assignment split-dollar is a departure from the usual NQDC plan in that the executive owns the policy, rather than the business. Assuming the executive needs some personal life insurance protection, he or she assigns the policy's cash value to the business but retains the net amount at risk for this needed protection. The business retains the right to access the entire cash value and receive that amount (or the amount of cumulative premiums if greater) at the death of the executive. The executive has no right to access the cash value prior to termination of the agreement and retains only the right to name his or her heirs as beneficiary of the death benefit in excess of the business's interest. Like endorsement split-dollar, the executive must either include the cost of current life insurance protection (REB) in his or her taxable

[81] For federal income tax purposes, life insurance death benefits generally pay income tax-free to beneficiaries pursuant to IRC Sec. 101(a)(1). In certain situations, however, life insurance death benefits may be partially or wholly taxable. Situations include, but are not limited to: the transfer of a life insurance policy for valuable consideration unless the transfer qualifies for an exception under IRC Sec. 101(a)(2)( i.e. the "transfer-for-value rule"); arrangements that lack an insurable interest based on state law; and an employer-owned policy unless the policy qualifies for an exception under IRC Sec. 101(j).

[82] Treas. Reg. Sec. 1.61-22(d).

[83] See footnote 72.

[84] Treas. Reg. Sec. 1.61-22(d)(2)(ii).

income or pay an equivalent amount into the policy as premium.[85] At the executive's death, the death benefit paid to the beneficiary(ies) is paid as an income tax-free benefit.[86]

The assigned cash value may partially or fully represent the executive's account balance, at retirement, or other distribution event. At a distribution event, the business could simply release the assignment on the policy and provide part or all of the benefit to the executive in a lump sum. The payment of the account balance, through a release of the collateral assignment, is income taxable to the executive and possibly deductible to the employer. The executive now has full control of the policy, including the ability to access the policy's cash surrender value through loans, withdrawal or surrender.

## Necessity of Two Agreements

If split-dollar is combined with an NQDC plan, two legal agreements are required. Each is independent of one another in terminology and both prepared by qualified counsel. The NQDC plan agreement should not specifically name the policy as the informal funding vehicle. If the life insurance is referenced as the sole funding source of the account balance, the executive could be held to have a sufficient interest in an identified asset that the plan would be deemed to be funded and thus immediately taxable to the executive.[87] To protect against this, two agreements are needed, one for the NQDC plan and one for the split-dollar design. Neither agreement should reference each other. Each agreement should comply with its respective requirements.

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[85] Treas. Reg. Sec. 1.61-22(d). The Collateral Assignment method is permitted to use the economic benefit model, as described in this paragraph, in a non-equity design (all cash value must be assigned to the employer). Treas. Reg. Sec. 1.61-22(c)(1)(ii).

[86] For federal income tax purposes, life insurance death benefits generally pay income tax-free to beneficiaries pursuant to IRC Sec. 101(a)(1). In certain situations, however, life insurance death benefits may be partially or wholly taxable. Situations include, but are not limited to: the transfer of a life insurance policy for valuable consideration unless the transfer qualifies for an exception under IRC Sec. 101(a)(2)( i.e. the "transfer-for-value rule"); arrangements that lack an insurable interest based on state law; and an employer-owned policy unless the policy qualifies for an exception under IRC Sec. 101(j).

[87] See *Dependahl v. Falstaff Brewing Corp.*, 653 F.2d 1208 (8th Cir. 1981), *aff'g in part* 491 F. Supp 1188 (E.D. Mo. 1980), *cert. denied*, 454 U.S. 968 (1981) and 454 U.S. 1084 (1981).

# Special Design Considerations

Depending on the circumstances and needs of the parties involved, special design considerations may apply to some NQDC plans. Some of these special design considerations are discussed below.

## Rabbi Trusts

A Rabbi Trust is a type of irrevocable trust formed by the employer and trusteed by an independent trustee. The assets used to informally fund the NQDC plan are placed inside the Rabbi Trust and the trust distributes the executive's account balance according to its terms, which are identical to the NQDC agreement or reimburses the business for its payments if the business chooses to pay the benefit out of other assets. A Rabbi Trust is primarily used to protect against a bad faith refusal to pay by the business owner. A business owner may want to access the assets used to informally fund the account balance if there has been a change of heart or if there has been a change of ownership. Further, if the business's owner or majority shareholder wants to participate in the NQDC plan, a Rabbi Trust may put an effective shield between him or her and the assets used to informally fund the benefit without putting them in constructive receipt from plan inception (see Business Owners on page 35).

Even though the assets used to informally fund the benefit may be out of the reach of the business, a Rabbi Trust does not put the executive in constructive receipt because the assets used to informally fund the benefit are still within the reach of the business's creditors.[88] Therefore, the assets used to informally fund the benefit could still be lost to a creditor. Any distribution triggers that are pulled by a decrease in the business's financial health (i.e., financial trigger) put the executive in constructive receipt at plan inception since the ultimate goal of these triggers is to remove the assets used to informally fund the benefit from the reach of the business's creditors. Distributions may only be made in the event of separation of service, disability, death, change of ownership, specific dates, and/or unforeseeable emergencies. Each of these allowable distribution triggers is discussed in Distribution of Benefits on page 25. A Rabbi Trust is not a necessary requirement for an NQDC plan, but may be a valuable tool for both the executive and the business owner.

## Foreign Trusts

If assets set aside to informally fund an NQDC plan are placed inside a foreign trust, such assets will be treated as transferred to the executive, thus requiring immediate income taxation, even though the assets may be subject to the claims of the business's creditors.[89] In addition to income taxation, the executive may also be required to pay additional penalty taxes. The rule does not apply in the case where the assets are located in a foreign jurisdiction and the relevant services are performed in such jurisdiction.[90]

## Type of Business

For tax-purposes, businesses are basically of two types: C-Corporations and the pass-through entities (i.e., S-Corporations, partnerships and limited liability companies (LLCs)). For organizational purposes, C-Corporations can further be divided into three sub-types: closely held, public or professional. The

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[88] Priv. Let. Rul. 8113107. For examples of Rabbi Trusts, see the Rev. Proc. 92-64, 1992-2 CB 422; Rev. Proc. 92-65, 1992-2 CB 428.

[89] IRC Sec. 409A(b)(1).

[90] *Id*. The foreign trust rule does not apply where substantially all of the services to which the NQDC relates are performed in the foreign jurisdiction where the assets are located.

determination as to which type of business is involved will be relevant concerning whether an NQDC plan is appropriate. In addition, whether the participant is a business owner or a non-owner executive is determinative. The following discussion will be divided into two categories: non-owner executives and business owners. Each business type and sub-type will be addressed to ascertain the appropriateness of the NQDC plan.

### *Non-owner Executives*

Generally, for the non-owner executive, the type of business is irrelevant. The executive's main concern is the pre-tax deferral of income. The fact that it may appear appropriate from the executive's perspective, however, still must be balanced against the business owner's interests. Usually, if the business is a C-Corporation, the business owner will find implementing an NQDC plan for its executives attractive.

For instance, in a closely-held business, the business owner will probably own between 51% and 100% of the company. Deferrals into an NQDC plan, however, are not deductible; i.e., they are included in the tax base and are taxable to the business. Therefore, depending on the percentage of ownership, taxing the deferrals to the business may be of insignificant difference economically than taxing them directly to the business owner(s). Since the business will typically be in a lower tax bracket than the business owner, this result may be desirable considering the benefits an NQDC plan will confer upon valued executives.

In a publicly traded company, executives may be less likely to participate in an NQDC plan. After separation of service, key employees of a publicly traded company must wait six months before they may receive a distribution from the NQDC plan.[91]

## Business Owners

Implementing an NQDC plan for business owners presents an entirely different perspective. As discussed in the previous section, a business owner absorbs the income tax impact personally. Although this may be less of a problem if they own a C-Corporation, it is significant if they own a pass-through entity. NQDC planning for business owners of pass-through entities makes little sense. Since they are already taxed on the "deferrals," why not take the income personally and avoid the risk that they may lose their account balance to a business creditor? Many small businesses are formed as sole proprietorships, S-Corporations, or LLCs taxed like a partnership. All of these business forms are pass-through entities and NQDC planning for the owner of these business types is unlikely.

There are three other factors that an owner of a C-Corporation implementing an NQDC plan will want to consider. First, if the owner of a C-Corporation is the driving force behind the business and sells it prior to receiving his or her deferred compensation, then he or she may face the risks of the new owner of the business.[92] The risks of the new owner are that the business could fail after the original business owner retires or perhaps the new owner could refuse or may be unable to honor the deferred compensation obligation.

Second, the IRS has expressed some concern whether an NQDC plan for business owners can effectively be done within the spirit of the law. Specifically, they focused on controlling shareholders stating that,

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[91] IRC Sec. 409A(a)(2)(B)(i).

[92] The plan may allow for distributions upon a change of ownership or effective control. See Distribution of Benefits on page 25.

since a controlling shareholder really controls the business, he or she may be in constructive receipt of any deferrals and matching contributions since there are no restrictions to his or her access to the account balance.[93] The courts have been less prone than the IRS to enforce this view.[94] This issue is unresolved but many feel that the use of a Rabbi Trust, as discussed previously on page 34, may provide sufficient restriction on the business owner's ability to access the assets used to informally fund the account balance.

Finally, just as with executives, the owners of a publicly traded company may also find an NQDC plan less attractive due to the fact they must also wait six months, following separation of service, to receive a plan distribution.[95]

Despite these factors, however, many C-Corporation business owners may still choose an NQDC plan because their participation encourages non-owner executive participation and because they can defer the current receipt of income.

An NQDC plan may still be applicable to non-majority business owners. In many cases these owners may own only a small percentage of the business. In fact, in this respect they may more resemble an executive than a business owner.

## Uninsurable or Older Executives

Usually, when life insurance is used in an NQDC plan, the intention is to put one life insurance policy on each executive with the respective policy's cash surrender value either being the measure of the executive's account balance or determinative in measuring the executive's account balance. Problems arise, however, when the executive is uninsurable due to poor health or is too old for the cash surrender value to have sufficient time to accumulate successfully.

If the executive is uninsurable, then a life insurance policy on his or her life is not viable. Even if the executive is insurable, he or she may be too old for the accumulation of cash surrender value in the policy to be sufficient to informally fund the NQDC plan. Fortunately, however, there are some options.

### *A Different Informal Funding Choice*

Life insurance is not the only informal funding choice. In lieu of life insurance, the uninsurable or older executive's NQDC plan could be informally funded with mutual funds, stocks, bonds, CDs (Certificates of Deposit), or some other investment choice. Deferred annuities, however, may not be an appropriate asset for taxable entities to informally fund the account balance. These annuities, owned by a non-natural person such as a business, do not enjoy tax-deferred growth. Income on such annuities is currently taxable as it accrues.[96]

### *Aggregate Funding*

*Aggregate funding* means combining the corporate obligations created by all the NQDC plan executives and managing it as a whole. An aggregate funded NQDC plan using life insurance approaches life

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[93] Tech. Adv. Mem. 88-28-004.
[94] *William A. Carnahan v. Comm.*, TC Memo 1994-163, *aff'd. without opinion*, 70 F3rd 637, 95-2 USTC 50, 592 (D.C. Cir. 1995).ui
[95] IRC Sec. 409A(a)(2)(B)(i).
[96] IRC Sec. 72(u).

insurance on a grouped basis such as: 1) same death benefit for all executives; 2) same premiums for all executives; or 3) selecting a subset of executives and spreading either the same premiums or same death benefit for the entire group over a subset. Although more commonly used with SERPs, aggregate funding can be used with either Voluntary Deferral Plans or 401(k) Mirror Plans. For example, suppose there are four eligible executives for the Voluntary Deferral Plan but only one is insurable. One policy could be purchased on this insurable executive, into which the deferrals of all executives would be placed.

In cases with large numbers of executives, there is a higher probability of the premature death (i.e., death before retirement) of one or more of the insured executives. In these cases, the aggregate funding can be calculated using both the policies' cash surrender value and death benefits from premature deaths as a source of the account balance assuming the use of reasonable actuarial assumptions.

### *Alternating Funding*

*Alternating funding* means switching between or among different informal funding choices depending on availability and circumstances. For example, suppose an older executive is insurable but the life insurance policy's cash surrender value will not be sufficient to informally fund account balance until well after the executive has retired. In this case, the account balance in the early years can be paid from the business's treasury or from aggregate funding. In the later years of retirement, when the cash surrender value is sufficient, the remainder of the account balance can be paid from the life insurance policy insuring the executive.

# Income Tax Issues

## Constructive Receipt

In order to avoid constructive receipt of the account balance, the agreement to defer must be entered into prior to the services being rendered. Further, the business's promise to pay must be unsecured.[97] For the business's promise to be unsecured, the plan must be considered unfunded (i.e., informally funded). The definition of unfunded for Internal Revenue Code purposes is similar to the definition of unfunded for ERISA purposes, that is, plan assets must be general assets of the business and subject to the claims of creditors.

It is crucial that the agreement to defer is made prior to the beginning of the taxable year in which the services giving rise to the benefits are performed.[98] If the plan is a newly formed plan, or the executive is newly eligible, the executive has 30 days from the date of eligibility to elect to defer future unearned compensation (see Deferral Election on page 20).[99] Under the doctrine of constructive receipt, an executive cannot defer income that has already been earned.

### *Constructive Receipt Plan Failure*

In any years the plan has failed to meet either the general constructive receipt rules, such as formally funding the plan, or the specific constructive receipt rules under IRC Sec. 409A (i.e., impermissible distributions, election deferrals, or use of foreign trusts), all deferred compensation under the plan will immediately be included in the executive's income. In addition to current income taxation, a violation of the IRC Sec. 409A requirements will also result in two additional penalty taxes. First, the executive must pay an amount equal to the interest at the underpayment rate plus 1% for all underpayments that would have occurred had the compensation been included in income when first deferred. Second, a penalty tax of 20% will be assessed on the amount included in income.[100]

An example will illustrate the effect of the additional taxes under IRC Sec. 409A. If the executive had previously deferred $20,000 four years ago, but this deferral violated the constructive receipt rules, the executive would pay income tax on this $20,000 plus the two additional taxes. Assuming the executive is in the highest marginal income tax bracket of 37%, the income tax due on $20,000 would be $7,400. If the underpayment rate was 5%, the executive would pay an interest amount of 24% [6% (5% + 1%) x 4 (for each year since the deferral election was made four years ago)] on the income tax due. This would result in an interest penalty of $1,776 ($7,400 x 24%). Additionally, the $20,000 would also be subject to a penalty tax of 20% or $4,000. In this example, the total tax bill is $13,176 on the original $20,000 deferral.

## Economic Benefit

Even if the NQDC plan is funded, the executive may avoid taxable receipt of benefits if he or she does not have an economic benefit.[101] In other words, the doctrine of constructive receipt applies as if income

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[97] IRC Reg. Sec. 1.451-2(a); Rev. Rul. 60-31, 1960-1 CB 174; Rev. Proc. 92-65, 1992-2 CB 428.
[98] IRC Sec. 409A(a)(4)(B)(i).
[99] Rev. Proc. 92-65, 1992-33 I.R.B. 16, 8/17/92.
[100] IRC Secs. 409A(a)(1); 409A(b)(4).
[101] It should be noted with respect to this last item that even though the executive may not be taxed because there is no economic benefit, the plan would fail the top-hat exemption under ERISA because it was funded.

has been received and the doctrine of economic benefit applies if valuable property rights have been conferred.

Under IRC Sec. 83, unsecured and unfunded promises to pay are excluded from the definition of property and hence not taxable to the executive. If the plan is funded, however, the promise is now property and potentially taxable to the executive if it has value and is not subject to a substantial risk of forfeiture.[102] A substantial risk of forfeiture is not the same as unfunded or informally funded.

A substantial risk of forfeiture exists when the executive's rights to the use and enjoyment of the property are conditioned upon the future performance of substantial services.[103] Whether a substantial risk of forfeiture exists is based upon facts and circumstances.[104] A substantial risk of forfeiture exists when benefits can be forfeited upon termination for reasons other than death or permanent disability. Central to this is that "substantial" means that there must be a possibility that the employee will not perform the required services in order to be exempted from taxation under IRC Sec. 83.

## Directing Hypothetical Investment Options

NQDC plans may offer the executive the ability, similar to a qualified 401(k) plan, to allocate the salary deferrals and/or employer contributions among investment options. This ability presents a challenge to the plan. The issue is whether giving the executive this ability will cause him or her to be in constructive receipt of the account balance.

The IRS stated in PLR 8607021, supplemented by PLR 8702022, that constructive receipt is avoided if the executive may designate a certain hypothetical investment fund as a measure of the investment performance of the amounts credited to the executive and the business is not obligated to follow such designation. Some commentators go even further and, relying on PLR 9332038, believe that giving the executive a right to request certain investments, rather than designating hypothetical investments, will not cause constructive receipt. In addition, these commentators apply, by analogy, Treas. Reg. Sec. 1.457-1(b)(1), which allows the executive to direct the investments of the eligible NQDC plans of tax-exempt organizations without causing constructive receipt. In either case, the facts of PLR 9332038 (e.g., whether the investments were hypothetical and what the business's role was in that choice) are incomplete and the Service has not specifically extended Treas. Reg. Sec. 1.457-1(b)(1) to cover the NQDC plans of for-profit organizations. Therefore, even though this issue must be decided with the assistance of legal counsel, the conservative "hypothetical investment fund" approach of PLR 8607022 appears to be more sound.

In effect, the hypothetical investments act as indices for the growth of the account balance. Actual placing of the money into these investments is not required. Upon distribution, however, the executive is still contractually promised a benefit determined in part by these hypothetical investment indexes. Therefore, a business would be well advised to make such conforming investments in order to satisfy its contractual obligation to the executive.

[102] IRC Sec. 83(c)(1).
[103] IRC Sec. 409A(d)(4).
[104] Treas. Reg. Sec. 1.83-3(c)(1).

As a practical matter, although not contractually obligated to do so, in order to make sure it can meet its contractual obligation upon distribution, the business generally puts the deferrals and matching contributions into the allocated investment. But, the important distinction is that they are not required to do so nor does the executive have the right to force them to do so.

Exactly what these hypothetical investments should be is another matter. Many choose simple indexes such as treasury bills of varying duration. Other NQDC plans, however, may offer several portfolios, similar to the separate accounts of a qualified 401(k) plan.

## Pro-Rata Interest Deduction Disallowance

Within TRA '97 an often overlooked tax law[105] was passed that potentially impacts all NQDC plans informally funded with life insurance. This law is the pro-rata interest deduction disallowance and it applies to all policies issued after June 8, 1997.[106]

The pro-rata interest deduction disallowance means that a portion of a business's deductible interest (not the interest related to the life insurance policy, but all otherwise deductible interest, e.g., mortgage interest, interest on lines of credit, etc.) will be disallowed equal to the ratio of life insurance cash value to total business assets. In numerical terms, if one third of a business's assets is life insurance cash value, then one third of all business interest deductions will be disallowed. The cash value of all business life insurance, wholly business-owned policies, as well as policies used in split-dollar designs, is figured into the interest disallowance calculation.

On its face this law poses a serious threat to the use of cash value life insurance as the informal funding choice for NQDC plans. Fortunately, however, included in this law are sufficient exceptions to preserve most of the uses of business-owned life insurance without causing the pro-rata interest disallowance. If, at the time the life insurance policy was issued, the insured was either a 20% or more shareholder (or a spouse in a survivor life policy), an officer, a director or an employee, the pro-rata interest disallowance will not be applied.[107] At this time, only policies on less than 20% owners and persons otherwise unrelated to the business, such as customers, will cause the pro-rata disallowance.

[105] IRC Sec. 264(f).
[106] IRC Sec. 264(f)(2)(A).
[107] IRC Sec. 264(f)(4).

# Withholding and Reporting Requirements

## Income Tax

An objective of the properly designed NQDC plan, offering voluntary salary deferrals, is the executive's pretax deferral of income. As such, if properly done and with timely deferral elections, no income tax need be withheld or reported on the deferral. Assuming the executive is a W-2 employee, pretax deferrals do, however, need to be reported on the executive's Form W-2 in box 12 using code Y. Yearly deferrals plus earnings need to be reported.

If IRC Sec. 409A is violated such that the executive is now in constructive receipt of his or her account balance, the amount that is required to be included in income must be reported on the executive's W-2 Form in box 12 using code Z. These amounts will be subject to the underpayment interest and the 20% penalty tax discussed earlier.

Permitted distributions to the executive of his or her account balance must be reported on the executive's W-2 Form in box 1 and in box 11.

Distributions made to the executive's beneficiary, due to the death of the executive, are reported on Form 1099-Misc.

If the individual is not an employee, deferrals of compensation must be made on Form 1099-MISC in box 15a. Permitted distributions should be reported on box 7 of Form 1099-MISC. Should the NQDC plan fail IRC Sec. 409A, such that the individual is in constructive receipt of the account balance, this amount must be included in box 7 and box 15b of Form 1099-MISC.

## Social Security and Other Payroll Taxes

Employer contributions or executive salary deferrals are subject to social security, Medicare, and federal unemployment tax withholding when they are vested (i.e., not subject to a substantial risk of forfeiture). While employer contributions may be subject to a vesting schedule, executive voluntary salary deferrals generally are not. As such, salary deferrals are subject to these taxes at inception.

Unlike the rules for federal income tax withholding, withholding requirements for FICA (social security and Medicare) and FUTA (federal unemployment) taxes are not controlled by when the employee receives the deferred compensation payments, but rather by when the latter of two events occurs: (i) when the services for the amounts deferred have been performed by the employee, and (ii) when the employee's rights to the deferred amounts are no longer subject to substantial risk of forfeiture.[108]

Most executives, however, will earn salaries well above the maximum compensation limits for social security and federal unemployment taxes. OBRA '93, however, removed the compensation limit from the Medicare portion of FICA taxes. Therefore, Medicare tax will still be withheld on all amounts deferred by the executive.

[108] IRC Secs. 3121(v) Sec. 3306(r); *see* Notice 94-96, 1994-2 CB 564.

Once FICA and FUTA have been withheld, any further growth on the deferrals is inoculated from further FICA and FUTA taxation.[109] Since FICA and FUTA will have been withheld upon plan vesting, benefit payments from an NQDC plan will not be subject to FICA and FUTA taxation. Further, benefits received from an NQDC plan are not considered wages for purposes of calculating the reduction in Social Security benefits under the work test rules.[110]

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[109] Treas. Reg. Sec. 31.3121(v)(2)-1(a)(2)(iii).
[110] Rev. Rul. 77-25, 1977-1 CB 301.

# ERISA Issues

ERISA (the Employee Retirement Income Security Act of 1974) was enacted to regulate employee benefit plans. There are two types of employee benefit plans, welfare benefit plans and pension benefit plans. Because they pay a benefit at retirement, NQDC plans are pension benefit plans for purposes of ERISA.

Pension benefit plans must satisfy all five Parts of Title I of ERISA. These parts are as follows: Part 1 Reporting and Disclosure; Part 2 Participation and Vesting, Part 3 Funding, Part 4 Fiduciary Requirements, and Part 5 Claims Procedure. NQDC plans can be exempted from most of these requirements if the plan is "unfunded," i.e., all plan assets are reachable by the business's creditors and it is limited to the "top-hat" group of employees. If the plan is exempt, then the only ERISA requirements are a brief written description of the plan to be filed with the Department of Labor (i.e., the DOL letter) and a formal claims procedure.[111]

## Unfunded

A plan is considered unfunded if benefits are paid solely from the general assets of the company. To be considered a general asset, the assets must be reachable by the creditors of the company.[112] Life insurance policies can be used to informally fund the plan if the business owns and is beneficiary of the contracts, and the contracts are subject to the claims of the business's creditors.[113]

## Top-Hat Group

The "top-hat group" is defined in the regulations as a "select group of management or highly compensated employees."[114] Other than that general definition and except for some advisory rulings and statements by key DOL personnel, the DOL has not offered any specific limitations or definable boundaries for top-hat group qualification.[115] There may be a bright line between the top-hat group of executives and other employees. Where this does not exist, the business must take careful consideration in determining the boundaries of the top-hat group.

Generally, it is understood that the purpose of the top-hat exception was to remove from ERISA those employees who did not need its protection.[116] People who do not need the protection of ERISA participate in the decision-making process of the business and are therefore able to protect themselves in the determination and application of employee benefits. They are typically business owners and key executives (those with officer designations) usually less than 10% of the total workforce.[117]

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[111] DOL Reg. Sec. 2520.104-23(b).
[112] DOL Reg. Sec. 2520.104-23(d)(2), DOL Adv. Op. 92-01A.
[113] DOL Adv. Op. 81-11a; see *Belka v. Rowe Furniture Corp.*, 571 F. Supp. 1249 (D. Md. 1983); see also *Belsky v. First National Life Insurance Company*, 818 F.2d 661 (8th Cir. 1987).
[114] DOL Reg. Sec. 2520.104-23.
[115] Further, top-hat group for purposes of ERISA is not the same as the IRC Sec. 414(q) definition of highly compensated employee used in qualified pension plans.
[116] DOL Adv. Op. 90-14A.
[117] The following cases have addressed the top-hat group question: *Darden v. Nationwide Mutual Insurance Company*, 717 F. Supp. 388 (E.D.N.C. 1989); *Pane v. RCA Corporation*, 868 F.2d 631 (3d Cir. 1989); *Loffland Bros. Co. v. Overstreet*, 758 P.2 813 (1988); *Belka v. Rowe Furniture Corp.*, 571 F. Supp. 1249 (D. Md. 1983).

# Proxy Reporting and SEC Registration

## Proxy Reporting

The SEC requires full disclosure of management compensation in the proxies of publicly traded corporations.[118] Management for SEC disclosure purposes means the Chief Executive Officer and highest paid four executive officers whose annual salary and bonuses exceed $100,000. If an NQDC plan is established, included in the proxy must be a clear description of the plan and a Summary Compensation Table listing all deferrals, accruals and payments for the prior three years. Specifically, the amounts deferred and payments from the plan should be listed in column "e" of the Summary Compensation Table (SCT) and titled "Other Annual Compensation." Any above-market interest accruing on these deferrals must be listed in column "h" of the SCT. Interest credited to the NQDC plan is "above market" if it exceeds 120% of the applicable federal long-term rate with compounding at the rate that corresponds most closely to the rate under the business's plan at the time the interest rate or formula is established. The "above market" rate need not be reported, however, if the interest rate is calculated on the same basis as used by a qualified plan that is broadly available to employees.

If life insurance is used as the informal funding choice, it need not be identified in the proxy because what is important for proxy reporting purposes is the amount of compensation deferred and the potential benefit payable. Life insurance is irrelevant for these purposes in the proxy. Should life insurance be stated in the proxy as the informal funding choice for the NQDC plan, it may cause constructive receipt of plan benefits (see Constructive Receipt on page 38).

Nevertheless, if the NQDC plan is informally funded with life insurance and part of that life insurance death benefit is being used to provide a personal death benefit through combination with a split-dollar design (see Split-Dollar Combinations on page 32), the split-dollar aspect may also have to be listed in column "i" of the Summary Compensation Table.

## SEC Registration

For years it was generally believed that NQDC plans were not securities and did not have to be registered as such. For protection, however, many plans obtained "no action" letters from the SEC. The SEC stopped issuing "no action" letters some time ago and now takes the position that most NQDC plans are securities and must be registered unless otherwise exempted. If registration is required, a Form S-8 must be filed with the SEC.

Since the SEC has not issued any regulations on this issue, deciding whether or not to register can be difficult and must be determined on a case by case basis. Apparently, the most significant issue in determining whether or not an NQDC plan is a security is whether investment is the primary motive for entering into the plan. This motive is more likely if the executive is making a choice to defer, such as with a Voluntary Deferral Plan. Further, it would appear that an executive's ability to direct deferrals and/or employer contributions among hypothetical investment accounts would be investment motivated.

[118] Item 401 of Regulation S-K of the Securities Exchange Act of 1934.

# Accounting for NQDC Plans

## APB Opinion No. 12, FASB Statement No. 106

The Accounting Principles Board, or APB, was the controlling organization prior to the formation of Financial Accounting Standards Board, or FASB. In 1967, APB Opinion No. 12 was issued, which dealt with the accounting treatment of voluntary deferral plans. This opinion is still the controlling authority for most deferred compensation plans, although it has been subsequently amended by FASB Statement No. 106 "Employer's Accounting for Post Retirement Benefits Other Than Pensions."

Under APB No. 12, deferred compensation contracts should be accounted for individually on an accrual basis. The estimated amount of future payments under each contract should be accrued in a systematic and rational manner over the period of active employment from the time the contract is entered into. If elements of both current and future services are present, only the portion applicable to the current services should be accrued. Thus, the costs of voluntary deferred compensation plans must be accrued over the period up to the full eligibility date using a systematic and rational approach. Two common methods of accruing for voluntary deferral plans are the "straight line sinking fund" method and the "benefit/years of service" method (See FASB No. 87 discussed below).

In order to properly accrue the liability, the value of the future payments to the employee must be determined. The amounts to be accrued periodically should result in an accrued amount at the full eligibility date equal to the then net present value of all the future benefits expected to be paid. The full eligibility date as defined in FASB Statement No. 106 is: "the date at which the employee has rendered all service required to earn the right to receive the benefits expected to be received." The full eligibility date is not affected by when benefit payments begin.

For example, assume a company agrees to pay an executive $50,000 per year for 10 years at retirement. The executive is 45 years old and is eligible to collect any time after age 55, with a normal retirement date of age 65. In this example, the active service period is 10 years (age 45-55), since the full eligibility date is age 55. If the employee could not collect until age 65, the accrual period would be 20 years (age 45-65).

In order to determine the present value of the future benefit payments, an interest rate must be assumed for discounting purposes. APB No. 12 provides no explicit guidance on determining what interest rate is to be used, however, many companies use a rate associated with high quality fixed income investments, the discount rate required for pensions and post-retirement benefits, or the company's incremental borrowing rate.

Let's examine how this treatment is applied to an executive's deferred compensation plan. If an executive is to receive 10 payments of $10,000 per year at retirement, the value of these payments is $100,000. For simplicity, we will assume full eligibility at retirement. This type of plan can be a defined benefit voluntary deferral plan or a supplemental executive retirement plan (SERP). However, the employer does not need to have $100,000 available on the date of retirement, since it is assumed that the deferral account is invested and will earn interest until actually paid out. Assuming a 7% discount rate, the amount needed at retirement is $70,235. This is the liability amount that needs to be accrued over the period up to the date of full eligibility.

If the payments were to be paid for the life of the executive, the future benefit would be calculated using the life expectancy of the executive. The life expectancy should be determined using current mortality tables.

The annual liability accrual is an expense for income statement purposes and a liability for balance sheet purposes. Under the straight line sinking fund method, a deferred compensation expense account, an interest expense account, and an accrued deferred compensation liability account are created in order to record the journal entries. The interest element is computed by multiplying the assumed discount rate by the accrued liability up to that point. This results in an increasing amount of interest expense each period as the liability grows.

This expense is not deductible for income tax purposes until the benefit is actually paid to the employee, thus creating a temporary difference between financial and tax accounting records. Additional discussion of tax accounting is provided under the Accounting for Taxes section on page 50.

Assuming the executive had 10 years of service remaining until retirement, the $70,235 liability would be accrued over the 10 year service period. The initial deferred compensation expense calculated using the 7% discount rate would be $5,084. Under the straight line sinking fund method, this amount would remain constant each year, with the interest expense increasing each year as discussed above. At the end of the 10th year, the total value accrued equals the net present value of the future benefits. Thus, the balance sheet will reflect a $70,235 deferred compensation liability in year 10. The following exhibit shows the journal entries using the straight line sinking fund method for the example described above. After the journal entries for the 10th year are recorded, the deferred compensation liability account will reflect a balance of $70,235.

| | DEBIT | CREDIT |
|---|---|---|
| **YEAR 1** | | |
| Deferred Compensation Expense | $5,084 | |
| Deferred Compensation Liability | | $5,084 |
| **YEAR 2** | | |
| Deferred Compensation Expense | $5,084 | |
| Interest Expense | $ 356 | |
| Deferred Compensation Liability | | $5,440 |
| **YEAR 3** | | |
| Deferred Compensation Expense | $5,084 | |
| Interest Expense | $ 736 | |
| Deferred Compensation Liability | | $5,820 |
| **YEAR 4** | | |
| Deferred Compensation Expense | $5,084 | |
| Interest Expense | $1,144 | |
| Deferred Compensation Liability | | $6,228 |
| **YEAR 5** | | |
| Deferred Compensation Expense | $5,084 | |
| Interest Expense | $1,579 | |

| | | |
|---|---|---|
| Deferred Compensation Liability | | $6,663 |
| **YEAR 6** | | |
| Deferred Compensation Expense | $5,084 | |
| Interest Expense | $2,046 | |
| Deferred Compensation Liability | | $7,130 |
| **YEAR 7** | | |
| Deferred Compensation Expense | $5,084 | |
| Interest Expense | $2,544 | |
| Deferred Compensation Liability | | $7,628 |
| **YEAR 8** | | |
| Deferred Compensation Expense | $5,084 | |
| Interest Expense | $3,079 | |
| Deferred Compensation Liability | | $8,163 |
| **YEAR 9** | | |
| Deferred Compensation Expense | $5,084 | |
| Interest Expense | $3,650 | |
| Deferred Compensation Liability | | $8,734 |
| **YEAR 10** | | |
| Deferred Compensation Expense | $5,084 | |
| Interest Expense | $4,261 | |
| Deferred Compensation Liability | | $9,345 |

## Defined Contribution Plans

In the examples used, the deferred compensation plan provided for a defined benefit payment of $10,000 per year for 10 years. Another type of deferred compensation plan is the defined contribution plan. A defined contribution plan specifies the amount contributed or deferred into the plan, but does not specify the amount that will be paid to the executive. That amount will be determined by the account balance that has accrued at retirement.

In a defined contribution plan where the employee is fully vested in the contribution, the entire amount of the employee's deferral, plus any vested interest credited must be accrued as a liability. In addition, any matching contributions made by the employer that are vested, must also be accrued. If interest accruals or matching contributions are subject to a vesting schedule, these amounts can be accrued over the vesting period. Assume a 55 year old executive agrees to defer $10,000 per year until retirement at age 65. The company will match 25% of the deferral, and will credit an interest rate of 7%. The employer's deferred compensation liability for the first year would be $13,375 ($10,000 deferral plus $2,500 company match, plus $875 interest, assuming the salary deferral and company match occurred at the beginning of the year). The journal entry for this liability is:

| | DEBIT | CREDIT |
|---|---|---|
| Deferred Compensation Expense | $12,500 | |
| Interest Expense | $ 875 | |
| Deferred Compensation Liability | | $13,375 |

## FASB Statement No. 87 "Employers' Accounting for Pensions"

In general, most deferred compensation plans will fall under the accounting principles outlined in APB No. 12. However, if the deferred compensation plan is deemed to be equivalent to a pension plan, FASB Statement No. 87 "Accounting for Pension Plans" controls the accounting treatment. Examples of plans that would fall under the purview of FASB Statement No. 87 are excess benefit plans and supplemental plans covering employees who are not part of a select group of highly compensated employees that are generally known as the "top-hat group". Voluntary deferral plans and SERPs covering only the "top-hat group" would usually be accounted for using APB No. 12, as discussed above.

If FASB Statement No. 87 applies, the method used to accrue benefit costs must be the "benefit/years of service" method. In contrast, if APB No. 12 applies, the company may use either the straight line sinking fund method or the benefit/years of service method, two methods which are recognized as systematic and rational methods of accrual. Depending on the provisions of the plan, FASB Statement No. 87 requires companies to make a number of assumptions regarding the employee population covered, interest rates, and return on plan assets among others. The statement also provides guidance on how to account for situations where actual experience differs from the assumptions used. Because the provisions of FASB Statement No. 87 are quite complex, use of actuaries and accounting experts is advised. The example below is for illustrative purposes only. Returning to our hypothetical executive who will receive $10,000 per year for 10 years, the steps used in determining the benefit liability under the benefit/years of service method are as follows:

### *Calculating the Benefit Accrual*

Determine the present value of $10,000 per year for 10 years assuming 7% interest: $70,235.

Divide present value by years of service remaining: $70,235/ 10 = $7,024.

Determine present value of $7,024 per year for 10 years at 7%: $3,570. This is the amount of service cost liability that must be accrued in the first year.

### *Calculating the Interest Accrual*

Calculate interest at 7% on $3,570 service cost: $3,570 x 7% = $250. This is the interest cost that must be accrued in the first year. The interest accrual is calculated using the total accrued liability.

The $3,820 total annual service and interest cost is the amount of liability to be accrued on the financial statement. The exhibit below shows the figures for years 2-10:

| Year | Service Cost | Service Cost + Beg. Liability | Interest Cost | Ending Liability |
|---|---|---|---|---|
| 2 | $3,820 | $ 7,640 | $ 535 | $ 8,175 |
| 3 | $4,088 | $12,263 | $ 858 | $13,121 |
| 4 | $4,374 | $17,495 | $1,225 | $18,720 |
| 5 | $4,680 | $23,400 | $1,638 | $25,038 |
| 6 | $5,008 | $30,046 | $2,103 | $32,149 |
| 7 | $5,359 | $37,508 | $2,626 | $40,134 |
| 8 | $5,733 | $45,867 | $3,210 | $49,079 |
| 9 | $6,135 | $55,213 | $3,864 | $59,077 |
| 10 | $6,564 | $65,642 | $4,593 | $70,235 |

This example assumed the same interest rate for the entire period. If rates fluctuated during the period, the calculations would change with every rate change. The employer can choose to "smooth" interest fluctuations for calculation purposes.

## Accounting for Benefit Payments

When benefits are paid to the employee, the accrued liability account must reflect a systematic reduction for the benefit paid. In addition, an interest expense is incurred for the difference between the present value liability reduction, and the actual payment made to the employee. For example, if an employee is to receive $10,000 per year for 10 years, the present value of this benefit is $70,235, which is carried on the books as a liability. The $10,000 payment to the executive is treated as a combination of $4,916 interest expense and a $5,084 reduction of the liability account. The amortization of the liability would be as follows:

| Year | Beginning Liab. | 7% Interest | Liab. Reduction | End Liab. |
|---|---|---|---|---|
| 1 | $70,235 | $4,916 | $5,084 | $65,151 |
| 2 | $65,151 | $4,561 | $5,439 | $59,712 |
| 3 | $59,712 | $4,180 | $5,820 | $53,891 |
| 4 | $53,891 | $3,772 | $6,228 | $47,664 |
| 5 | $47,664 | $3,336 | $6,664 | $41,001 |
| 6 | $41,001 | $2,870 | $7,129 | $33,871 |
| 7 | $33,871 | $2,371 | $7,629 | $26,242 |
| 8 | $26,242 | $1,837 | $8,163 | $18,079 |
| 9 | $18,080 | $1,266 | $8,734 | $ 9,345 |
| 10 | $ 9,345 | $ 655 | $9,345 | $ 0 |

The journal entry for the first $10,000 payment to the executive would be:

| | DEBIT | CREDIT |
|---|---|---|
| Interest Expense | $4,916 | |
| Deferred Compensation Liability | $5,084 | |
| Cash | | $10,000 |

The cash to fund the benefit payment would come from the policy's available cash value. Though linked, the deferred compensation liability and benefit payments are accounted for independently of the accounting for the insurance.

# Accounting for Taxes

## FASB Statement No. 109 “Accounting for Income Taxes”

While the employer must accrue the expense of the deferred compensation plan on a current basis, the ability to deduct this expense for tax purposes is generally deferred until such time as the benefit is paid to the executive. This creates a temporary difference between financial and tax accounting, as was discussed earlier.

Under FASB Statement No. 109, a deferred tax liability or asset is recognized for the estimated future tax effects attributable to temporary differences between financial accounting and income tax accounting and carryforwards. FASB Statement No. 109 is quite complex and cursory treatment of the subject is given below.

The amount of deferred tax asset or liability must be calculated using the procedures outlined in FASB Statement No. 109:

1. Identify the amounts and types of temporary differences, the amount of operating losses and tax credit carryforwards, and the remaining period for using these carryforwards.
2. Measure the deferred tax asset (and/or deferred tax liability) for temporary differences and loss carryforwards using the applicable tax rate.
3. Reduce deferred tax assets by a valuation allowance, if it is more likely than not (more than 50% likelihood) that all or some portion of the deferred tax assets will not be realized. The amount of the valuation allowance should equal the amount of the tax asset that is more likely than not to be realized. In other words, if there is a more than 50% chance that the corporation will not be able to use the tax asset in the future, the asset should not be carried on the books. In determining whether a valuation allowance is needed, all available evidence must be considered. This would include the company’s current financial position, results from current and prior years, possible sources of future taxable income, and any future “tax planning strategies” the company may undertake to utilize the deferred tax assets. FASB Statement No. 109 gives explicit guidance as to under what instances a valuation allowance would be used.

Let’s look at how to account for the deferred tax asset. Because of the temporary difference between financial and tax accounting, in the example below taxable income is higher than book income for financial reporting purposes. We will assume the employer has taxable income and book income of $450,000 (before taking into account any timing differences). If an employee elects to defer $50,000 of his salary, book income would remain at $450,000, while taxable income would increase by the $50,000 deferral (which would not be currently deductible for income tax purposes) to $500,000. Assuming a 21% tax bracket, the income tax payable ($500,000 of taxable income x 21%) for the current year would be accounted for as follows:

| | **DEBIT** | **CREDIT** |
|---|---|---|
| Current Income Tax Expense | $150,000 | |
| Current Income Tax Payable | | $150,000 |

However, assuming no valuation allowance is needed, the delayed tax deduction creates a $10,500 ($50,000 x 21% tax bracket) deferred tax asset for financial accounting purposes that must be recorded. A second journal entry is recorded to reflect the deferred tax asset:

| | **DEBIT** | **CREDIT** |
|---|---|---|
| Deferred Income Tax Asset | $10,500 | |
| Deferred Income Tax Expense | | $10,500 |

At the time benefits are paid, the tax deduction is taken and the deferred tax asset reverses. The journal entry to expense the tax asset is the reverse of the entry used to create the asset:

| | **DEBIT** | **CREDIT** |
|---|---|---|
| Deferred Income Tax Expense | $10,500 | |
| Deferred Income Tax Asset | | $10,500 |

For additional questions, feel free to contact Pacific Life's Advanced Designs Unit at 800.800.7681 x3690 or advanced.designs@pacificlife.com.

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