

Five common mistakes in nonqualified deferred compensation plans

By Lisa E Silva

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A nonqualified deferred compensation plan is an arrangement in which an employee is compensated for services after the year the services were performed. The intent of most plans is to allow executives to defer compensation to later years, when they expect to be in a lower tax bracket.

NQDC plans remain the only solution for tax-efficient savings where government restrictions on qualified plans mandate reverse discrimination against executive savings. Companies use these plans to provide their top executives with substantial retirement benefits that cannot be achieved with qualified plans, such as a 401(k). NQDC plans have been attractive to employers because of their minimal regulations and reporting requirements.

In a post-Enron world, where 409A regulations are on everyone's radar, companies are struggling to become and remain compliant. The recently finalized IRS regulations are the first to set forth clear guidelines on the administration of all employer-sponsored deferred compensation plans. Due to the plan documentation deadline of Dec. 31, many companies are finally taking a look at their plans. It makes sense to ensure that you are avoiding five common pitfalls:

1. Miscalculation of FICA

Unfortunately, many plan sponsors are negligent in this area. Deferred dollars are subject to FICA taxes at the time of deferral, not distribution. The only exception is when the employee is required to perform future services in order to have a legal right to the promised payment. In this case, the deferred amount (plus earnings up to the date of vesting) is subject to FICA taxes when all the required services have been performed. Employer contributions that are subject to a vesting schedule require FICA taxes to be paid at the time of vesting.

Most executives will hit the FICA maximum (which includes Social Security) mid-year. Once this occurs, they will only be responsible for the 1.45% rate associated with Medicare. Failing to pay FICA is a huge issue - more severe than any other type of 409A infringement. The penalties associated with not paying FICA impact both employees and employers; they include back pay, interest and fines. Willful misrepresentation or miscalculation of FICA could lead to imprisonment.

2. Failing to review and/or update the funding mechanism

There are three approaches companies can take to fund the liability associated with deferred compensation plans: purchase corporate-owned mutual funds, purchase corporate-owned life insurance, or do nothing and pay future liabilities out of cash flow as they arise. Because of the risk and potential accumulation of dollars in the plans, most companies elect the first or second option.

This decision is typically made at plan inception. Plan sponsors then make the mistake of not readdressing the funding mechanism every few years to ensure that it is functioning in the most efficient capacity and providing the employer with the greatest tax leverage. Plan sponsors that operate with net operating losses are attracted to corporate-owned mutual funds because they can offset the taxation of turnover within the funds with their losses and avoid paying the costs built into the COLI contracts.

However, once the plan sponsor begins to operate with a profit or has used all of its net operating losses, a conversion to include COLI could make sense from a tax perspective.

3. Insufficient communication.

Plan sponsors should know what they owe, and employees should know what they have. Most lawsuits are a direct result of miscommunication and misunderstanding. Clear outlines of exactly what the plan is, who's contributing what, how it operates and where to find up-to-date account information, must be made available to all participants.

This is not a one-shot deal. The program should be readdressed with new information each year, not just at inception. Situations where employees don't know what they have, and employers can't demonstrate what is owed, can be catastrophic. Plan sponsors must take the time to educate new participants and re-educate existing participants at enrollment each year. This will remove any ambiguity surrounding the plan and increase the perceived value of the employer-sponsored program.

4. Operational noncompliance

Employers can have the best-drafted, most bulletproof plan in the world, but without proper administration, deviation happens. Running a deferred compensation plan involves more than maintaining a spreadsheet of assets and liabilities. Plan administration must sync with plan documentation. Penalties for noncompliance are a pretty hefty tax bite.

5. Underestimating the importance of investments

NQDC plans are not subject to all the rules and regulations of ERISA and do not carry the weight of fiduciary liability. There is little push to regularly monitor the investments within a plan and/or create an investment policy. For ease, many organizations opt to mirror the investment of their 401(k) plans.

This leads to two issues. First, many organizations fail to update the investment options on the NQDC side when they amend their 401(k) offerings, leaving the NQDC plan with subpar investment options. Second, key executives are typically looking for greater diversification.

Offering more diverse investment options and monitoring them regularly will increase the attractiveness of the plan, which will boost participation and create greater perceived value.

Deferred compensation plans are a great way to give executives the ability to accumulate retirement savings or short-term savings on a pretax and tax-deferred basis. They afford great flexibility and can be structured to create a highly attractive retention and/or incentive tool. Plan sponsors must always remember that these plans require constant and diligent monitoring.

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