I. Introduction

In the competitive market for qualified personnel, employers seeking to recruit, retain, and reward key employees have increasingly turned to nonqualified compensation plans. Unburdened from the contribution and participation limits placed on qualified retirement plans, and with a retention element not available in a simple bonus plan, the nonqualified plan provides a sponsoring employer with a customized financial incentive necessary to recruit and keep these sought-after employees. It has become a crucial technique, supplementing an employee’s qualified retirement to provide a complete retirement package.

Nonqualified plans come in many different forms but common to all is a contractual agreement between an employer and an employee that specifies when, how, and how much an employee will be paid in the future for certain future services. This article defines the issues and strategies that clients must address when considering nonqualified plans for their key employees. It outlines the different types of plans — their structure, taxation, legal requirements, and funding. It also details the changes to nonqualified plans required by the American Jobs Creation Act of 2004 and IRS Notice 2005-1.
II. Defining Nonqualified Plans

Although the Internal Revenue Service (IRS) uses the term deferred compensation as a catch-all phrase which includes all types of plans that defer income, there are actually two distinct categories of deferred compensation: qualified plans and nonqualified plans. Qualified plans, such as a 401(k), are those arrangements which allow for significant tax deferral, but are subject to the complex and often burdensome Employee Retirement Security Act of 1974 (ERISA) provisions and the statutory qualification provisions of the Internal Revenue Code (IRC).

A nonqualified plan is a contractual agreement between an employer and an employee that specifies when and how future compensation will be paid, but one that does not conform to the IRC requirements of a qualified plan. The plan represents an unfunded and unsecured promise to pay benefits in the future. As with qualified plans, an employee does not face income tax liability until plan benefits are actually received. In contrast to a qualified plan, the employer may not place assets in a trust outside the reach of corporate creditors nor take an income tax deduction for setting aside assets intended to informally fund the plan.

When viewed from the perspective of the whole workforce, nonqualified deferred compensation plans have traditionally played a secondary role as compensation and retirement planning tools. However, within the realm of key employees – executives, officers, and critical personnel – the nonqualified plan can take center stage.

Nonqualified deferred compensation plans provide employers with the means to reward only certain designated employees by encouraging them to set money aside for retirement or by setting aside money on their behalf. Since the employer does not have to extend participation to the rank and file employees, it may retain and reward the key employees more effectively than with qualified plan benefits alone, since qualified plan costs include necessary contributions on behalf of a broad spectrum of employees.

The use of vesting, or so-called “golden handcuffs,” encourages employees to stay with their employer and to perform more effectively through the promise of financial security at a later date. Such vesting restrictions do not suffer from the limits applied to qualified plan benefits, and may be individually tailored to create a better incentive for the participant to achieve the employer’s goals. Similarly, specific performance targets defined within the nonqualified plan agreement can help align the goals of the business and employee by providing increased benefits when the company or the participant reach the stated objective.

Since nonqualified deferred compensation plans avoid the complexities of ERISA, the employer avoids time-consuming and expensive administration and compliance, again allowing a more efficient allocation of resources to the employees who impact the business the most.

---

1 Plan benefits under a nonqualified plan are taxable the earlier of actual or constructive receipt. Most plans are designed and operated to delay taxation until actual receipt.
Nonqualified Plan Types

Nonqualified plans can be subdivided into a variety of categories. For purposes of this discussion nonqualified plans will be categorized as follows: compensation deferral plans, supplemental compensation plans, death benefit only plans, and hybrid plans.

A **Deferral Plan** provides an employee with future benefits in place of current benefits. In other words, deferral plans are arrangements that defer earnings that the employee would otherwise take currently. The reduction of an employee's current salary or bonus distinguishes this plan from the others, as the employee's election to reduce current compensation provides the employer with the money to pay future benefits. In this respect a true deferral plan places the employer in the role of custodian of the employee's money until retirement or other specified time. Strictly speaking, a deferred compensation plan does not include an employer contribution, only so-called “employee money.”

A **Supplemental Compensation Plan** is essentially an additional fringe benefit for key employees. Under a supplemental plan – sometimes known as a supplemental executive retirement plan (SERP) or a salary continuation plan – the employee has no option to receive the funds as current compensation. The plan benefit supplements other employee benefit plans. In contrast to a deferral plan, the employer will finance the plan without the employee reducing his or her current compensation. Supplemental plans may in turn be designed as defined contribution (i.e., benefits defined by the growth of contributions over time) or defined benefit (i.e., specific benefit defined in the plan from the beginning).

**Death Benefit Only** (DBO) plans are like supplemental plans in that they may be treated as incentive-based employee benefits that do not require employee contributions. However, these types of plan provide no tangible lifetime benefits to an employee, at retirement or otherwise. Instead, at the participant's death the employer pays a benefit to the participant's designated beneficiary. Death benefit only plans are typically considered supplemental plans since they are an employer paid benefit. In most cases, an annual benefit is paid to a participant's beneficiary upon the death of the participant, although the plan may allow the employer to pay under another schedule. The employee will have no right to amend the terms or amount of payment of the benefit.\(^2\)

A **Hybrid** plan combines the features of a deferred compensation plan and a SERP, allowing both employee and employer contributions to the hypothetical account. In response to this similarity with a popular qualified plan, they are often referred to as 401(k) Mirror or 401(k) Look-Alike plans.

Keep in mind that the types of plans are general categorizations; the mutability of plan design in the nonqualified area allows for many different styles and combinations of plan types. While marketing interpretations of plans lead to many plan names, at heart they may be dissected into these basic forms.

\(^2\) Unlike a split-dollar plan, the DBO plan does not create current taxable income to the employee (whereas the split-dollar plan will generate economic benefit costs or imputed interest amounts). The taxes on the death benefit (income and sometimes estate) are the major disadvantage of a death benefit.
Eligible Participants

ERISA is the federal statutory framework that governs the administration of employee benefit plans and the rights of the beneficiaries under those plans. It applies to any employee benefit plan established or maintained by an employer engaged in commerce or in any activity affecting commerce. However, ERISA imposes different standards of restrictions and different administrative and reporting requirements on different types of plans.

Nonqualified compensation plans are always intended to fit into one of the specific exemptions provided in ERISA and thereby avoid most or all of the requirements imposed on qualified deferred compensation plans. Since avoiding the more burdensome requirements of ERISA is a crucial element in the success of a nonqualified compensation plan, it is essential that the plan meet one of ERISA’s specific exemptions.

Most nonqualified plans should be designed to take advantage of ERISA’s “select group” or “top hat” exemption, which applies where the plan participation will be extended only to a select group of management or highly compensated employees. While there is no clear definition of what constitutes a “top hat” group, the rule seeks to limit participation to individuals who have the capability to bargain with the employer, such as officers and highly paid personnel with unique skills. Though not strictly the same, many plan sponsors interpret the ERISA definition of “key employee” to exclude any employee not classified as a highly compensated employee (i.e., making more than $90,000 in 2005) by the IRC.

In terms of the number of eligible employees in any given plan, one court recently addressed the issue of “select group” of employees in terms of a ratio with the employer’s total workforce, stating that this group should be less than 15% of the workforce. Please keep in mind that there are no purely quantitative definitions to the term “highly compensated employee.” As a result, notwithstanding precedent, it is possible in a given situation for a group of less than 15% to be deemed excessive or for an employee making more than $90,000 to be a non-highly compensated employee.

Nonqualified deferred compensation plans are not limited to situations where an employer/employee relationship exists. Directors and independent contractors may make deferrals under a nonqualified deferred compensation plan, even though a traditional employer/employee relationship does not exist.

Although nonqualified plans may generally be established between almost any kind of business organization and its employees, they are not appropriate where there are not enough employees to allow the arrangement to fit within the guidelines. For example, a nonqualified plan established for two of an employer’s four employees would not likely meet the ERISA “select group” standard since the plan would benefit 50% of the employees.

3 See, for example, requirements related to antidiscrimination provisions (requiring participation by rank and file employees); vesting and funding requirements; annual reporting and disclosure requirements.
Further, the IRS takes the position that a nonqualified plan will not prevent the immediate taxation of benefits promised to an employee-owner if that person has “control” of the employer. The IRS interprets the term control loosely – it is not limited to situations where the employee-owner owns more than 50% of the employer. In Notice 2005-1, the IRS clarified its position on this issue, providing that where an employee owns “significant amount of the total combined voting power or value of all classes of stock” of the employer (or a parent corporation), a number of additional factors must be examined before it may be concluded that the necessary substantial risk of forfeiture could exist. The factors to be taken into account are:

- The employee’s relationship to other stockholders and the extent of their control, potential control and possible loss of control;
- The employee’s position in the company and the extent to which he or she is subordinate to other employees;
- The employee’s relationship to the officers and directors;
- The person or persons who must approve the employee’s discharge;
- Past actions of the employer in enforcing the plan’s restrictions.

For example, an owner-employee of 30% of a C corporation’s stock may be able to participate in an effective nonqualified plan if the other shares are owned by a single unrelated individual. On the other hand, where the president of a corporation owns 10% of the shares and the other shares are diversely held (or held by people or entities under his or her influence), then it may be determined that an enforceable restriction on his access to deferred money may not exist. Because of the risk that an agreement may benefit a person who owns all or part of the employer, nonqualified plans are not recommended for controlling owner-employees.

Finally, the tax characteristics of certain types of business organizations known as pass-through entities, such as partnerships and S corporations, make nonqualified deferred compensation plans for their owners undesirable. While plans set up by S corporations and partnerships for the benefit of non-owner employees may be suitable, plans for owner-employees generally are not.

For example, assume John owns 50% of an S corporation and participates in a nonqualified deferred compensation plan under which he intends to defer $10,000 of salary one year. Also assume that the corporation uses income earned during the year to pay John’s salary or establish the deferral account. The S corporation will not be able to take an income tax deduction for the $10,000 in the deferral year since the money was not paid to the employee. Consequently, $10,000 of additional corporate-level income will pass through to the owners, 50% (or $5,000) of which will be charged to John. Thus, though John has forgone receipt of $10,000 he still has taxable income of $5,000. If John had owned 80% of the S corporation, his $10,000 deferral would be even less effective, since he would be charged (as owner) with $8,000 of pass-through income.

**ERISA “Unfunded” Plans**

Nonqualified deferred compensation plans must be unfunded for both income tax purposes and ERISA purposes. The “excess benefit plan” and “select group” plan ERISA exemptions for
deferred compensation also require that the plan be “unfunded.” Since most employers create nonqualified plans to prevent the employee from recognizing income tax currently and wish to avoid the complications of a funded ERISA plan, the vast majority of nonqualified deferred compensation plans are structured to be unfunded for both purposes.

Funding differs from plan financing, though many loosely use the former term to encompass the latter. Plan financing (sometimes called informal funding), discussed below, refers to the practice wherein an employer sets up an asset reserve from which the future benefit payments will be taken. Though a plan may be financed, (or funded) informally, it should not be considered funded if drafted properly. The Department of Labor (DOL) has indicated that a plan is unfunded if it provides benefits solely from the employer’s general assets. An unfunded plan does not grant the participant a special security interest or right in an asset other than that as general creditor.

Various revenue rulings define a funded plan and these ruling constitute the basic authority for the income tax treatment of nonqualified, unfunded salary continuation plans. They require that the employee’s contractual right to receive benefits in the future, though evidenced by the deferred compensation agreement, be simply an unsecured contractual promise to pay the future benefit. A plan is considered unfunded if:

- there is no reserve set aside to pay promised benefits, or
- any reserves remain a general asset of the corporation, subject to attachment by the corporation’s general creditors.

In other words, the employee cannot have a current beneficial interest in the funds if the plan is to be considered unfunded for tax purposes. This is an important point because taxation is deferred until the participant actually receives benefits in an unfunded plan.

A number of guidelines have evolved from the similar DOL and IRS interpretations of “funded” plans when assets are used to back up plan obligations. In order to be an unfunded plan:

- the employer must have all the rights of ownership in the assets, which must remain subject to the employer’s creditors;
- neither the participant nor beneficiary can have any preferred claim against the assets or any beneficial ownership interest in the assets;
- no representation can be made to the participants or beneficiaries that the assets will be used to provide benefits;
- the plan benefits must not be limited or governed in any way by the assets;
- the plan must not require or allow employee contributions of the employee’s personal assets; and
- if the employer buys life insurance on the participant, the insurance proceeds must be payable only to the employer (i.e., the employer must be named the beneficiary of the policies).

---

6 ERISA §§ 201(7), 301(a)(9), 4021(b)(8).
7 See, e.g., DOL Regs. §§ 2520.104-23(a)(1) and 2520.104-23(d)(2)
III. Plan Financing and Security

While nonqualified plans are unfunded (for ERISA and IRC purposes), many employers choose to informally fund or finance the plan benefits by setting aside money each year. Financing allows the employer to know that when the time comes to pay the benefits a corresponding asset will exist from which to pay it. In this way, future cash flow will not be affected by the participant's retirement. Further, plan participants will likely perceive a financed plan as a stronger incentive than a plan dependent on profits or borrowing after the employee has retired.

Though many types of investments may be used to accumulate this informal reserve, employer owned permanent life insurance is often the preferred asset to use as a financing vehicle for nonqualified deferred compensation plans, since cash values grow tax-deferred (although in some cases subject to Alternative Minimum Tax), and the death proceeds are generally received income tax free. Though premium payments are not deductible to the employer, life insurance cash values may be withdrawn (up to the amount of basis) or borrowed against without causing the employer to recognize income tax.⁹

The flexibility of today's cash value life insurance products allow for plan funding to be closely tailored to the individual plan benefit, whether fixed (e.g., defined benefit SERP), established by formula (e.g., defined contribution plan), or derived from results of a hypothetical investment results (e.g., 401(k) mirror plan). Where a plan calls for a preretirement death benefit, a policy insuring the participant will pay a benefit at the time the employer needs it. If the employee survives to retirement, the employer may choose to keep the life insurance in force until the employee's death. Retirement benefits can be paid from current operating revenues, although cash values could be used to pay at least part of the benefits.

Since benefit payments to the plan participant or beneficiary are fully deductible, there may be substantial tax leverage if the insured employee dies prior to retirement. A plan may be designed so that the receipt of the tax free proceeds at the employee's death reimburses the employer for the after tax cost of the benefits and any other costs of the plan the employer may wish to recover, including the premiums for the insurance policy.

Any insurance policy used to informally finance the nonqualified deferred compensation agreement should be kept separate from the agreement. To avoid ERISA and IRC funded status, the plan should not reference the policy or any other specific asset. While proper financing may result in the policy cash value precisely equaling the promised plan benefit, the plan should not depend on or refer to the policy values.

---

⁹ Compare the cost of a sinking fund of growth and income stocks where dividends and capital gains may reduce the value of the fund when the employer withdraws money. Please note that life insurance values may affect the owner's Alternative Minimum Tax (AMT). Withdrawals from life insurance contracts classified as modified endowment contracts (MEC) will be taxed differently – as coming first from gain and then from basis.
Securing the Benefit

Employees sometimes express concern about the security of a nonqualified compensation plan. They may worry that a mere change in ownership or unexpected financial hardship could affect the business's ability to pay benefits when the time comes. Since a totally secure fund (i.e., a funded plan) triggers immediate taxation, there is no perfect solution to these potential problems. Therefore, it is the responsibility of the professional advisor(s) involved in the transaction to attempt to create a balance between financial security and tax deferral.

Vesting is one step toward improving the employee's comfort level with the risks of nonqualified plans. Another is a rabbi trust (discussed below) that can be used to establish a barrier to the controlling shareholder's "early access" to the plan financing, while still staying within the regulatory limits.

Vesting of Benefits

The term "vested benefits" does not have the same meaning for nonqualified plans as for qualified plans. In an unfunded nonqualified compensation plan, a vested benefit does not provide any rights in assets set aside for plan liabilities, as it would with a qualified plan. This insulates the plan from violating the "risk of forfeiture" rules and generating current income tax. Instead, the employee's interest in the plan – his or her benefit – merely is made nonforfeitable. That is, the employee is not granted any particular right with respect to the underlying assets set aside to fund the plan, but is assured of the right to be paid the vested amount as of the future payment date.

Commonly, an employee's account or benefit is automatically vested with respect to any of his or her salary and bonus deferrals but vested over a stated period of time for supplemental (employer paid) nonqualified benefits. There are three popular types of vesting schedules:

Cliff: With this type of vesting the employee is vested at 0% for a specified number of years after which the employee becomes 100% vested.

Graded: With graded vesting, the employee becomes vested gradually, with increases usually occurring on an annual basis.10

Rolling Cliff: This type of vesting works the same way as cliff vesting except that each year's employer contributions have a different vesting date.

---

10 For example, the employee's account may vest 10% per year beginning in the year following the year of enrollment into the plan, so that in the sixth full year of participation he or she would have the right to 60% of the account upon reaching the specified distribution date (i.e., retirement age).
The Rabbi Trust

A rabbi trust is an irrevocable grantor trust created by the employer to hold plan assets and pay benefits. As a grantor trust, a rabbi trust is transparent for tax purposes – the employer is treated for income tax purposes as the owner of the assets contributed to the trust (i.e., gains and losses of trust assets are treated as the employer’s gains and losses for income tax purposes). However, the trust has substance for purposes of legally withdrawing money. Since it is irrevocable, a rabbi trust provides employees some measure of protection by restricting employer access to the funds. As long as plan financing assets have been contributed to the trust, the employer cannot later decide to withdraw the funds from the trust (as, for example, a new ownership group might want following a change in control). Benefits will be paid by the rabbi trustee whether or not the employer still wants to fulfill the nonqualified plan’s promise to pay. Importantly, however, the rabbi trust cannot protect the assets from invasion by the employer’s creditors as a result of bankruptcy or insolvency.11 As is sometimes said, the rabbi trust can protect the employee from the employer’s unwillingness to pay, but not its inability to pay. Using a rabbi trust does not cause a deferred compensation plan to be considered funded for ERISA purposes.12

Two prohibited uses of rabbi trusts are outlined in IRC 409A (created under the American Jobs Creation Act (AJCA) of 2004). First, assets may not be placed in an offshore trust without the contributions being included in the employee’s income as of the date of contribution, irrespective of any substantial risk of forfeiture and whether or not the employee yet has a contractual right to the assets. Thus, offshore rabbi trusts will not prevent immediate income taxation of contributed funding assets. This provision addresses the perceived risk Congress associates with assets held outside the reach of the U.S. government.

Second, a rabbi trust may not come into being upon the condition of a triggering event during the course of the nonqualified arrangement. If a plan requires the employer to transfer assets to a rabbi trust as a result of an event relating to the financial health of the employer, all assets so transferred will be included in the employee’s income immediately. For example, if the plan states that a trust will come into being if the employer’s stock value falls more than thirty dollars per share in a fiscal quarter, and that any policies of life insurance must be transferred to the trust, the plan will not satisfy this new rule. As a result, the fair market value of the policies would be included in the participant’s income and subject to a twenty percent (20%) penalty tax. Importantly, a plan document may establish a rabbi trust arrangement from the plan’s inception. Only plans that allow for a rabbi trust to spring into being during participation will be penalized.

Note that an implied understanding that a trust will be set up may also be prohibited under Notice 2005-1 provisions requiring plans not only to be drafted properly, but also operated in accordance with the law.

---

11 In light of this fact, the IRS ruled in 1981 that funds that had been set aside in a special trust are still forfeitable to the employee and would not cause a current income tax liability to the employee. PLR 8113107 (Dec. 31, 1980).
IV. Taxation Issues

A variety of taxation issues arise from the creation of nonqualified deferred compensation plans. This section will address the most common issues, which relate to income tax, gift and estate tax, and employment taxes.

Income Taxation of the Employer

An employer's use of cash value life insurance to informally finance its responsibilities under a nonqualified compensation arrangement raises a number of income tax questions, the most common of which are addressed below.

Deductibility of Premiums

When the employer is a direct or indirect beneficiary of a life insurance policy, it may not take a deduction for the premiums paid.13 No deduction will be allowable until such time as the premium paid, or a portion thereof, is included in the employee's income, whether the employee's rights under the plan are forfeitable or not.14

Deductibility of Interest Payments

After June 20, 1986, the deduction for interest on loans to pay premiums is limited to loans of $50,000 or less per insured.15 Prior to that date, employers could apply the four-in-seven rule, under which the employer could deduct the interest paid on the funds borrowed to pay premiums, if at least four of the first seven annual premium payments had been paid without the use of borrowed funds.16

Deductibility of Benefit Payments

Benefit payments are not deductible until the payments are actually made and included in the employee’s income, regardless of the tax accounting method used by the taxpayer.17 Benefit payments made to the employee’s beneficiary and included in the beneficiary’s income will also be deductible expenses of the employer. However, as is always the case, the amount of the deductible expense must be reasonable with respect to the services performed by the employee.18

13 I.R.C. §264(a)(1).
14 I.R.C. §404(a)(5).
16 I.R.C. §264(a)(3).
18 I.R.C. §162, 212.
**Taxability of Insurance Proceeds**

The insurance proceeds received by the employer at the insured’s death will be income tax-free unless a transfer for value has occurred.¹⁹ The normal rules associated with insurable interests still apply, though an insurable interest need only exist at the inception of the plan – a plan that continues past employment will be unaffected. However, life insurance proceeds may be subject to the AMT. Fortunately, the accumulation of cash in the life insurance policy that is later used to pay a deferred compensation liability will not generally be subject to the Accumulated Earnings Tax (AET).

**Income Taxation of the Employee**

Employees are not taxed on deferred amounts or plan contributions until they actually receive the payments. This assumes proper drafting and implementation of the plan (e.g., that the agreement to defer the income is made before compensation is earned; that plan assets are not placed beyond the reach of the employer’s creditors).

Deferred compensation distributions received by a beneficiary are included in the recipient’s income in the year received. In the case where the distribution is financed by a life insurance contract, the distributions are still subject to income taxation. Since the distributions are received pursuant to an employment contract, they are *not* considered “amounts received under a life insurance contract.”²⁰

Where the plan uses life insurance as the general asset reserve, the employee will incur no current income tax liability as long as these three additional requirements are met:

- The employee has no beneficial interest in the policy;
- The policy is accessible to the general creditors of the employer; and
- The employer is the sole applicant, owner, and premium payer of the policy.²¹

**Controlling Shareholder Issues**

If a deferred compensation participant is a controlling shareholder, some special considerations arise, in particular the reasonableness of the controlling shareholder’s compensation. If a shareholder-employee’s total compensation is “unreasonable,” the IRS may deny a deduction for employer payments not deemed to be ordinary and necessary business expenses.

The IRS will not issue an advance letter ruling on the tax consequences of a nonqualified unfunded deferred compensation arrangement with respect to a controlling shareholder employee who is eligible to participate in the arrangement.²² Should the IRS disapprove of the treatment of a controlling shareholder, it may determine that any amounts deferred be considered constructive dividends.

---

¹⁹ I.R.C. §101(a).
²⁰ *Essenfeld v. Commissioner* 311 F.2d 208 (2nd Cir. 1963).
Estate and Gift Taxation

The designation of a nonqualified plan beneficiary will not be a taxable gift unless lifetime payments are actually made to that beneficiary while the participant is alive.

Nonqualified plan survivor’s benefits are included in the employee’s gross estate.\(^{23}\) The amount included in the gross estate is the present value of the benefits if (i) the employee was receiving benefits at the time of death, or (ii) if the employee had an enforceable right to receive future benefits. The IRS considers an employee to have an enforceable right, if, at the time of the employee’s death, he or she had complied with the terms of the compensation agreement.\(^ {24}\)

Depending upon how it is structured, nonqualified plan benefits may qualify for the unlimited marital deduction. If a plan provides a benefit in a single lump sum to the surviving spouse, the marital deduction would be available. To the extent the benefit is payable for a term of years, the benefit would not qualify for the unlimited marital deduction unless (i) the income is payable to the surviving spouse at least annually, (ii) only the surviving spouse may be entitled to the income, (iii) only the surviving spouse may change the beneficiary of the income.

In connection with an irrevocable beneficiary designation, death benefit only plans may provide an estate tax-free death benefit. Under a death benefit only plan, the employee receives no lifetime benefit and typically has no right to vary the terms of payment of the benefit or to vary the amount of the benefit. However, the IRS will include benefits under death benefit only plans in the estates of decedents who have retained an element of control. If estate tax exclusion is an important part of the plan, special care must be taken in drafting the agreement to be certain it does not include a power that would cause estate tax inclusion. Alternatively, another planning technique, such as a split-dollar agreement could be considered.

As an item of income in respect of a decedent (IRD), a participant's beneficiary may take a deduction against income from payments received. The total deduction available is equal to the estate tax paid that is attributable to the plan benefit. Several methods are used for applying this deduction, but most use a ratable or amortized method of allocating the deduction in cases where the beneficiary will receive survivor distributions over a specified period.

Federal Insurance Contribution Act (FICA)

The FICA tax, also known as the social security tax, is paid by the employer and employee in equal measure. This tax is composed of two elements: the old age, survivor, and disability (OASDI) portion, which is paid on wages up to the maximum covered wage base for the year at a current rate of 6.2%; and the hospital insurance (HI) or Medicare portion, which is paid on wages without limit at a current rate of 1.45%.\(^ {25}\)

---

\(^{23}\) I.R.C. §2039(a).
\(^{24}\) Treas. Reg. §20.2039-1(b).
\(^{25}\) Social Security wage base for the OASDI portion is $90,000 in 2005.
Proposed Treasury Regulations issued in 1996 provide guidelines for the taxation of amounts related to compensation provided under a nonqualified plan. Under these regulations, all plans are subject to FICA withholding, regardless of whether structured as supplemental or deferred compensation. Thus, even though the participant will not pay income tax on nonqualified amounts, he or she may face social security taxes on such amounts. Under a nonduplication rule, account payments corresponding to benefit amounts previously subject to FICA are exempt from FICA tax.

The timing of the tax depends on the type of plan and the type of benefits. For account balance plans (i.e., defined contribution plans), FICA applies when the benefits in the account are no longer subject to a risk of forfeiture. Stated another way, when the account vests, FICA applies. Since in a true deferral plan a participant’s account will usually be fully vested at all times, and since most participants in such plans will already be over the OASDI wage base, subjecting vested deferral amounts to FICA will only mean subjecting the account to the HI tax at 1.45%. For supplemental defined contribution plans with a vesting schedule, the date when the account vests will cause the vested amount as of that date to be considered wages for FICA purposes.

For nonaccount balance plans, a similar timing rule applies, but to the present value of a vested benefit instead of to the present account value. Thus, if a plan has no vested benefit amount, benefits will be considered FICA wages only when actually paid. However, if a plan provides that a participant’s ultimate benefit becomes 50% vested in a given year, then 50% of the present value of that benefit will be included in the FICA calculations for that year. As with account plans, the determination that plan benefits constitute wages for FICA purposes will usually only affect the HI portion since most participants will already be over the OASDI taxable wage base.

For plans under which only a death benefit will be provided (DBO plans), FICA does not apply.

V. Plan Design Considerations

One of the most important tax benefits of an unfunded nonqualified compensation plan is that the employee can be vested in future benefits without incurring a current income tax liability. This goal of deferring current tax liability is in conflict with the employee’s goal of assuring (as much as legally possible) his or her ultimate receipt of the promised benefit. To resolve the tension between these two competing goals, courts have applied the constructive receipt and economic benefit doctrines. The rules set forth in IRC 409A, Notice 2005-1 and the forthcoming regulations have further defined these traditional concepts.

26 See Prop. Regs. §§31.3121(v)(2)1 and 2; §31.3306(r)(2)-1. The regulations use the term “deferred compensation” but these regulations apply to true deferral plans as well as supplemental (employer money only) plans.

27 An account balance plan is a nonqualified plan with the following features: (1) crediting principal to an account for a participant; (2) crediting income (earnings) to the account based on the principal; and (3) paying benefits based only on the account balance as of the distribution date. See §31.3121(v)(2)-1(c).

28 A nonaccount balance plan's benefit is reasonably ascertainable if the benefit calculation depends only on assumptions or inputs related to interest rates, mortality, and cost of living. Present value calculations must use reasonable mortality and interest assumptions and a commonly accepted accounting methodology.

29 See IRC §3121.
If a plan does not meet the statutory guidelines of IRC §409A, any amounts deferred or accrued are included in the participant's income. This includes any previously deferred amounts, by any participant affected by the provision causing the violation. The amount included in income is also subject to interest at the underpayment rate plus one percent (1%) and a penalty tax of twenty percent (20%).

**Employee Deferral Elections**

Under the rules of constructive receipt, an employee is taxed on income when it is made available to the employee, even if the employee does not actually take the money. Arising in the context of deferred compensation plans (i.e., not SERPs), good drafting traditionally demanded that a plan require an employee to elect to defer money before earned. Such an agreement, coupled with an unsecured “promise to pay,” did not cause constructive receipt. Now, however, under statutory guidance issued by the IRS in 2004, deferral elections must conform to the following rules in order to prevent taxation of the employee on the deferred amounts:

- First-time mid-year deferral elections must be made within thirty days of eligibility. Only amounts earned with respect to service performed subsequent to the election may be deferred.
- On-going elections must be made in the taxable year preceding the year of service.
- For performance-based compensation where the compensation depends upon services performed over a period of at least twelve months, the deferral election may be made no later than six months before the end of the measuring service period.
- An election to further delay payments (or change their form) must be made at least twelve months prior to the first payment (as originally scheduled), but not before twelve months prior to the original deferral election.

These specific rules apply in addition to the pre-AJCA general rules of constructive receipt.

**Noncompetition Agreements**

Under the concept of economic benefit, if funds are irrevocably transferred for the future benefit of an employee, this is an economic benefit subject to current income taxation. A nonqualified

---

30 Interest is retroactive to the date it would have been included had the plan not been in place – i.e., the year of deferral.
32 Note that the thirty day window begins as of the first day of eligibility, not participation.
33 In a change from prior law, participants may no longer stop deferrals mid-year (with a possible exception for unforeseeable emergencies).
34 Notice 2005-1, Q&A 23 outlines a preliminary definition of performance-based compensation, but indicates that future regulations will define the term.
35 For example, a plan may allow a participant to change the date of receipt of payments from July 1, 2006 to January 1, 2007, but the election must be made by July 1, 2005. If the subsequent deferral relates to a separation from service or change in control, the payment date must be moved back at least five years from the original first payment date.
A compensation plan can create taxable income if the plan is funded or the employee’s rights are not subject to a “substantial risk of forfeiture.”

Notice 2005-1 provides that substantial risks of forfeiture added after the beginning of a service period are disregarded for purposes of determining whether a risk of forfeiture exists. As a result, a subsequent (or mid-stream) deferral election of a vested benefit that otherwise meets the IRS guidelines will not be effective unless the amounts are conditioned upon additional substantial future services or the occurrence of a condition related to a purpose of the employee’s work. This rule prevents the use of a so-called “rolling risk of forfeiture” to delay the payment period once the service period has begun.

A by-product of this interpretation is that nonqualified amounts may no longer be made subject to the necessary substantial risk of forfeiture merely by a contractual promise to refrain from work (i.e., a noncompetition agreement with the employer). Noncompetition agreements alone will not prevent nonqualified amounts from being taxed to the employee when earned.

**Acceleration of Payments**

Except for certain distribution triggers outlined below, payments under a nonqualified plan may not be accelerated without substantial penalties to the employee. Conditions under which payments may be made without penalty prior to the stated beginning date are:

- Where a qualified domestic relations order (QDRO) requires;
- Where there is a conflict of interest requiring a certificate of divestiture;
- If an employee has income taxes related to the vesting of 457(f) plan account;
- If the payment is a distribution of less than $10,000 and represents all of the participant’s interest in the plan;
- If required to pay FICA taxes.

A plan can not permit an employee to elect to receive early distributions in exchange for a penalty of a nominal amount. The use of this so-called “haircut provision” has been thwarted by IRC §409A.

---

36 Treas. Reg. §§ 1.61-2(d); 1.446-1(a)(3),(c)(1)(i).
37 Notice 2005-1 at A-10 states that the risk of forfeiture must be substantial and must relate to the purpose of the compensation, i.e., it must relate to the employee’s performance or business activities or organizational goals (such as the attainment of a prescribed level of earnings, equity value, or a liquidity event).
38 The penalty on the participating employee for not conforming to the requirements of 409A are immediate inclusion in income of any deferred amounts, plus interest at the underpayment rate plus one percent (i+1%), and a penalty tax equal to twenty percent (20%) of the compensation required to be included in income.
39 For example where a newly elected public official must divest himself or herself of interests in a company making bids on government projects.
40 The amount able to be distributed cannot exceed the amount of income tax withholding that would have been required of the employer at the time of vesting.
41 The distribution must be made prior to the later of (a) end of the year if the employee terminated that year, or (b) the date two-and-a-half months after separation from service.
Under 409A a plan may continue to provide distribution options at the normal specified distribution date(s), so long as the choice does not affect the timing of income inclusion. Thus, for example, a participant may be given the choice at retirement of taking distributions under a lump sum or taxable annuity. Since the same amount will be taxed to the participant under either option, the provision will not invalidate the plan.

**Distribution Options**

Prior to 2004, plans had many triggers for distributions to begin. Following the AJCA of 2004 and Notice 2005-1, the events that may be used as triggering dates for nonqualified plan payments to begin have been limited. Distributions from a nonqualified plan may not be made prior to one of the following distribution events:42

- Separation from service;43
- Disability;44
- Death;
- A specified date;
- A change in control or ownership of the employer;
- An unforeseeable emergency causing financial hardship.45

The focus of the change in the law was meant to place the distribution timing beyond the control of the participant. So, for example, a plan could provide that payment begin when the participant turns age 58 (the year her son begins college), but could not provide that distributions begin upon the son’s enrollment into a college. Benefit payments may depend upon such a time, but not such an event.

**Permitted Change in Control Events**

Not all change in control events may be used to trigger benefit payments. Notice 2005-1 describes the permitted circumstances that may be used as a distribution event.46 Generally, a plan may permit a payment under a nonqualified plan upon the occurrence of a number of “change of control events”: (i) a change in the ownership of the corporation; (ii) a change in effective control of a corporation; or (iii) a change in the ownership of a substantial portion of the assets of the corporation.

42 Presumably the list of events includes those listed earlier under the anti-acceleration rules, such as de minimus cash-outs and distributions pursuant to a QDRO.
43 A key employee of a publicly traded company may not be allowed to receive distributions within the first six (6) months after separation from service.
44 Disability as defined in the employer’s disability/health plan or the Social Security definition
45 IRC 409A(a)(2)(B) gives the examples hardships caused by an illness or accident to the participant, spouse, or dependent, or a casualty on or to the participant’s property. Other unforeseeable circumstances may qualify.
46 Notice 2005-1, at Q&A 11-14
A “change in ownership” occurs when a person (or group acting in concert) not holding more than 50% acquires ownership of stock that together with previously acquired stock constitutes more than 50% of the corporation's outstanding total fair market value or total voting power. That is, if a person becomes majority owner, a change in ownership has occurred. Note that the attribution rules of IRC §318 apply in determining an individual's ownership percentage for these purposes, so that stock owned by certain family members, for example, will be treated as owned by the individual.\(^\text{47}\)

A “change in effective control” occurs when one of the following occurs:

- A person (or group) acquires ownership of stock representing 35% or more of the total voting power of the stock of such corporation over a 12-month period; or
- A majority of members of the board are replaced during any 12-month period by directors whose own appointment or election was not endorsed by the directors replaced.

A “change in the ownership of a substantial portion of the corporation’s assets” occurs, with certain exceptions, when a person or group (acting collectively) acquires over a 12-month period assets from the corporation that represent 40% or more of the total fair market value of all the corporation's assets.\(^\text{48}\) For example, if Corporation A transfers 45% of its assets to Corporation B in exchange for 35% of Corporation B's stock, then Corporation A has undergone a change in the ownership of a substantial portion of its assets (and B has undergone a change in effective control).

To qualify as a change in control event, the event must be objectively determinable and not subject to any discretionary procedure that is not strictly ministerial. For example, a plan may require that the board of directors (or compensation committee or plan administrator) certify a change of control before paying benefits, but the plan must define “change in control” in an objective formula to which the board's certification must adhere (e.g., sale or transfer of more than 50% of outstanding stock in a given year). Further, the event must relate to ownership of the plan sponsor (or its parent) and not an unrelated or subsidiary corporation.

**VI. Existing plans – Grandfathering and Amendments**

IRC §409A, Notice 2005-1 and the forthcoming regulations subject all plans to the design requirements outlined above with respect to amounts deferred or provided as a benefit in 2005 and

\(^{47}\) Stock underlying a vested stock option will be considered owned by an individual for purposes of attribution.

\(^{48}\) Certain transfers are ignored for determining if a qualifying change of assets has occurred, including: (i) transfers to a shareholder in exchange for stock (i.e., in a redemption); (ii) transfers to entities of which 50% or more of the total voting power or value is owned by the corporation; (iii) transfers to a person or group that owns 50% or more of the corporation; or (iv) transfers to an entity at of which least 50% of the total value or voting power is owned by a person described in (iii), above (e.g., a brother-sister corporation).
thereafter. They apply as well to all amounts previously deferred or benefits previously provided under plans that are materially modified after October 3, 2004. For example, an unmodified plan established in 1997 with a prohibited haircut provision (allowing the participant to get 100% of her account at will, subject to a 6% penalty for early withdrawal) will not successfully defer income earned in 2005 and following, but will still allow for tax deferral of amounts credited for 1997–2004.

Generally, these guidelines allow for changes to bring plans into compliance or to reduce benefits without such amendments being considered material modifications. However, changes that enhance or add a benefit or right will be considered a material modification (subjecting all amounts to the new guidelines), even if the right or feature is permitted under IRC §409A. For example, the addition of a right to a payment for an unforeseeable emergency would be a material modification, but the removal of a haircut provision will not be. Changes to a hypothetical investment measure (e.g., for 401(k) Mirror plans) are not considered material changes.

Under Notice 2005-1, plans do not have to be amended to conform to IRC §409A until December 31, 2005, but must be operated in good faith reliance on its provisions during 2005. That is, if the plan is operated as if properly amended, amounts deferred in 2005 will not be included in the employee’s income merely because the plan document had not yet been legally amended.

VII. Conclusion

While the rules for nonqualified deferred compensation (and its many variations) have changed, this employee benefit remains attractive for employers seeking to recruit, retain and reward key employees.

---

49 Notice 2005-1 indicates that a deferred amount or accrued benefit will be considered grandfathered only if (i) the employee has a legally binding right to be paid the amount, and (ii) the right to the amount is both earned and vested. For these purposes, the employee’s right to the money must not be conditioned on a requirement to perform further services (substantial or otherwise).

50 Section 409A is not effective with respect to current or future earnings on amounts deferred unless applicable to the amount deferred (e.g., as where a material change makes the amount deferred subject to the new guidelines).

51 Terminating a plan, or amending a plan to stop future deferrals is not a material modification.
This material is designed to provide general information for use by legal counsel. It is not intended as, nor may it be considered, the legal opinion of MetLife on tax or other matters. Private legal counsel alone may be responsible and relied upon for those purposes. Similarly, only qualified private legal counsel may recommend the application of this general information to any particular situation or prepare an instrument chosen to implement any design discussed herein. Any individual receiving a copy of this material should share it with his or her own private legal counsel prior to acting upon any of the plans, designs, or applications it presents.

Circular 230 Notice:

Pursuant to IRS Circular 230, MetLife is providing you with the following notification:
The information contained in this article is not intended to (and cannot) be used by anyone to avoid IRS penalties. This newsletter supports the promotion and marketing of life insurance and annuities. You should seek advice based on your particular circumstances from an independent tax advisor.