Nonqualified Deferred Compensation: An Important Source of Retirement Income

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Nonqualified deferred compensation plans provide a valuable source of retirement income for many thousands of U.S. employees. These plans benefit not only senior corporate officers, but also many mid-level managers, salespersons, and other professional staff.

Nonqualified plans have been thoroughly scrutinized by Congress and the media in recent months. Although some abuses may have developed in this area that need to be addressed, recent legislative proposals would needlessly curtail many beneficial and nonabusive nonqualified deferred compensation plans.

We provide below some general background on the differences between qualified and nonqualified plans and the key rules that apply to nonqualified plans. We explain how nonqualified plans play a meaningful role in the retirement and compensation programs of U.S. companies and how these plans help fill the gaps in retirement income caused by various Internal Revenue Code (Code) limitations. We explain that unlike "tax shelters," nonqualified plans have substantial economic and legal consequences for employers and employees. Finally, we address some of the nonabusive plan features that Congress and the media have recently scrutinized.

"QUALIFIED" AND "NONQUALIFIED" PLANS

It is difficult to know exactly what types of arrangements are intended to be covered when the term "nonqualified deferred compensation plan" is used. Generally, any employer-sponsored retirement plan or arrangement that does not meet the requirements for a "qualified retirement plan" under section 401(a) of the Code can be described as a "nonqualified deferred compensation plan" or a "nonqualified plan." For purposes of this discussion, only nonqualified plans sponsored by for-profit employers will be considered.

Employers Prefer to Provide Qualified Plan Benefits

Favorable federal income tax rules apply to an employer maintaining a "qualified" retirement plan. The employer may deduct amounts as they are contributed to the plan's trust, and the earnings on the trust assets are not taxed. By contrast, an employer may not deduct amounts set aside to meet its obligations under a nonqualified plan until plan benefits are paid to, and taxable to, employees. Further, the employer must pay tax on the earnings generated by any such amounts set aside. Given these tax advantages, an employer would strongly prefer to provide retirement benefits to its employees through its qualified plan(s), rather than a nonqualified plan.

Employees Prefer to Receive Qualified Plan Benefits

Employees would also strongly prefer to have their retirement benefits provided for in a qualified plan, because (1) an employer is not required to set aside any assets to fund a nonqualified plan, and (2) any amounts it does set aside must remain subject to the claims of its creditors. Thus, if an employer goes bankrupt, employees are very likely to lose a significant portion, or all, of their nonqualified plan benefits. By contrast, employers are required to fund benefits earned under a qualified plan by contributing assets to a trust. If the employer becomes insolvent, its creditors may not reach these assets, as they must be held by the trustee for the "exclusive benefit of plan participants." In addition, benefits under qualified plans (but not nonqualified plans) generally are exempt from the employee's own creditors in bankruptcy.

The federal income tax treatment of an employee is also more favorable under a qualified plan. Generally, benefits earned under both qualified and nonqualified plans are taxed only upon distribution to an employee. However, the taxation of certain distributions from a qualified plan will be deferred if the employee "rolls over" the distribution into an IRA or another qualified plan. Distributions from a nonqualified plan may not be rolled over, and thus, are subject to immediate taxation. In addition, except for 401(k) contributions, there are no Social Security taxes on contributions or benefits under qualified plans.

Thus, there are a host of reasons both employers and employees prefer to have retirement benefits provided under a qualified plan rather than a nonqualified plan. However, as explained below, the Code contains numerous limits on contributions and benefits under qualified plans. These limits are intended to cap the so-called "tax subsidy" provided by the government and to promote substantial coverage of rank-and-file employees. However, the limits are so restrictive and complex that they act as a disincentive to the maintenance of qualified plans by employers and result in large gaps in retirement savings and preparedness for many thousands of employees. Therefore, retirement benefits that are in excess of these limits must be provided under a nonqualified plan.

See the attached Appendix A for a brief comparison of qualified and nonqualified plans.

BRIEF HISTORY OF NONQUALIFIED PLANS

Nonqualified deferred compensation plans and arrangements have existed for more than 50 years. In their earliest and simplest form, these plans generally involved an advance agreement between an employer and an employee that an amount to be earned in a given year would be paid to the employee in a subsequent year, generally upon retirement or termination of employment. If the agreement were structured properly in accordance with all Code requirements, the employee would not pay tax on the deferred amount until it was paid to him. The employee hoped to be in a lower income tax bracket when payment was received, and thus, pay less taxes on the deferred amount. While nonqualified plans now take many forms, this same basic structure and tax treatment still applies. The governing tax principles have been based essentially on general constructive receipt principles discussed later in this paper.

ERISA Accommodates Nonqualified Plans

When the Employee Retirement Income Security Act (ERISA) was enacted in 1974, nonqualified plans were common enough and so well accepted that Congress created exceptions to most of

ERISA's substantive requirements for them (although ERISA's enforcement provisions do apply). As discussed below, the primary exception applies to a so-called "top hat plan." A top hat plan is one that is "unfunded and is maintained by an employer primarily for the purpose of providing deferred compensation for a select group of management or highly compensated employees." Another exception applies to "excess benefit plans," i.e., nonqualified plans that provide benefits in excess of the Code section 415 limits for qualified plans.

Limits Placed on Qualified Plan Benefits

Beginning with the enactment of ERISA, Congress has periodically added limitations to the Code to restrict the benefits that may be provided under qualified plans.[1] For example:

- In 1974, the Code was amended to limit the annual amount that could be contributed to an employee's account under a defined contribution plan and the annual amount of benefits that could be paid to an employee from a defined benefit plan. Code section 415.
- In 1986, the Code was amended to cut the annual amount of employee pre-tax contributions to a 401(k) plan from $30,000 (the then current Code section 415 limit) to $7,000. Code section 402(g).
- In 1986, the "ADP" nondiscrimination testing requirements were tightened, and "ACP" nondiscrimination testing requirements were added to the Code, to further limit the amounts that highly compensated employees could contribute, and the employer matching contributions they could receive, under a 401(k) plan. Code sections 401(k) and 401(m).
- In 1986, and again in 1993, the Code was amended to limit the amount of compensation that could be considered in calculating the amount of a participant's benefit. The reduction in the compensation limit to $150,000 in 1993 resulted in a major increase in the employees affected. Code section 401(a)(17).

These Code limits have repeatedly reduced the amount of benefits that highly paid employees would otherwise receive under the normal provisions of a qualified plan.[2] In addition, due to budget constraints, Congress has periodically frozen or rolled back inflation increases in the qualified plan limits. In recent years, these limits have impacted larger and larger numbers of employees. Employers increasingly have had to offer middle and senior level managers, salespersons, and nonmanagement professional staff benefits under nonqualified plans to make up for the reduced benefits that may be paid from qualified plans.

TYPES OF NONQUALIFIED PLANS

While traditional deferred compensation plans are still widely used, nonqualified plans now take various forms. Two of the more common types of nonqualified plans, "mirror" 401(k) plans and "SERPs," provide benefits that would otherwise be provided under qualified plans if the limits under the Code did not exist. These plans are described in more detail below.

Supplemental or "Mirror" 401(k) Plans

These defined contribution plans allow an employee to defer amounts he would have been able to defer under his employer's qualified 401(k) plan but for the limits under the Code. Deferred amounts are credited to a bookkeeping account the employer maintains for the employee. The employer may also credit the employee's account with the amount of matching contributions he would have received under the 401(k) plan had his contributions not been limited by the Code. The account balance is credited with interest or earnings until paid to the employee. In many cases, an employee will be able to choose the investment vehicle(s) used to measure earnings credited to his bookkeeping account, and the vehicles will often be very similar or identical to those available under the employer's 401(k) plan. These elections do not, however, control the actual investment of any amounts set aside by the employer to meet its nonqualified plan obligations. In fact, the employer is not required to set aside any assets to meet its nonqualified plan obligations, and any assets that are set aside remain subject to the claims of the employer's creditors.

Supplemental Pension Plans or "SERPs"

These defined benefit plans typically provide an employee with benefits he would have received under his employer's qualified defined benefit pension plan but for limits under the Code.

These and other types of nonqualified plans are structured to meet certain requirements under the Code and ERISA. We outline those requirements below and discuss briefly how certain common nonqualified plan features have been designed to fit within these rules.

CODE RULES

The Code requirements a nonqualified plan needs to meet are less complex than those imposed on qualified retirement plans. The two primary sets of rules under the Code that apply to nonqualified plans are the constructive receipt and economic benefit rules.

Constructive Receipt Rules and Employee Elections

Under the constructive receipt rules, a taxpayer may be subject to taxation on an amount prior to actually receiving it. These rules apply when an amount has been set aside and a taxpayer may draw upon it without substantial limitations or restrictions. Accordingly, a nonqualified plan must place substantial restrictions on an employee's ability to receive his plan benefits. Thus, an employee may not simply demand an immediate payment of his nonqualified plan benefits.

A few examples of how substantial restrictions are placed on an employee's ability to receive nonqualified plan distributions follow:

- If a plan permits an employee to elect the time and method for the post-employment distribution of his plan benefits, the election must be made well in advance of the employee's termination of employment.
- Any "subsequent election" to change an originally scheduled date to commence the payment of benefits or the method of payment must be made sufficiently in advance of the originally scheduled distribution date.
- A "hardship" distribution will typically only be allowed if the employee suffers an "unforeseeable emergency" for reasons beyond his control and which results in severe financial hardship (as currently permitted under published IRS authority).
- If a plan does permit an employee to elect an immediate distribution of his plan benefits, typically an employee making such an election will forfeit a substantial portion (often 10%) of his benefit under the plan, and may not earn additional benefits for some period of time (a so-called "haircut" distribution).

Qualified plans are not subject to the constructive receipt rules. So employees may elect the time and method for distribution of their qualified plan benefits after they have terminated employment and have a better sense of their retirement income needs. Less stringent rules also apply to the ability to change payment elections and to elect in-service distributions in certain types of defined contribution plans. This flexibility is yet another reason employees would prefer to have their benefits payable from a qualified plan.

Economic Benefit Rules and Rabbi Trusts

An employee may also be taxable on the value of his nonqualified plan benefits under "economic benefit" principles. These rules would apply if an employer sets aside funds outside the reach of its creditors to meet its obligations to the employee under such a plan. In order to avoid this result, an employer will normally keep any assets earmarked for payment of plan benefits either in its own accounts or in a so-called "rabbi trust." In either case, the assets will remain available to meet the claims of the employer's creditors in the event of its insolvency.

A "rabbi trust" is typically established with a financial institution serving as trustee. Because the assets of such a trust remain subject to the claims of an employer's creditors, a rabbi trust does *not* protect an employee from the risk of his employer's becoming insolvent and unable to meet its obligations under the plan. However, if an independent financial institution holds these assets in trust and the trust agreement has appropriate provisions, the trust may provide the employee with some protection from a change in the control of his employer, or from the employer's otherwise having a change of heart and attempting to avoid making payments due under the plan.

Some employers irrevocably set aside assets in a "secular trust" to meet their nonqualified plan obligations. Because the assets of a secular trust are not subject to the claims of an employer's creditors, the "economic benefit" rules apply, and an employee will be taxable on the value of his vested interest in the trust assets. For this reason, secular trusts are used infrequently.

ERISA RULES – "TOP HAT PLANS"

Employer-sponsored plans that provide employees with deferred compensation benefits generally are subject to ERISA's requirements. However, so-called "top hat" retirement plans are exempt from almost all of the substantive rules of ERISA. In order to qualify as a top hat plan, a plan must be (1) unfunded, and (2) "maintained by an employer primarily for the purpose of providing deferred compensation for a select group of management or highly compensated employees." The top hat exception generally recognizes that federal law should not dictate a plan's terms or funding with respect to employees at these levels of the company. Nonqualified plans are typically designed to fit within this exemption.

Basically, a plan will be considered "unfunded" for this purpose if the employer has not set aside assets outside the reach of its creditors to meet its obligations under the plan (similar to the economic benefit rules discussed above). Because the assets of a rabbi trust are subject to the claims of an employer's creditors, plans with rabbi trusts are considered "unfunded."

Whether a plan meets the "select group" requirement is a more difficult question. In most of the cases on the subject, courts have focused on specific objective measures, such as the percentage of the workforce covered by the plan and the average salary of the covered employees compared to the average for the workforce, to determine whether a plan covers a select group. The Department of Labor indicated in 1990 that, in its view, participation in such plans should be limited to individuals with the ability to "influence" the terms of the plan.

KEY ASPECTS OF NONQUALIFIED PLANS

Several key aspects of nonqualified plans deserve closer inspection than that given them in recent months. Specifically, we explain below why:

- nonqualified plans are an important source of retirement income for a large number of employees;
- these plans have economic substance and are properly disclosed;
- certain devices used by a small percentage of nonqualified plans are potentially abusive; and
- recent legislative proposals would go much farther than is necessary to address potentially abusive practices and would needlessly curtail many common and nonabusive practices.

Plans Meet Retirement Income Shortfalls

Due to the many Code limitations described above, the retirement benefits many executives, salespersons, and management employees receive from qualified plans will represent a considerably smaller percentage of their final pay than that received by rank-and-file employees. The same is true of the Social Security benefits these employees will receive in retirement. Nonqualified plans help fill these gaps in retirement income, so that these employees can receive a percentage of final pay in retirement more comparable to that received by a rank-and-file employee.

It is important to keep in mind also that many employers that used to offer both a qualified defined benefit pension plan and a 401(k) plan now offer only a 401(k) plan. Thus, many employees are covered under only one qualified plan, which may or may not provide significant retirement income.

Plans Benefit Numerous Employees

The number of employees covered by nonqualified plans has grown significantly in recent years. Any employee earning over $90,000 is now considered a "highly compensated employee" for qualified plan purposes, and, thus, the employee's benefits may be reduced based on some of the Code limits described above. Thus, many middle managers and salespersons in this income range rely on nonqualified plans to supplement their qualified plan benefits. Often, these employees are the ones most severely affected by Code limitations (e.g., the ADP test). Notably, a recent survey on nonqualified plan coverage found that persons with incomes below $100,000 were eligible to participate in approximately 50% of the nonqualified plans.

Plans Have Economic Substance

Unlike many tax shelters and other arrangements some companies have entered into in recent years, nonqualified plans have substantial economic and legal consequences for employers and employees beyond their tax treatment. An employee who participates in such a plan foregoes current cash compensation in return for his employer's unfunded, unsecured promise to pay deferred amounts in the future. The employee bears the risk that the employer will become insolvent and unable to pay these benefits. The employee also bears the risk of his own insolvency.

An employer sponsoring a nonqualified plan retains the use of the cash that it would have paid to the employees absent the nonqualified plan. However, the employer generally is still subject to tax on the income generated by this amount, even if the amount is placed in a rabbi trust. Moreover, the employer cannot deduct these amounts until they are actually paid to the employee.

In many cases, an employer may use cash it would have paid to the employees to make capital investments in the business or hire new workers. Particularly in the case of small employers, nonqualified plans may be integral to the ability of the employer to grow and create new jobs.

Plans and Liabilities Are Publicly Disclosed

Unlike some corporate liabilities that have drawn attention in recent corporate scandals, an employer's liabilities under a nonqualified plan are included on its financial statements. Similarly, any assets set aside to fund these liabilities, including amounts placed in a rabbi trust, are included as assets of the employer on its financial statements.

Public companies also file electronic copies of their nonqualified plans with the SEC as exhibits to their periodic Form 10-K and Form 10-Q filings. Thus, the nonqualified plans of public companies are available for inspection through the SEC's Web site. Additional information about the amount of benefits under certain nonqualified plans maintained by a public company will be provided in the company's annual proxy statement (also available for inspection on the SEC's web site).

Potential Abuses and Legislation

Recent legislative proposals and media attention have focused on potentially abusive nonqualified plan practices. Specifically, concerns have been raised about devices intended to prevent an employer's creditors from accessing assets set aside by the employer to meet its nonqualified plan obligations. These devices include the use of offshore rabbi trusts and early payment triggering devices. A triggering device could provide, for example, that when an employer's finances deteriorate to a certain predetermined level, the assets set aside would be paid out to plan participants or be moved to a secular trust. The vast majority of nonqualified plans do not utilize these types of devices.

Recent legislative proposals in the nonqualified plan area would go significantly beyond these potentially abusive devices. These proposals would subject an employee to federal income taxes on deferred amounts (or invite the IRS to issue regulations doing the same) merely because amounts were set aside in a rabbi trust or the nonqualified plan contained certain distribution elections.

As explained above, placing assets in a rabbi trust does *not* remove the assets from the reach of an employer's creditors. At most, a rabbi trust provides employees with limited protection against nonpayment in the event of a change in control of their employer or a change of heart by current management. And, again as explained above, most nonqualified plans place substantial restrictions on an employee's ability to elect a distribution of his plan benefits.

It is worth noting that the IRS routinely issues private letter rulings to employers on their nonqualified plans and related rabbi trusts. These rulings are issued pursuant to two IRS revenue procedures on the subject (one of which includes a "model" rabbi trust) and provide assurance that the plans and related trusts achieve the desired tax treatment. Routine IRS approval of these plans stands in marked contrast to the IRS's recent attacks on certain abusive executive compensation arrangements as tax shelters.

Joint Committee on Taxation's Enron Report

Recently, the Joint Committee on Taxation (JCT) issued a report that described certain aspects of Enron Corporation's nonqualified plans and made recommendations for extensive changes in the tax laws for such plans.[3] The report recommended restrictions on rabbi trusts and prohibitions on the use of "haircuts" and other provisions for the acceleration of payment. The report also recommended prohibiting subsequent payment elections and participant-directed investments in nonqualified plans.

As noted above, assets held in a rabbi trust must remain subject to the claims of an employer's creditors, and rabbi trusts do *not* protect an employee from the risk of his employer's becoming insolvent and unable to meet its obligations under the plan.

"Subsequent elections" are often permitted under nonqualified plans to provide employees with limited flexibility in their retirement planning. Longstanding case law makes clear that such an election does not result in constructive receipt of deferred amounts, provided the election is made sufficiently in advance of the originally scheduled distribution date.

Employees in some nonqualified plans, particularly mirror 401(k) plans, may be permitted to designate the investments used to measure earnings credited to their bookkeeping accounts. In recent private rulings, the IRS has determined that the ability to make such elections does not result in constructive receipt. These elections do not control the actual investment of any amounts an employer sets aside to meet its nonqualified plan obligations, and they have no impact on the ability of an employer's creditors to access any such amounts. Thus, it is difficult to understand why the ability to select the earnings crediting vehicle should result in constructive receipt or economic benefit issues.

CONCLUSIONS

Nonqualified plans are an important part of the retirement income and compensation programs of many employers. They help employees—including many below the executive ranks—to achieve their retirement income goals. These plans are not concealed, abusive perquisites reserved for a handful of top executives. Any legislation in the nonqualified plan area should target only potentially abusive practices, such as the use of inappropriate off-shore rabbi trusts or insolvency triggering devices. Legislation should not limit the ability of employers and employees to establish nonabusive deferred compensation arrangements consistent with longstanding tax principles.

NOTES

1. Many of these changes were made to raise revenue— in some cases, to help offset the cost of unrelated revenue-losing provisions.
2. Increases in some of these limits under the Economic Growth and Tax Relief Reconciliation Act of 2001 (EGTRRA) have provided some incremental relief for employers and employees, but these changes have not been made permanent.
3. Joint Committee on Taxation, *Report of Investigation of Enron Corporation and Related Entities Regarding Federal Tax and Compensation Issues, and Policy Recommendations* (JCS-3-03), February 2003.

Appendix A

Comparison of Qualified and Nonqualified Plans		
Tax (or Other) Effect	Qualified Plans	Nonqualified Plans
Employer Deduction	Deduction at time of contribution to trust.	Deduction deferred until employee is taxed.
Tax on Investments	Tax on earnings of assets deferred until amounts are distributed to employee.	Employer currently taxed on earnings of any assets (unless earnings are tax-exempt).
Tax on Employee's Benefits	Tax deferred until amounts distributed to employee. Tax-free rollovers to IRAs and qualified plans allowed.	If properly structured, employee is not taxed until actual receipt. Rollovers are not allowed.
Limits on Contributions/Benefits	Section 415 limits (DC and DB); $200,000 compensation limit; 401(k) deferral limit ($12,000 for 2003); nondiscrimination rules (e.g., ADP and ACP).	Only as imposed by employer.
Payment Flexibility	Constructive receipt rules do not apply; thus, great flexibility.	Constructive receipt rules apply; thus, employee's access to funds subject to substantial restrictions.
Claims of Employer's Bankruptcy Creditors to Assets Set Aside	Amounts must be placed in trust; employer's creditors have no claim to assets.	Employer's creditors have claims to assets, even if held in a "rabbi trust."
Claims of Employee's Bankruptcy Creditors	Protected from claims.	Not protected from claims.
Social Security Taxes	No (except for 401(k) contributions).	Subject to limited extent.