IFG MEMO

WHAT TO DO WHEN QUALIFIED PLAN CONTRIBUTIONS ARE NOT ENOUGH

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Consider a Non-Qualified Deferred Compensation Plan!

A deferred-comp plan can be any plan or arrangement that defers compensation and, along with it, income tax to a later year. While the employee can defer income and taxation on that income, the employer cannot take a tax deduction until the compensation is ultimately paid. So, why would any company consider such an arrangement?

401(k)s have limitations

While employers get current expense deductions for contributions paid into 401(k) plans, these plans are rarely, if ever, enough to meet the retirement income needs of owner-employees, executives, or other highly-compensated executives.

It's not atypical to find that the average wage-earner in a company achieves a retirement income of about 60%-80% of final compensation; however, a highly-compensated executive may only achieve an income of about 10%-30% of final compensation. Because of limits on Social Security and on qualified plans, the published limits are often illusory – simply due to the fact that executives may not be able to fund their plans to the published limits because of nondiscrimination testing… meaning they may lose matching contributions for the same reason.

If an employer is willing to forgo the current deduction, or is already maxing-out its existing qualified plan, it can gain freedom to design and informally fund a non-qualified plan at its discretion.

The good news: There are no limits on either contribution or benefits under a non-qualified plan, except reasonable compensation limits. In effect, it's like having an "unlimited 401(k)-like deferral option. In addition, the employer can choose the plan participants and the employer matching or contribution schemes.

There's more: The employer can avoid all the burdensome non-discrimination, disclosure, and reporting requirements by fitting the plan into an ERISA safe harbor exemption as a non-qualified plan, even though there are some additional requirements.

Maybe more attractive than stock-option plans.

Since accounting changes have now required companies to expense equity arrangements on the income statement, a stock option may potentially produce no financial benefit to a plan participant, even though the company has incurred a significant and non-recoverable accounting cost for that option. A non-equity nonqualified plan could produce a comparable (and certain) financial benefit to the participant and still produce a lower compensation accounting cost.

When is a Nonqualified Deferred Compensation plan appropriate?

The employer must have continuance beyond the retirement of the owner-employee and key executives, which means there must be competent successor business management. So, there must be an entity available in the distant future. Therefore, small, closely-held businesses or professional corporations without clear succession plans to continue the business would not be appropriate candidates. However, certain trust techniques can help reduce some of these uncertainties. You should consult with your financial and legal advisors to determine if this approach is right for you.

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