

Abstract: Nonqualified deferred compensation plans pay executives at some time in the future for services currently performed. Of course, in the hectic course of the average exec's schedule, keeping up with the details isn't always easy. This article explains how these plans differ from qualified plans and what both execs and employers should know.

Avoid penalties by abiding by the NQDC tax rules

Nonqualified deferred compensation (NQDC) plans pay executives at some time in the future for services to be currently performed. If you participate in such a plan, or your business offers one as an employee benefit, it's critical for everyone involved to abide by the applicable tax rules. Of course, in the hectic course of the average exec's schedule, keeping up with the details isn't always easy.

How they differ

NQDC plans differ from qualified plans, such as 401(k)s, in a variety of ways. First, these plans can favor certain highly compensated employees. And though the executive's tax liability on the deferred income also may be deferred, the employer can't deduct the NQDC until the executive recognizes it as income. What's more, any NQDC plan funding isn't protected from the employer's creditors.

What you need to know

NQDC plans also differ in terms of some of the rules that apply to them. Internal Revenue Code (IRC) Section 409A and related IRS guidance have tightened and clarified some of these rules. Specifics to study up on include:

Timing of initial deferral elections. Executives must make the initial deferral election before the year they perform the services for which the compensation is earned. So, for instance, if you wish to defer part of your 2019 compensation to 2020 or beyond, you generally must make the election by the end of 2018.

Timing of distributions. Benefits must be paid on a specified date, according to a fixed payment schedule or after the occurrence of a specified event — such as death, disability, separation from service, change in ownership or control of the employer, or an unforeseeable emergency.

Elections to change timing or form. The timing of benefits can be delayed but not accelerated. Elections to change the timing or form of a payment must be made at least 12 months in advance. Also, new payment dates must be at least five years after the date the payment would otherwise have been made.

Employment tax issues

Another important NQDC tax issue is that FICA taxes are generally due when services are performed or when there's no longer a substantial risk of forfeiture, whichever is later. This is true even if the compensation isn't paid or recognized for income tax purposes until later years.

So, if you're the plan participant, your employer may withhold your portion of the tax from your salary, or ask you to write a check for the liability. An employer may also pay your portion, in which case you'll have additional taxable income.

Consequences of noncompliance

The penalties for noncompliance with NQDC plan rules can be severe. Plan participants may be taxed on plan benefits at the time of vesting, and a 20% penalty and potential interest charges also will apply. So, if you're receiving NQDC, check with your employer to make sure it's addressing any compliance issues.

Putting it all together

Whether you're a busy exec who participates in an NQDC plan or an employer offering one, please contact our firm. We can help incorporate your plan or other executive compensation into your year-end tax planning.

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