THE INS AND OUTS
OF NONQUALIFIED DEFERRED COMPENSATION PLANS

What are they?

Deferred compensation plans are employer-sponsored plans designed for highly compensated employees who have exhausted the benefits they are eligible to receive from their qualified employer plans. These plans are used to reward and retain high performers, increase retirement or other savings objectives, manage cash flow and defer taxes.

Nonqualified plans don't meet the requirement for the tax benefits and protections afforded to qualified employer plans by federal law. But they also don't have the limits on contributions or the same inclusive rules on participation that qualified plans do. While a deferred compensation plan must follow rules (private sector plan rules fall under section 409(a) of the Internal Revenue Code), they're far more flexible than qualified plans. However, participants should be aware that there are certain situations (such as termination before meeting vesting requirements and company bankruptcy) that could result in forfeiture or diminished receipt (as in diminished receipt of deferred compensation amounts).

Who participates?

Employers can be very selective in who participates in deferred compensation plans. They're generally offered to those who receive compensation in the range of or above the exclusion threshold for qualified plan benefits. Employers have many plan design options with varying rules on participation and can structure different rules for different cohorts of employees from the named executive officers in the C-suite to executive-level and highly compensated employees.

How does it work?

Deferred compensation plans have two main plan types:

Supplemental plans: This type of plan is a promise by the employer to pay future compensation for work performed by the employee today. The plan can supplement and mirror the characteristics of a qualified defined benefit plan or it can be a stand-alone structure called a management incentive plan, executive incentive plan or, simply, deferred compensation plan. The participant elections, if any, are limited to investments and distributions, and these plans will have vesting requirements.

Elective plans: This type of plan offers the choice to defer compensation that an employee is scheduled to receive until a later date. Eligible compensation could be base salary, bonus pay, commissions, and even vesting restricted stock unit (RSU) and performance stock unit (PSU) awards. Employers may make matching and/or non-elective contributions to the plan, but the bulk of the contribution is an employee deferral election.

These plan types can mirror qualified defined contribution plans and have names such as a 401(k) restoration or excess plan. They can also be stand-alone elective plans or a component of a broader supplemental and elective deferred compensation structure.

Both types have flexibility in design and vary greatly from employer to employer. A single employer may offer more than one type of deferred compensation plan based on the level of seniority and responsibility of the employee.

Common questions

Q: How do I know if I can participate?

A: Unlike qualified plans, deferred compensation plans are limited to select employees. If you're eligible, you'll get direct communication from your human resources or benefits department. If overall compensation is in the range or above the Employee Retirement Income Security Act (ERISA) compensation limit ($340,000 in 2024), an employee should check with HR about plan eligibility.

Q: What elections should I pay close attention to?

A: Do you have distribution elections for any deferred plan? Do you want the distribution at retirement or at a certain future date? Should it be a lump sum or an installment distribution of 5 to 15 years? Generally, elections must be made at the time of enrollment, and if not, the plan will use the default election. Some plans allow for distribution changes at a later date, but not all. Investment options are a choice for some supplemental plans and all elective plans.

Q: What kind of investment choices will I have?

A: In some supplemental plans, you may not have any investment choice, and the plan will inform you what the investment entails. In elective plans and some supplemental plans, you may have a menu of choices, including company stock and mutual funds. The choices often mirror what you see in your qualified defined contribution plan, and in most cases, they are nominal investments — you aren't invested in the security, just tracking its performance. Your gains or losses are recorded in the plan's record-keeping system.

Q: Why should I participate in a deferred compensation plan?

A: If it's supplemental, it means that your employer regards you highly enough to incentivize productive behavior and reward you for your continued employment.

Use elective plans for tax optimization and/or building retirement assets. A year of higher compensation (base, bonus, vesting RSUs and performance shares, and a supplemental plan distribution) could be a good time to use an elective plan to defer salary for tax reasons.

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