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Nonqualified Retirement Savings Plans

The advent of 401(k) and other qualified employer-sponsored retirement plans has been a boon for those seeking to save for retirement while reducing their current tax bite. But for the growing numbers of individuals earning over $100,000 per year, the benefits of these "qualified" plans are restricted. Because of limitations set by the IRS and the Employee Retirement Income Security Act (ERISA), contributions to qualified plans (both employee and employer matches) are capped and decline proportionately as the individual's income rises. For executives and other highly compensated individuals, the restrictions can reduce contribution limits to a nominal percentage, rendering immaterial the benefits from any qualified plan.

In response to this dilemma, many companies offer nonqualified plans to certain highly compensated employees. Such plans come in many shapes and sizes: defined benefit excess plans, defined contribution excess plans, voluntary deferred compensation plans, and supplemental executive retirement plans (SERPs). Nonqualified plans are not registered with ERISA and are not subject to its limitations. However, these plans are also not protected by ERISA, and executives who participate in them should be aware of their drawbacks as well as their benefits.

Contributions

The first point to keep in mind with nonqualified retirement savings plans is that they are all different. Since they are not governed by ERISA rules, they can be tailored to a specific company's -- or individual's -- needs. Accordingly, contribution limits, employer matches, and vesting schedules will differ significantly from plan to plan. And even within the same company, plan specifics may vary from individual to individual. For example, a Senior VP-level plan is likely to differ from the CEO's plan.

But most nonqualified plans do have certain common features. For one, contribution limits for nonqualified plans have no legal caps and are often significantly higher than for qualified plans. As with qualified plans, contributions to nonqualified plans are tax deferred; taxes are not paid until funds are distributed. Unlike qualified plans, however, contributions are not technically owned by plan participants until they are paid; fund liabilities -- including employee contributions -- represent an unsecured promise to pay on the part of the employer. This can present issues in the event of a sale of the company or if the company goes bankrupt. Depending upon the plan's investment structure, you may find yourself at the end of a line of creditors making dibs on what you thought were "your" plan assets.

Funding Structure

In order to qualify for tax-deferral status, nonqualified plans must pass muster with the IRS on two basic principles: constructive receipt and economic benefit. In essence, these fundamental precepts require a plan to be structured in such a way that plan participants are perceived to be "at substantial risk of forfeiture" -- i.e., participants do not "own" plan funds until they are distributed -- and plans must be funded informally. This means that nonqualified plans require indirect funding structures.

Typically, plans are funded in one of three different ways: "pay-as-you-go," mutual funds, and life insurance. "Pay-as-you-go," or self-fund plans, fund plans directly from operating cash. As benefits come due, they are paid and deducted as business expenses. In practice, this structure is seldom used, as it poses significant cash flow issues to the sponsoring company and offers little in the way of guarantees that the company will meet its funding obligations in the future.

In a plan funded by mutual funds, plan funds are held in a trust -- typically a "rabbi trust" (so named because of a 1981 IRS ruling granting tax-deferred status to a trust established by a synagogue for its rabbi) -- which is invested in mutual funds. The trust will often invest in the same mutual funds available in the company's qualified plan, thus "mirroring" the qualified plan, and offering participants identical fund selection and weightings. Plans structured this way offer simplicity to plan sponsors and a certain amount of security to plan participants, whose plan benefits are assured even if the company is acquired or management tries to renege on its promises.

Perhaps the most popular funding mechanism is corporate-owned life insurance (COLI). In this arrangement, employers fund plans with life insurance. Although COLI-funded plans can be complex, they offer tax-free growth[2], can be cost effective, and are attractive to sponsors seeking to match assets with liabilities created by deferred compensation plans.

If a Nonqualified Plan Is Part of Your Compensation Package...
Find out what the funding structure of your plan is. Different structures affect the security of plan assets in the future, and distribution rules are more flexible under certain structures.
Read the small print of your plan agreement and consult your financial advisor before deferring a significant percentage of your salary. Nonqualified plans differ significantly from company to company and can be very complex.
Maximize your allowable contributions to a qualified plan before deferring any of your salary to a nonqualified plan. You should also fully contribute to a Roth IRA, if you are eligible.

Distributions

Unlike with qualified plans, distribution options under nonqualified plans are determined entirely by the sponsoring company, not ERISA. A given employer may limit the choices on how and when employees receive distributions. Certain plan structures, such as those set up within the framework of a life insurance policy, may permit more flexibility than others.

While employee contributions to most plans are typically 100% vested from day one (although not owned until paid), vesting schedules are often imposed for the employer contributions -- earning some nonqualified plans the nickname "the golden handcuff," in that payout periods are usually stretched out long enough to encourage the executive to remain with the company sponsoring the plan.

Unlike qualified plans, nonqualified plans do not permit employees to roll over plan assets into an IRA or another nonqualified plan when changing jobs. Instead, employees must begin receiving payouts -- and pay taxes on them -- when they leave the company. If this occurs between the ages of 62 and 65 while simultaneously receiving Social Security, an employee could exceed earnings limits imposed by the Social Security Administration and lose some Social Security benefits. Finally, be aware that the IRS has additional tax rules governing nonqualified deferred compensation and distributions. Check with a qualified tax advisor to ensure compliance with the rules.

Source / Disclaimer:

[1]Represents legal limit established by ERISA. Individual company plans will vary.

[2]Certain taxes may apply if sponsor company is subject to the alternative minimum tax.

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