



Nonqualified Deferred Compensation Arrangements

Nonqualified deferred compensation plans or arrangements basically consist of an employer's promise to pay part or all of an employee's (or independent contractor's) compensation in a taxable year after the one in which such compensation is earned. These plans, which can be funded or unfunded, come in many forms and are used for a variety of business purposes. Usually, however, the participants in such plans are an employer's key executives or other highly compensated personnel. Nonqualified plans can either be used in lieu of, or in conjunction with, an employer's qualified retirement plan(s).

Employers and employees have different reasons for wishing to defer an employee's compensation. Frequently, employers that adopt nonqualified plans do so primarily to attract and retain key personnel or to stimulate employees' performance. If the employer's business is relatively new, the employer also may be better able to afford such payments in future years, after the business has established itself.

The tax rules that apply to nonqualified deferred compensation plans are complex and failure to comply can result in severe consequences to the employee. These issues are discussed in detail below.

A nonqualified plan must provide that compensation for services performed during a taxable year may be deferred at the participant's election only if the election to defer is made no later than the close of the preceding taxable year, or at such other time as provided in IRS regulations. In the case of a participant's first year of eligibility, the election may be made with respect to services to be performed subsequent to the election within 30 days after the participant's eligibility date. In the case of any performance-based compensation based on services performed over a period of at least 12 months, the election may be made no later than six months before the end of the service period.

Generally, the time and form of distributions have to be specified at the time of initial deferral. Subject to certain requirements, a plan may allow changes in the time and form of distributions. A plan may specify the time and form of payments that are to be made as a result of a distribution event or could allow participants to elect the time and form of payment at the time of the initial deferral election.

The penalties for noncompliance can be severe. Failure to comply with these changes may result in the immediate taxation of participants' deferred compensation. Participants' deferred compensation benefits may be treated as having been subject to income tax back to the date when the plan failed to comply with these changes. The income tax on each participant may be calculated from that date (or eligibility date) to the current date, adding interest on the underpayment and a 20% excise tax. The IRS has issued final regulations under the Tax Code section discussed above. Plan documents must be amended to comply with the law and regulations by December 31, 2007, and certain employee elections must be made by that date as well.