

## **Nonqualified Deferred Compensation Not Just For The Big Corporations**

*By Bruce J. McNeil*

The value of nonqualified deferred compensation plans and the benefits to be gained from such plans may not yet be fully appreciated or realized by cooperatives. These plans may play a key role in decisions regarding the compensation to be paid to attract or retain a key employee or employees, to provide additional retirement benefits for the key employee or employees, or to achieve certain and desired business objectives for which incentives may be provided to the key employee or employees. This article is intended to provide an overview of these arrangements.

### **Nonqualified Deferred Compensation Arrangements**

Nonqualified deferred compensation arrangements are contractual arrangements between the employer and the employee, or employees, covered by the arrangement. Such arrangements are structured in whatever form achieves the goals of the parties; as a result, they vary greatly in design. Considerations that may affect the structure of the arrangement are the current and future income needs of the employee, the desired tax treatment of deferred amounts, and the desire for assurance that deferred amounts will in fact be paid.

In the simplest form, a nonqualified deferred compensation arrangement is merely an unsecured, unfunded promise to pay a stated dollar amount at some point in the future. However, in most cases, such a simple arrangement does not meet the needs of the parties to the arrangement; thus, the typical nonqualified deferred compensation arrangement is more complicated and may involve a funding vehicle or other mechanism to provide a level of security to the employee.

A nonqualified deferred compensation arrangement may provide for the deferral of base compensation (i.e., salary), incentive compensation (e.g., commissions or bonuses), or supplemental compensation. The arrangement may permit the employee to elect, such as on an annual basis, whether to defer compensation or to receive it currently, similar to a salary reduction or cash-or-deferred arrangement under a qualified employer plan. Alternatively, the arrangement may provide for compensation that is payable only on the occurrence of future events, not currently.

A nonqualified deferred compensation arrangement may be structured as an account for the employee (similar to a defined contribution or individual account plan) or may provide for specified benefits to be paid to the employee (similar to a defined benefit pension plan). Under an account structure, depending upon whether the arrangement is unfunded or funded, a hypothetical or actual account is maintained for the employee, to which specified contributions and earnings are credited. The employee may be permitted to participate in the investment of the amounts credited to the hypothetical or actual account. The benefits to which the employee is entitled are based upon the amount

credited to the account. Under a defined benefit structure, the terms of the nonqualified deferred compensation arrangement specify the amount of benefits (or formula for determining benefits) to be paid to the employee.

### **Top-Hat Plans**

The structure of a nonqualified deferred compensation plan may be in many forms and certain types of arrangements are referred to by specific terms. A “top-hat plan” is a term generally used for certain nonqualified deferred compensation plans that are exempt from most of the substantive requirements of the Employee Retirement Income Security Act of 1974, as amended (“ERISA”). The ERISA exemption applies to a plan that is unfunded and is maintained by an employer primarily for the purpose of providing deferred compensation for a select group of management or highly compensated employees. ERISA does not provide statutory definitions of the terms “select group,” “management,” or “highly compensated employees,” and the Department of Labor has not issued regulations defining those terms. Employees sometimes claim ERISA protection (e.g., vesting or funding) for the benefit under a nonqualified deferred compensation plan; however, most nonqualified deferred compensation arrangements are intended to fall under the top-hat exemption.

A top-hat plan is exempt from the ERISA requirements relating to participation and vesting, funding, and fiduciary responsibility. A top-hat plan is not exempt from the reporting and disclosure requirements or the administration and enforcement provisions of ERISA.

### **Section 457 Plans**

Another type of plan that is adopted by a governmental entity or a tax-exempt organization is an eligible deferred compensation plan which is governed by and described in Section 457 of the Internal Revenue Code (the “Code”). Generally, amounts deferred under a nonqualified deferred compensation arrangement of a tax-exempt employer are currently included in the employee’s income unless the arrangement is an eligible deferred compensation plan described in Section 457 of the Code. The maximum annual deferral under such a plan is \$13,000 for 2004 (the maximum annual deferral that also applies to a plan governed by Section 401(k) of the Code), or the employee’s total includible compensation, if less. In general, amounts deferred under a Section 457 plan may not be made available to a plan participant before the earlier of (1) the calendar year in which the participant attains age 70 1/2, (2) when the participant has a severance from employment with the employer, or (3) when the participant is faced with an unforeseeable emergency. Amounts deferred under an eligible deferred compensation plan of a tax-exempt employer are includible in the employee’s income when paid or otherwise made available to the employee. Amounts deferred under a Section 457 plan of a tax-exempt employer must remain the property of the employer, subject only to the claims of the employer’s general creditors.

If compensation is deferred under a plan of a tax-exempt employer that is not an eligible deferred compensation plan (an “ineligible plan”), the deferred amounts are includible in the income of a participating employee when the deferred compensation is not subject to a substantial risk of forfeiture, even if the deferred compensation is not funded. An ineligible plan is governed by and described in Section 457(f) of the Code. An ineligible plan has more flexibility with regard to the amount that may be deferred, but compensation deferred under the ineligible plan is includible in the gross income of the employee for the first taxable year in which there is no substantial risk of forfeiture of the right to such compensation. An employee’s right to such deferred compensation is subject to a substantial risk of forfeiture if the employee’s rights to full enjoyment of the deferred amount is conditioned upon the future performance of substantial services by the employee.

### **Rabbi Trusts**

A nonqualified deferred compensation arrangement is typically “unfunded” so that the deferred amounts are not includible in gross income until the amounts are actually or constructively received. However, the unfunded status of such an arrangement presents the risk that the employee will not receive his or her deferred compensation when due. Therefore, the question that arises is what sort of security can be provided for the employee without incurring current income tax consequences, i.e., without having the arrangement being considered funded for tax purposes.

An arrangement that has been developed to provide employees with a level of security is a “rabbi trust.” A rabbi trust is a trust or other fund established by the employer to hold assets from which nonqualified deferred compensation payments will be made. The trust or fund is generally irrevocable and does not permit the employer to use the assets for purposes other than to provide nonqualified deferred compensation. However, the terms of the trust or fund provide that the assets are subject to the claims of the employer’s creditors in the event of the insolvency of the employer.

### **In Summary**

A nonqualified deferred compensation arrangement may be used to provide (1) supplemental retirement income for a key employee, (2) an incentive to a key employee to meet certain performance objectives, (3) to attract or retain a key employee to the service of the employer, and (4) a method of deferring compensation and the tax on such compensation to a fixed and determinable future date. A nonqualified deferred compensation arrangement may be a very useful and valuable compensation tool for a cooperative to provide incentives to a key employee or employees to perform services for the cooperative so that desired performance objectives may be achieved or to encourage a key employee or employees to remain with the cooperative.

#### ***About the Author***

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