Nonqualified Deferred Compensation Plan

	Employer	Key Employee
Agreement	Agrees to pay compensation for a set period after a stated date or death.	Agrees to continue service until specified date (e.g., normal retirement age). Optional: After separation, agrees not to compete and/or to provide consultation services.
Advantages	Employer retains key employee.	Employee (or heirs) receives extra retirement benefit when tax bracket may be lower.
Taxation	Benefits paid to employee (or heirs) are deductible to employer when paid or constructively received.	Benefits are taxed when payments are made or constructively received.

How It Works

General Comments[1]

- Deferral must generally be agreed upon before the compensation is earned.
- If the plan is unfunded, the compensation is not taxable until received.
- If the plan is funded, the employee's rights must be subject to substantial risk of forfeiture and they must be nontransferable. If they are not subject to such risk or are transferable, the payments become currently taxable.
- Employer can pick and choose which employees to benefit. However, if they are not highly compensated, the plan may be subject to ERISA requirements.
- A cash value life insurance contract can be used to informally fund an agreement. It can provide the necessary funds at either death or distribution.[2]
- Nonqualified plans are not subject to the pre-age 59½ distribution penalties or the age-based mandatory distribution rules imposed on qualified plans, IRAs, etc.

[1] The AJCA of 2004 significantly changed nonqualified deferred compensation plan rules. If a plan fails to meet the new requirements, compensation deferred under the plan becomes currently taxable and penalties and interest apply.

[2] Under the provisions of IRC Sec. 101(j), added by the Pension Protection Act of 2006, death proceeds from a life insurance policy owned by an employer on the life of an employee are generally includable in income unless certain requirements are met. State or local law may vary. Professional legal and tax guidance is strongly recommended.