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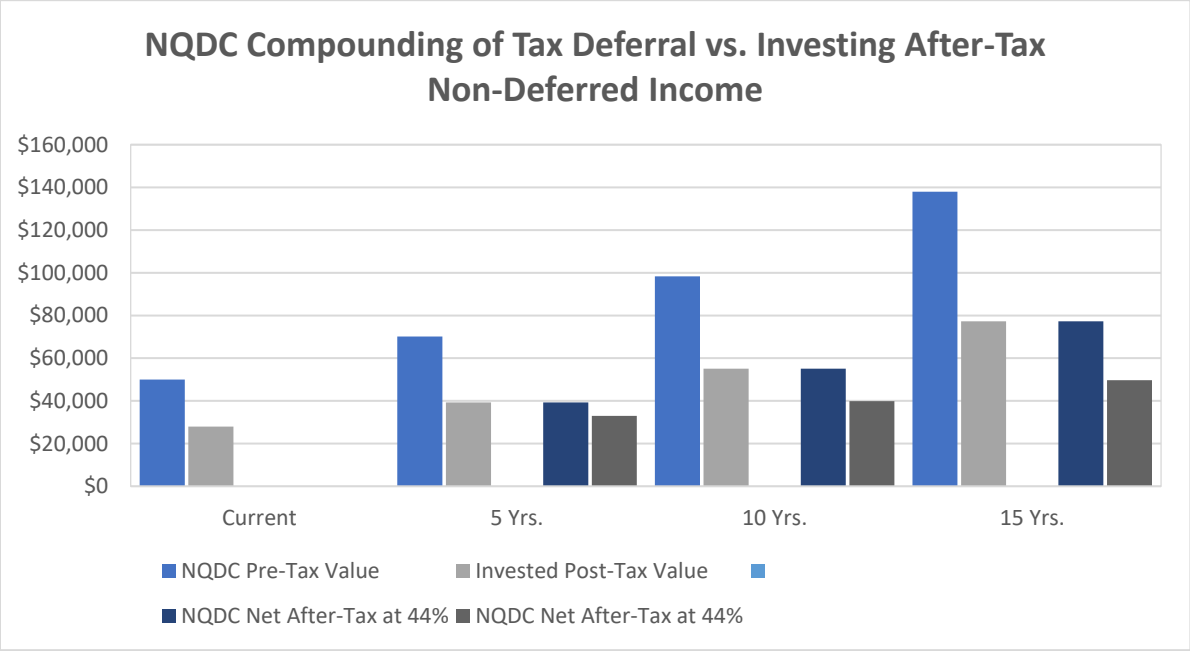
Executive Insights

Eight Things to Know about Deferred Compensation Plans

Below we'll explore differences between Non-Qualified Deferred Compensation (NQDC) Plans and Qualified Plans, some key factors to consider on whether to participate, and strategies to incorporate them into your plans.

1. The Potential for Increased After-Tax Benefits

The compounding effect of your pre-tax dollars could leave you with a higher pre-tax balance and higher taxes, but most importantly, a higher after-tax balance. Assuming your tax rate is the same or lower at the time of deferral and distribution, the after-tax proceeds using the NQDC is 38% higher for 10 years and 56% higher for 15 years.



The chart assumes $50,000 deferred in the NQDC. The post-tax investment assumes the $50,000 was not deferred and the income is taxed at a combined Federal and State tax rate of 44%, leaving $28,000 to invest. The after-tax investment is assumed to be invested in a tax-deferred investment. Both the NQDC and the after-tax deferred investment are assumed to grow at 7%/year and are distributed in a lump-sum and taxed at the same current federal and state tax rate of 44%.

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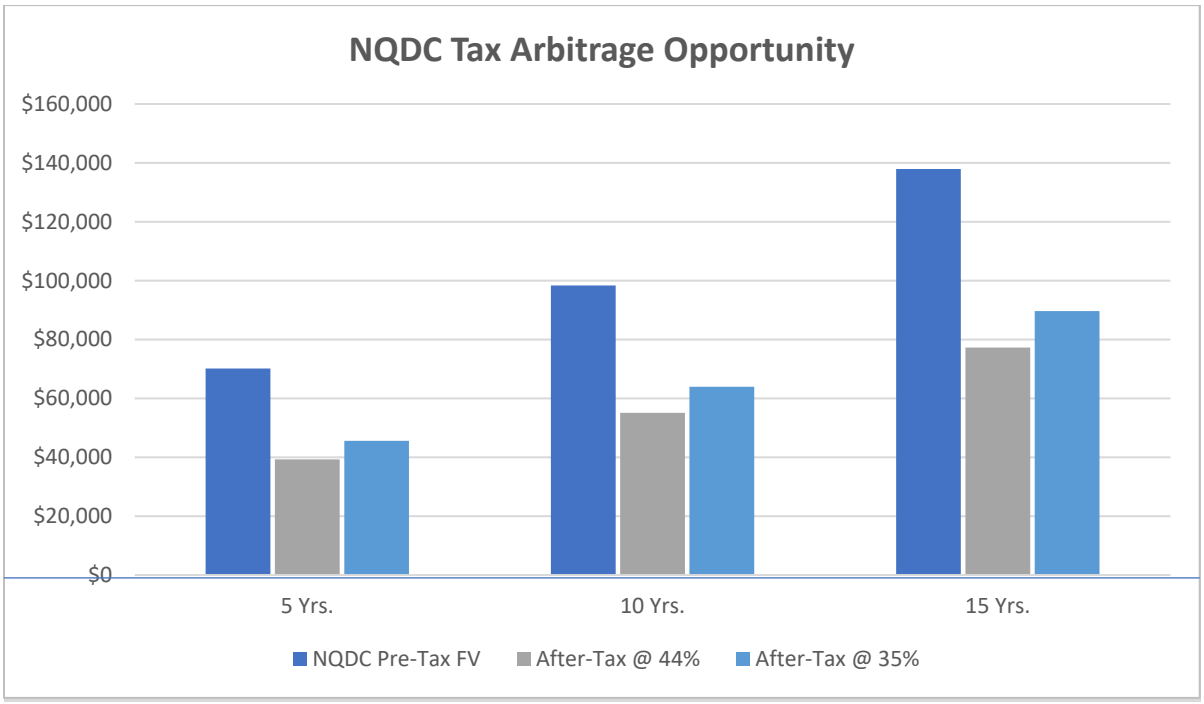
2. Potential for Income Tax Arbitrage

By planning distributions in years when your potential tax liability will be lower, you can pick up some additional after-tax dollars saving on the current deferred income and potential deferred earnings.



The Chart assumes $50,000 deferred in the NQDC. Investments are assumed to grow at 7%/year, are distributed in a lump-sum and taxed at the at a federal and state tax rate of 44% and 35%, respectively.

3. Investment Options

The majority of NQDC plans offer investment choices similar to 401(k) plans. However, there can be some unique options with guarantees tied to certain benchmarks or fixed rates that can't be found in 401(k) plans. Some NQDC plans allow executives to defer certain equity awards and hold the shares in the deferred compensation plans. There may be potential restrictions on selling the company's stock.

4. Fewer IRS Limitations

There are no regulatory limitations on income or contributions to NQDC plans. Currently, qualified plans are capped at $280,000 for 2019, and employee contributions are capped at $19,000 a year, plus an additional $6,000 for employees over age 50.

Some plans will have an employer match similar to their 401(k). While it often makes sense to maximize the 401(k) first, the lack of IRS limitations can make participation in NQDC plans attractive.

5. Defined and More Restrictive Distribution Rules

Unlike a 401(k) plan that allows you to roll over or pull out the funds after retirement at will, NQDC plans have more restrictive distribution rules. For example, Section 419 does not allow changes to the election within 12 months of the planned distribution. If you choose an NQDC distribution(s) at separation but leave the company sooner due to a new job offer or forced retirement, the funds will be paid out based on your initial election. Any changes in the deferral elections must extend five years beyond the original distribution start date.

6. Limited Early Withdrawal Provisions

Unlike in a 401(k), there are no loan provisions in an NQDC plan. You can petition for hardship withdrawals from the NQDC plan, but you're otherwise restricted from accessing the funds, aside from the planned distributions.

7. Forfeiture Risk

Forfeiture provisions can be found in NQDC plans. Companies may apply vesting schedules such as the language of forfeiture with non-compete provisions, leaving in un-amicable circumstances, or other "golden handcuffs" language.

8. Creditor Risk

Unlike a 401(k) or other qualified plans, in the event a company files for bankruptcy, the plan's assets are subject to creditor claims. The deferred compensation plan dollars are considered assets of the company. One possible solution is to set up a Rabbi Trust to protect the assets from the company, but it does not protect them from creditors. It's important to weigh this risk relative to the current environment and to future risks such as company debt load, market competition, consumer preferences, technology, regulatory, and other geopolitical risks. With that said, funds are not at risk once paid to you, so you should take into account the length of the payout, too.

As you can see, there are many variations of deferred compensation plans, and it is rare that any two are alike. One must read their plan documents carefully to avoid surprises and factor various scenarios into their planning as they could materially change the intended outcome.