

Nonqualified deferred compensation (NQDC) plans allow participants to set aside large amounts of tax-deferred compensation while enjoying the flexibility to schedule distributions to align with their financial goals. However, the plans also pose substantial risks. If your (or a prospective) employer offers an NQDC plan, or you're considering one for your business, weigh the pros and cons carefully.

What's the difference?

NQDC plans differ significantly from qualified defined contribution plans. The latter allows employers to contribute on their employees' behalf and employees to direct a portion of their salaries into segregated accounts held in trust.

Qualified defined contribution plans also generally allow participants to direct the investment of their account balances among the plan's investment options. The plans are subject to the applicable requirements of the Employee Retirement Income Security Act (ERISA) and the Internal Revenue Code, including annual contribution limits, penalties for early withdrawals, required minimum distributions, and nondiscrimination rules.

By contrast, an NQDC plan is simply an agreement with your employer to defer a portion of your compensation to a future date or dates. Many NQDC plans provide for matching or other employer contributions, while some permit only employer contributions. Employer contributions may be subject to a vesting schedule based on years of service, performance or the occurrence of an event (an IPO or sale, for example).

To avoid current taxation, NQDC plans may not be "funded," and they can't escape your employer's creditors. The plan is secured only by your employer's promise to pay. It's possible to set aside funds in a special type of trust to ensure that your employer doesn't use them for other purposes, but they remain subject to creditors' claims.

What are the pros?

Like qualified plans, NQDC plans allow you to defer income taxes on compensation until you receive it — although you may have to pay FICA taxes in the year the compensation is earned. NQDC plans also offer significant advantages over qualified plans. Depending on the specific plan's limits and distribution rules, you may have no contribution limits, allowing you to set aside substantial amounts of wealth. Participants may also enjoy greater flexibility to schedule distributions to fund retirement, college expenses, or other financial goals without penalty for distributions before age 59½ or required distributions at a certain age.

From an employer's perspective, NQDC plans are attractive because they can be limited to highly compensated employees and they avoid the cost of compliance with ERISA's reporting and administrative requirements. However, unlike contributions to qualified plans, deferred compensation isn't deductible by the employer until it's paid.

And the cons?

The biggest disadvantage of NQDC plans for participants is that deferred compensation is subject to the claims

of the employer's creditors and could be lost in the event of bankruptcy or insolvency. Also, you may not be able to take loans from the plan and can't roll over distributions into an IRA, qualified plan or other retirement accounts. What's more, there are limitations on the timing of deferral elections.

Is it right for you?

An NQDC plan offers attractive benefits, but it can be risky. [Contact us](#) to discuss how such a plan might affect your financial situation or whether it's right for your company.