Tax Alert
It's Critical to be Aware of the Tax Rules Surrounding Your NQDC Plan
November 9, 2016

Nonqualified deferred compensation (NQDC) plans pay executives at some time in the future for services to be currently performed. They differ from qualified plans, such as 401(k)s, in that:

- NQDC plans can favor certain highly compensated employees,
- Although the executive's tax liability on the deferred income also may be deferred, the employer can't deduct the NQDC until the executive recognizes it as income, and
- Any NQDC plan funding isn't protected from the employer's creditors.

They also differ in terms of some of the rules that apply to them, and it's critical to be aware of those rules.

What You Need to Know

Internal Revenue Code (IRC) Section 409A and related IRS guidance have tightened and clarified the rules for NQDC plans. Some of the most important rules to be aware of affect:

Timing of initial deferral elections - Executives must make the initial deferral election before the year in which they perform the services for which the compensation is earned. So, for instance, if you wish to defer part of your 2017 compensation to 2018 or beyond, you generally must make the election by the end of 2016.

Timing of distributions - Benefits must be paid on a specified date, according to a fixed payment schedule or after the occurrence of a specified event — such as death, disability, separation from service, change in ownership or control of the employer, or an unforeseeable emergency.

Elections to change timing or form - The timing of benefits can be delayed but not accelerated. Elections to change the timing or form of a payment must be made at least 12 months in advance. Also, new payment dates must be at least five years after the date the payment would otherwise have been made.

Employment Tax Issues

Another important NQDC tax issue is that employment taxes are generally due when services are performed or when there's no longer a substantial risk of forfeiture, whichever is later. This is true even though the compensation isn't actually paid or recognized for income tax purposes until later years. So your employer may:

- Withhold your portion of the tax from your salary,
- Ask you to write a check for the liability, or
- Pay your portion, in which case you'll have additional taxable income.

Consequences of Noncompliance

The penalties for noncompliance can be severe: Plan participants (that is, you, the executive) will be taxed on plan benefits at the time of vesting, and a 20% penalty and potential interest charges also will apply. So if you're receiving NQDC, you should check with your employer to make sure it's addressing any compliance issues. And we can help incorporate your NQDC or other executive compensation into your year-end tax planning and a comprehensive tax planning strategy for 2016 and beyond. Please contact us for further information.