THE NAUTILUS GROUP®

GUIDEPOST

Deferred Income Plan

Deferred Income Plan

A Deferred Income Plan (DIP) is a nonqualified deferred compensation plan between an employer and a key employee that provides supplemental retirement income to the employee. Generally, a DIP is funded through an election by the employee to defer a portion of his/her current compensation. Amounts deferred by an employee are placed in a "phantom account" for the employee that accumulates based on the applicable interest rate. At the distribution date specified in the agreement, the employee will receive the balance of his/her account, as specified in the agreement.

An employer may consider implementing a DIP if the employer wishes to:

- Provide an incentive to encourage key employees to remain with the employer;
- Allow its key employees to supplement their retirement income by forgoing current salary increases; and
- Protect a key employee's family in the event of his/her death.

Deferred Income Plan Design

To implement a DIP, the employer and the key employee enter into a written DIP agreement, drafted to comply with Internal Revenue Code (IRC) § 409A (Section 409A). Under the agreement, the key employee agrees to defer a portion of his/her salary and the employer agrees to contribute the deferred amounts to the employee's phantom account. Under some arrangements, the employer may elect to match deferrals made by the employee. The agreement defines the duties and obligations of the employer and the employee. The key employee will be 100% vested in his/her salary deferrals. At the distribution date as stated in the agreement (such as the employee's retirement), distributions will be made to the employee based on the value of the employee's phantom account. The agreement can also provide a survivor benefit to the employee's family in the event the employee dies prior to the time benefits under the agreement are paid in full.

Deferred Income Plan Funding

A DIP must be unfunded for Section 409A and Employee Retirement Income Security Act of 1974 (ERISA) purposes to avoid current income taxation. An agreement is generally considered unfunded if the employer's obligation is merely an unsecured promise to pay. This generally requires that the assets backing the agreement be subject to the claims of general creditors of the employer. The employee is a general creditor of the employer with respect to claims under the agreement.

Methods of Informal Funding

Various investment vehicles can be used to informally fund a DIP including savings accounts, bonds, stocks, mutual funds, and annuities. However, such assets would be subject to current income taxation and may be subject to market value fluctuation. Also, such assets generally do not allow for cost recovery, survivor benefits, and provide no guarantees.

Accordingly, permanent insurance on the life of the key employee is often utilized to informally fund a DIP. The employer is owner and beneficiary of the life insurance policy and may access the policy's cash values to fund the promised benefits to the employee. The cash value of the life insurance policy accumulates on an income tax-deferred basis. Depending on the policy type, the cash values may be credited based on a guaranteed crediting rate. The death benefit may provide both cost recovery to the employer as well as the funds needed to provide the promised survivor benefits.

If the employer purchases insurance on the life of an employee, the employer must comply with the "Notice and Consent" requirements under IRC § 101(j) to preserve the income tax-free nature of the life insurance policy's death benefit for the employer.

Deferred Income Plan Taxation

Income Tax Considerations - Employer

The employer receives an income tax deduction when the benefit is paid to the key employee as long as the benefit, when taken together with all other compensation paid to the key employee, is considered reasonable compensation in light of the services provided.

Income Tax Considerations - Employee

As long as there is not "constructive receipt" of deferred amounts and if the employee does not possess an economic benefit, there should be no current income tax consequence to the employee upon deferral. To avoid constructive receipt on amounts deferred, the employee deferral agreement must be entered into before the compensation is earned or services are performed. Where life insurance will be used to informally fund a DIP, to ensure the employee has no economic benefit, he/she should have no beneficial interest in the policy, including the right to name the beneficiary for any part of the death benefit proceeds. The employer should be sole applicant, owner, beneficiary and premium payer of any policy used.

If properly structured, an employee will not include any deferred compensation in taxable income until it is received. Once received, the entire amount received will be included in taxable income for that year. Similarly, any amount received by the employee's beneficiary after death will be treated as income in respect of a decedent and will be taxable to the beneficiary in the year received. The beneficiary will be entitled to an income tax deduction for any estate tax paid resulting from the benefits being included in the decedent's estate.

FICA and FUTA Implications

The Social Security Act Amendments of 1983 established a definition of wages for the Federal Income Contributions Act (FICA) and Federal Unemployment Tax Act (FUTA). Nonqualified deferred compensation benefits are part of an employee's FICA and FUTA wage bases at the later of the tax year in which the services are performed or the year in which there is no substantial risk of forfeiture of the rights to that amount (or, said another way, when the employee becomes fully vested in a benefit). Since an employee is vested in amounts deferred under a DIP, FICA/FUTA tax will apply.

Estate Tax Considerations

Should an employee die prior to receiving all benefits, the present value of any obligation payable to his/her estate or beneficiaries will be included in the employee's taxable estate. Of course, if the benefit is paid to a surviving spouse, the benefit may qualify for the unlimited marital deduction.

Nonqualified Deferred Compensation Compliance Requirements

IRC Section 409A

Internal Revenue Code Section 409A, which governs the timing of when compensation and benefits can be deferred and distributed, was enacted in October 2004 and became generally effective on January 1, 2005. Section 409A applies to compensation earned in one year but that is not paid until a future year. Section 409A generally applies to most nonqualified deferred compensation plans except for IRC §457(b) plans, which are exempt from §409A.

Section 409A imposes a series of requirements on nonqualified deferred compensation plan documents, the timing of elections to defer compensation, and the timing and form of payment under a plan. Section 409A requires the plan remain in compliance from the time the plan is established until the final distribution under the plan. The following highlights some key requirements that must be met to comply with Section 409A:

- The nonqualified deferred compensation plan must be in writing and include provisions designed to comply with Section 409A.
- An employee's election to defer compensation generally must be made before the start of the taxable year in which the compensation is earned.

- The election to defer compensation must specify the amount of compensation to be deferred.
- The election to defer compensation must state the time and form in which any deferred compensation will be paid.
- Neither the employer nor the employee may retain discretion regarding when payments will be made.
- The timing of the payments generally may not be accelerated by either or both the employer and/or employee.
- Deferred compensation may be paid only upon one or more of the following events:
    - At a specified time or pursuant to a fixed schedule;
    - The employee's separation from service;
    - The employee's death or disability;
    - A "change in control" of the employer; or
    - The employee's unforeseen financial hardship.
- Once established under the agreement, the timing of payments generally cannot be altered unless (1) an election is made at least 12 months prior to the date of distribution provided in the agreement and (2) the election defers the distribution by at least five years beyond the originally scheduled payment date.

If deferred compensation arrangements comply with the requirements of Section 409A, then the employee's deferred compensation is not taxed until actual receipt of compensation payments (as described above). If the arrangement does not meet the requirements of Section 409A, the deferred compensation is subject to retroactive constructive receipt (i.e., back to the time of the deferral). In addition to normal income tax, a 20% penalty tax will be imposed on the employee as well as interest at a rate 1% higher than the effective underpayment rate.

ERISA Compliance

ERISA, enacted on September 2, 1974, is designed to protect the interest of employees in both pension and welfare benefit plans sponsored by their employers. The term employee pension benefit plan is defined in part to mean any plan, fund or program which is established or maintained by an employer which "results in a deferral of income by employees for periods extending to the termination of covered employment or beyond." Thus, ERISA clearly covers nonqualified deferred compensation agreements that provide for distribution of the deferred amount at termination of employment.

Generally, this means that a nonqualified deferred compensation agreement must comply with certain ERISA requirements, including: (1) reporting and disclosure, (2) participation and vesting, (3) funding, (4) fiduciary responsibility, and (5) plan termination insurance. However, if a nonqualified deferred compensation plan is structured as an excess benefit plan or if it is unfunded and established only for a select group of management or highly compensated employees (often referred to as a "top hat" plan), it will be exempt from most of the ERISA requirements. However, the employer generally must notify the Department of Labor of the plan and provide a copy of the plan document to the Department of Labor.

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