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Non-qualified Deferred Compensation Plan (NQDC): An Essential Tool for Attracting, Engaging, and Retaining Top Talent

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The need to attract, engage, and retain top talent is paramount in today's dynamic landscape. Survey respondents in the 2014 Global Top Five Total Rewards Priorities Survey ranked finding, motivating, and keeping talent as the number one challenge over the next three years. In this competitive landscape for top talent, nonqualified deferred compensation (NQDC) can be one of the most important tools in an employer's toolbox for finding and retaining the best and brightest employees.

What is a NQDC plan?

Simply stated, a NQDC plan is an unfunded and unsecured promise by the employer to pay compensation to the employee at a specific time or upon a specific event in the future. Compensation can include base salary, annual incentive, and long-term compensation.

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NQDC plans are not new - they have been around for decades. When the Employee Retirement Income Security Act (ERISA) was enacted in 1974, an inequity between high- and low-income earners resulted. Employers began to offer savings plans considered "nonqualified" to address these inequities. NQDC plans do not have the tax-favored benefits of qualified retirement plans, and most do not have to comply with the participation, vesting, funding, distribution, and reporting requirements imposed on qualified plans by ERISA and the Internal Revenue Code (IRC). Since a NQDC plan does not generally have to comply with ERISA and IRC requirements, it is a flexible form of compensation that can be tailored to meet the objectives of both the employer and the employee.

NQDC Plan Objectives

When designing a NQDC plan it is important to understand the role of the NQDC plan – not as a stand-along program – but as a part of an integrated, comprehensive total rewards program. The NQDC plan should complement other compensation and benefit plans including retirement, incentive, equity, and health plans. To achieve the maximum benefit from a NQDC plan, employers must consider their own objectives as well as those of their employees.

Employer Objectives

From the employer perspective, NQDC is often structured to:

- Allow employees a means for retirement savings in excess of qualified plan limits - helping close the retirement gap;
- Offer a competitive benefits package when recruiting top talent;
- Retain key talent through "golden handcuffs" by offering deferred benefits subject to forfeiture unless certain conditions are met;
- Provide key talent with incentives and rewards without creating an immediate corresponding tax burden to the individual;
- Deliver future benefits without the legal requirements to fund those benefits; and
- Allow employees an equity-like experience without diluting existing shareholders (also known as phantom stock).

Employee Objectives

For the employee, NQDC plans are a valuable benefit to:

- Reach their retirement goals;
- Decide to take a new job;
- Decide to stay with a current employer;
- Avoid current taxation on regular or incentive pay;
- Avoid current taxation on any growth of accounts or benefits;
- Manage personal cash flow and taxes by deferring compensation to a future date when tax rates may be lowered; and
- Accumulate tax-favored savings and wealth beyond that allowed by their qualified plans and personal savings.

Types of NQDC Plans

There are three general types of NQDC plans:

1. Elective deferral plans

Under an elective deferral plan, the NQDC plan is designed to allow a participant to defer a portion of compensation that would otherwise be received immediately. The election is contained in a written agreement that specifies the amount of salary, bonus, commissions, or other income to be deferred, and the time and manner of payment.

2. Supplemental benefit plans

Under a supplemental benefit plan, the employer agrees to provide supplemental compensation in addition to regular salary and bonus. These plans are often called supplemental executive retirement plans or SERPs. Often times these plans are designed to "mirror" or "make up" a benefit that would otherwise be provided under a qualified plan without the limitations imposed by the IRC for compensation and annual contributions.

3. Phantom stock plans

Under a phantom stock plan, an employer promises to pay compensation at some future date based on reference to hypothetical or phantom shares of employer stock. Phantom stock plans are often used to give participants an equity-like experience and to align the interests of participants and shareholders.

Employers will often provide a combination of these three plan types to effectively meet the objectives of the employer and employee.

Summary

NQDC plans provide employers with a cost-effective, flexible, and powerful tool to provide appropriate incentives and rewards and encourage the retention of valuable talent within the organization. With proper design, careful implementation, and clear communication, a NQDC plan can play a pivotal role in recruiting, motivating, and retaining top talent in today's competitive landscape.