Nonqualified Deferral Plans

General

The Nonqualified Deferral Plan (NQDP) is one of the most popular nonqualified benefits offered to company executives today, because most highly compensated employees cannot make maximum 401k contributions since their company plan cannot satisfy the 401k Average Deferral Percentage (ADP) test.

Many NQDP's follow the format of a qualified 401(k) plan. These plans allow key executives to defer a significant portion of their compensation, over and above the dollar limit set for elective deferrals under a qualified 401(k) plan and allocate it across a set of *hypothetical investments*.

The terms *hypothetical investment* or *phantom investment* are used because the executive's contributions are not actually invested in the funds shown on the participant statement. In fact, the contributions remain the property of the company (or a trust). Due to tax and legal restrictions, the plan document is structured so that the contributions invested will be paid to the executive, along with investment earnings, *as if* such contributions were actually invested in the funds selected. In other words, the company is obligated to pay the hypothetical accumulated amounts to the executive, but must have the freedom to invest the contributions at their discretion, possibly not investing them at all.

Some NQDP's will allow large deferrals, but will not offer a variety of investments. For simplicity, these plans will credit a rate of interest, usually based on the performance of an outside index, to deferral account balances.

Irrespective of the investment crediting method, NQDP's generally take one of three forms:

401(k) Mirror Plan
A 401(k) mirror plan is set up to look and feel just like the company's qualified 401(k) plan. Key executives will be invited to participate in a plan that allows the same investment options as the qualified 401(k) plan. These plans mirror the features of the qualified plan with respect to options such as changing elections and transferring balances.

401(k) Excess Plan
Also known as an *overlay plan*, this type of plan allows the executives to allocate deferrals to the NQDP, over and above their maximum contribution to the qualified

401(k) plan. The range of hypothetical investment options may be as broad as the mirror plan, or limited to a basic interest rate crediting. The key here is that the excess plan is coordinated with the qualified 401(k) plan.

A common coordination is to deny the right to make contributions to the NQDP plan until the executive has made the maximum elective deferrals under the qualified 401(k) plan.

401(k) Wraparound Plan
Another type of coordination involves the restrictions applicable to qualified 401(k) plans. As stated above, an executive may not defer more than a statutory dollar amount into a 401(k) plan each year. However, the maximum amount may be less in any particular year, if the 401(k) plan violates the statutory ADP (Actual Deferral Percentage) test. In essence, this test is a discrimination test which is designed to limit the extent to which elective contributions of highly compensated employees exceed those of lower paid employees.

The coordination works as follows: The executive defers a specified percentage of compensation under the NQDP plan, and specifies that from this deferred amount, the maximum contribution would be made to the qualified 401(k) plan, after the 401(k) ADP testing is completed.

Typical Plan Structure

Flexibility is the operative term when it comes to structuring an NQDP.

Deferrable Compensation
Many plans will permit the deferral of up to 70% of the participant's base salary. Many plans also permit the deferral of up to 90% of bonus compensation, and other compensation components, such as director's fees, retainers, etc.

Investment Choices
Most plans offer a variety of investment options, with the majority of plans offering investments that mirror the return of the company's 401(k) investment options. A number of plans simply offer a competitive interest rate credit on the participant's deferral (i.e., Moody's Corporate Bond Index Rate + 5%).

Money Management
A plan that offers more than one investment choice will generally allow the participant to manage their account(s) by permitting the transfer of balances from one investment to another.

Distribution Options
The participant may select the time and method of payment for the participant's deferral elections, from a list of available choices for each applicable event, such as retirement, disability, death, or in-service withdrawal.