

## Nonqualified Deferred Compensation

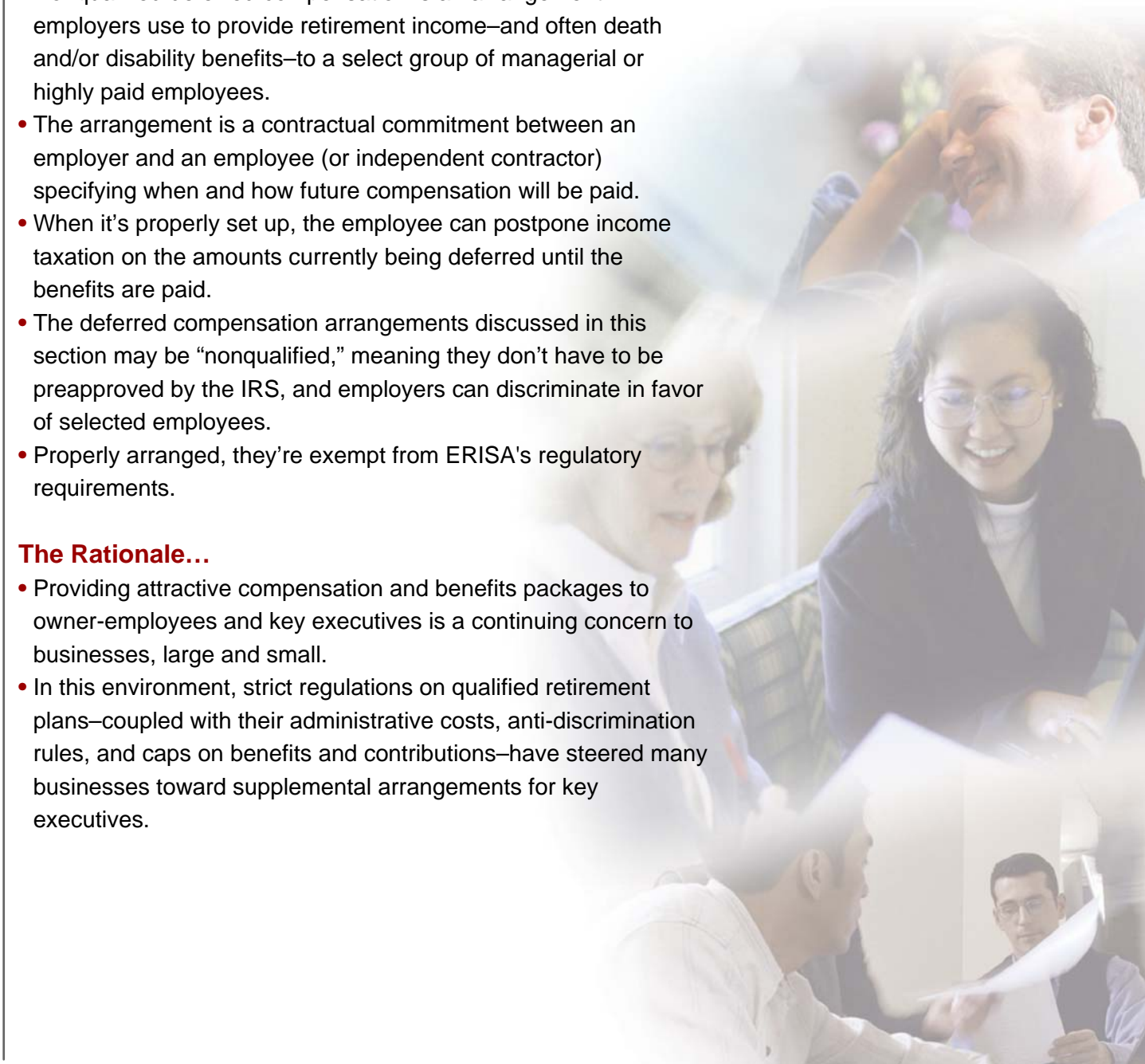


### The Concept...

- Nonqualified deferred compensation is an arrangement employers use to provide retirement income—and often death and/or disability benefits—to a select group of managerial or highly paid employees.
- The arrangement is a contractual commitment between an employer and an employee (or independent contractor) specifying when and how future compensation will be paid.
- When it's properly set up, the employee can postpone income taxation on the amounts currently being deferred until the benefits are paid.
- The deferred compensation arrangements discussed in this section may be “nonqualified,” meaning they don't have to be preapproved by the IRS, and employers can discriminate in favor of selected employees.
- Properly arranged, they're exempt from ERISA's regulatory requirements.

### The Rationale...

- Providing attractive compensation and benefits packages to owner-employees and key executives is a continuing concern to businesses, large and small.
- In this environment, strict regulations on qualified retirement plans—coupled with their administrative costs, anti-discrimination rules, and caps on benefits and contributions—have steered many businesses toward supplemental arrangements for key executives.



## Nonqualified Deferred Compensation

- Nonqualified deferred compensation arrangements allow employers to reward selected executives without taking on the administrative burdens of qualified plans.
- In many cases, deferred compensation is used in addition to qualified retirement plans, group insurance plans, and other broadly based employee benefit plans.

### Potential Candidates...

- The employer is a C corporation.
- The employer wants to benefit a select, highly compensated employee or group of such employees.
- The owner-employee of a business is looking for a way to improve his/her own compensation and benefits package.
- The employer needs to attract, retain, or reward one or more key employees.
- A key employee is already making maximum contributions to—or accruing maximum benefits from—a qualified retirement plan.
- The employer doesn't have a qualified retirement plan in place and doesn't want to establish one.

### The Flexibility...

- Only a nonqualified deferred compensation arrangement lets a business pick and choose among “top-level” employees without running afoul of anti-discrimination rules or minimum funding standards.
- A business can provide a different level of benefits for different employees.
- No government-mandated vesting rules apply.
- A deferred compensation arrangement can be customized to suit many individual situations.
- Paperwork and administrative costs are kept to a minimum.



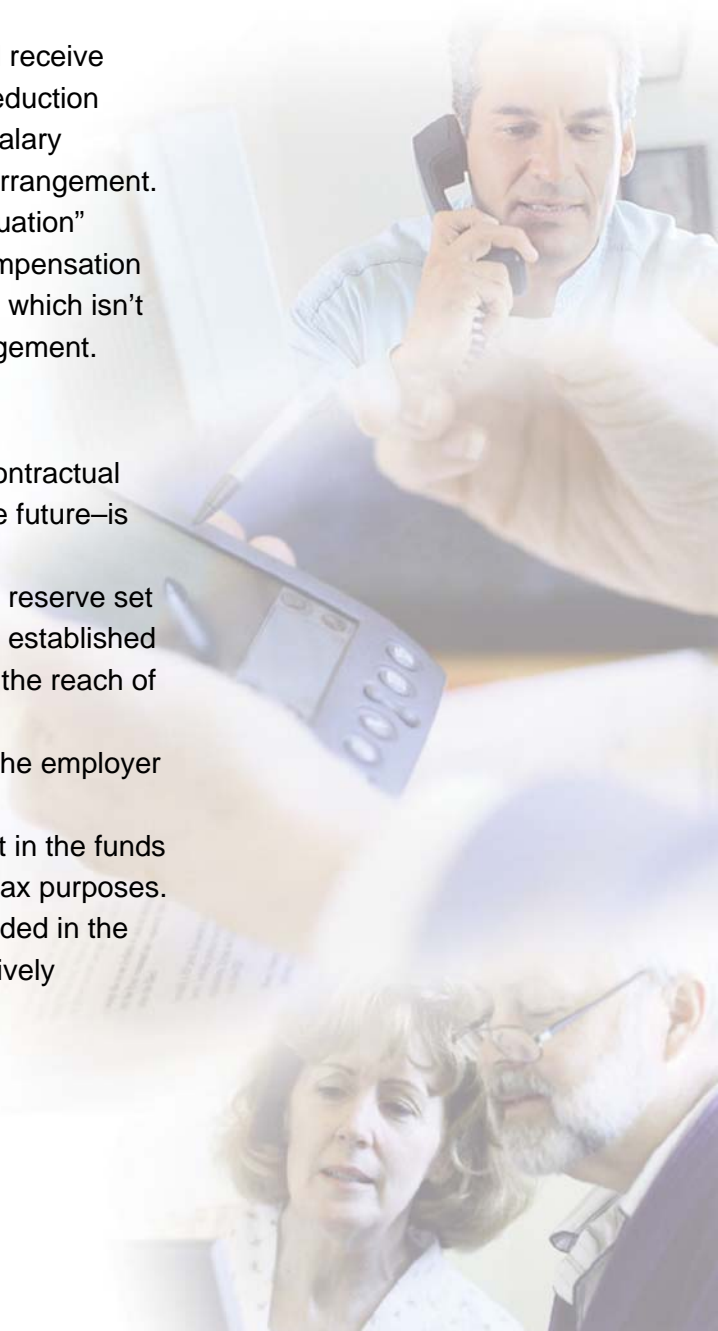
## Nonqualified Deferred Compensation

### The Process...

- A nonqualified deferred compensation arrangement typically provides that an employee will receive a stipulated sum for a fixed period of time—or for life—beginning at a future date, such as the employee's scheduled retirement.
- If the employee dies after payments have begun, the agreement may direct that any remaining benefits be paid to the employee's designated beneficiary.
- The arrangement may provide that the employee will receive future compensation as a result of a current salary reduction agreement, or in lieu of a future bonus or expected salary increase. This is sometimes called a “true deferral” arrangement.
- In contrast to true deferral, a so-called “salary continuation” arrangement commits the employer to pay future compensation to the employee in addition to current compensation, which isn't reduced by the employee's participation in the arrangement.

### The Funding...

- An arrangement in which the employee has only a contractual right—an unsecured promise to receive benefits in the future—is called an “unfunded” arrangement.
- An arrangement is considered unfunded if there's no reserve set aside to pay promised benefits, or such reserves are established but remain a general asset of the corporation, within the reach of general creditors.
- Life insurance or other assets can be purchased by the employer to provide a source of reserves.
- The employee can't have a current beneficial interest in the funds if the arrangement is to be considered unfunded for tax purposes. In this case the deferred amounts are generally included in the employee's gross income when actually or constructively received.



## Nonqualified Deferred Compensation

- By contrast, when the employer sets aside specific assets to meet its future obligations—with the selected employee as beneficiary and the assets out of reach of general creditors—the arrangement is considered to be “funded.”
- In a funded arrangement, the amounts set aside by the employer are currently includible in the employee’s gross income unless they’re subject to substantial risk of forfeiture.

### Acceleration of Benefits...

- Historically, participating employees were generally not taxed until they actually received payments as long as three conditions were met: the deferral was agreed upon before compensation was earned; the deferred amount was not unconditionally placed in trust or escrow; and the employer’s promise to pay was merely a contractual obligation and not evidenced by notes or secured in any other way.
- IRC §409A enacted new tax law rules that can result in loss of income tax deferral if the new rules are not met. For example, if the employee has early access to deferred amounts or control over them, income tax deferral can be lost.
- Moreover, a 20 percent penalty is applied on the amounts included in gross income, with interest charged at one percent over the normal rate on underpayments.
- Deferred amounts are now generally includible in the employee’s gross income—for all tax years in which they aren’t subject to a substantial risk of forfeiture—if the plan fails to meet any of three requirements: (a) distribution requirements; (b) no acceleration of benefits requirement, and (c) election of deferral requirements.
- Distributions are permitted only upon separation from service, death or disability, a fixed time specified in the plan, a change in an employer’s ownership or control, or an unforeseeable emergency such as severe financial hardship.



## Nonqualified Deferred Compensation

- Distributions at any other time will result in the loss of the income tax deferral.
- The acceleration of benefits requirement is generally met if the plan doesn't permit a prohibited acceleration of any payment or schedule of payments.
- Any changes in distribution methods that create an acceleration of payments will violate this rule, as will arrangements giving the plan administrator discretion over the timing of benefit payments that could result in accelerated payments.

### The Timing...

- To achieve income tax deferral, the employee's election to defer compensation generally must be made no later than the end of the preceding tax year.
- A special rule applies to the employee's first year of eligibility, when the initial deferral election can be made within 30 days of becoming eligible and still apply to compensation for services subsequently performed.

### The Bottom Line...

Even with changes in the tax law placing tighter restrictions on the distribution of benefits, nonqualified deferred compensation arrangements remain an effective way to reward and retain valuable, highly compensated employees on a selective basis.



## Nonqualified Deferred Compensation



### What Is Nonqualified Deferred Compensation?

Nonqualified deferred compensation is an arrangement established by employers to provide retirement income and often death and/or disability benefits to selected managerial or highly compensated employees. When it's properly arranged, the employee can defer income taxation of the deferred amounts until the benefits are paid.

Deferred compensation arrangements are "nonqualified," which means they don't have to be preapproved by the IRS, and employers can discriminate in favor of selected employees. Also, when properly arranged, they are exempt from ERISA's regulatory requirements.

### How Does It Work?

A nonqualified deferred compensation arrangement typically provides that an employee will receive a stipulated sum for a fixed period of time—or for life—beginning at a future date such as the employee's retirement. If an employee dies after payments have begun, the arrangement may direct that the remaining benefits be paid to the employee's beneficiary.

The arrangement may provide that the employee will receive future compensation as a result of a current salary reduction or in lieu of a bonus or salary increase. This is sometimes called a "true deferral arrangement."

An alternative is a "salary continuation arrangement." Here, the employer commits to pay future compensation to the employee in addition to current earnings, which aren't reduced by participation in the arrangement.

### What's the Tax Picture?

Generally speaking, the deferred amounts in an unfunded plan are includible in the employee's gross income when they are actually or constructively received. The deferred amounts in a funded plan are currently includible in the employee's gross income unless they are subject to a substantial risk of forfeiture.



## Nonqualified Deferred Compensation

IRC §409A imposes new tax rules that must be met to assure income tax deferral. Generally, if the employee has early access to the deferred amounts—or control over them—income tax deferral will be lost.

Amounts deferred under a deferred compensation plan will be includible in the employee's gross income for all tax years in which such amounts are not subject to a substantial risk of forfeiture if the plan fails to meet (1) distribution requirements; (2) no acceleration-of-benefit requirements; and (3) election requirements.

Under the new rules, distributions are permitted only upon separation from service; death; disability; a fixed time specified in the plan; a change in ownership or control of the employer; or an unforeseeable emergency such as a severe financial hardship. Distributions at any other time will result in loss of income tax deferral.

The acceleration-of-benefits requirement is met if the plan does not permit a prohibited acceleration of any payment, or schedule of payments. The plan administrator may not have discretion over the timing of benefit payments that could result in an acceleration of payments.

### **When Should the Deferral Election Take Place?**

To achieve income tax deferral, the employee's election to defer compensation generally must be made no later than the end of the preceding tax year.

A special rule applies to the employee's first year of eligibility. The employee's initial deferral election can be made within 30 days of becoming eligible and still apply to compensation for services subsequently performed.

### **What's the Conclusion?**

Even with changes in the tax law placing tighter restrictions on the distribution of benefits, nonqualified deferred compensation arrangements remain an effective way to reward and retain valuable, highly compensated employees on a selective basis.



## Nonqualified Deferred Compensation

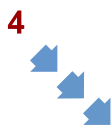
1. The employer and employee enter into a written nonqualified deferred compensation agreement.



3. When the employee satisfies the conditions to receive benefits, the employer begins to pay retirement—or disability—benefits from the policy values, subject to the federal income tax rules regarding policy withdrawals, loans and surrenders.



2. The employer may purchase an insurance policy.



4. At the employee's death, the employer may use the insurance proceeds to pay benefits to the employee's beneficiary if so provided in the deferred compensation agreement.



## Nonqualified Deferred Compensation

The American Jobs Creation Act of 2004 has imposed additional requirements on many NQDC plans. The changes address the timing of distributions, the timing of elections to defer income, funding rules and impose reporting requirements and interest and penalties on non-qualifying plans. Employers should consult with their tax advisors to determine whether existing plans need to be modified or changed, and new plans need to comply with these requirements.

Allstate Financial is the marketing name for Allstate Life Insurance Company ("ALIC"), its affiliates and subsidiaries. This information is provided for general consumer educational purposes by Lincoln Benefit Life Company ("Lincoln Benefit Life") and is not intended to provide legal, tax or investment advice. Lincoln Benefit Life issues fixed and variable insurance products that are sold through agreements with affiliated or unaffiliated broker-dealers or agencies. Lincoln Benefit Life's variable products are sold by registered representatives, investment advisors, and agents or bank employees who are licensed insurance agents. ALFS, Inc. serves as principal underwriter of SEC-registered contracts for Lincoln Benefit Life. Lincoln Benefit Life and ALFS, Inc. are wholly owned subsidiaries of ALIC.

---

LINCOLN BENEFIT LIFE  
AN ALLSTATE COMPANY

---