Nonqualified Deferred Compensation Plans
Can Help Highly Compensated Employees Achieve Financial Goals

Should you consider a Nonqualified Deferred Compensation (NQDC) plan? To help determine if a NQDC plan is appropriate for your business, consider the following questions:

• Would your company benefit from offering an additional program to assist with recruiting and retaining employees?

• Do your highly compensated employees (HCEs) contribute the maximum to a qualified retirement plan?

• Is your company treated as a pass-through organization for tax purposes?

• Is your company financially secure?

WHAT IS A NQDC PLAN? A NQDC plan can enable HCEs to defer income on a tax-efficient basis beyond what is available in qualified retirement plans. Contributions to NQDC plans may be in the form of participant salary deferrals and/or company contributions.
Bridging the Gap: Nonqualified Deferred Compensation Plans

Participant Experience With NQDC

In many ways, the participant experience is quite similar to that of a 401(k) or other qualified retirement plan. Participants may be able to view their accounts and make investment choices as they would in a qualified plan.

Subject to certain Internal Revenue Code restrictions, NQDC plans can allow participants to choose both the amount of the deferral, up to 100% of compensation, and the timing of deferral, including allowing multiple deferral periods. Finally, participants may be offered the ability to tie the investment returns of their deferred compensation to investment alternatives specified by the plan sponsor. ¹

By allowing participants to create separate investment “buckets” with distinct investment choices, NQDC plans can enable participants to properly finance discrete financial goals such as college education, retirement or a second home.

Sponsor Role in NQDC

Sponsoring companies must approve a NQDC plan document. Typically, a third-party administrator (TPA) is engaged to assist in structuring the plan, hosting the participant web interface and supplying the sponsor with relevant metrics for reporting purposes.

Tax advisors may also be involved to assist with company and participant tax situations.

**ASSET VS. LIABILITY DISTINCTION.**

Unlike a 401(k) or other qualified retirement plan, employee balances are unsecured liabilities to the participants. This includes employees’ deferrals, company contributions and any amounts credited to the accounts based on investment returns.

Many sponsoring companies will make corresponding investments to offset their exposure to market volatility in the participant accounts. Such investments typically include mutual funds and/or corporate-owned life insurance. Such investments are referred to as “informally funding” a plan.

However, to avoid violating the “constructive receipt” rules associated with NQDC plans, the assets may not be viewed as property of the participant. In the unfortunate event of bankruptcy, amounts which could have been used to fund plan benefits may instead need to be used to satisfy the claims of company creditors.

**DO SPONSORS HAVE TO INFORMALLY FUND THE ASSET?** No. Sponsors are under no obligation to informally fund their NQDC plan. Sponsors may employ a “pay-as-you-go” approach to funding distributions.
**Tax Treatment of NQDC**

Generally, at the time of deferral, the amounts deferred should not be included in the income of the participant, aside from for the purposes of certain payroll taxes (e.g., FICA). If the requirements of the Internal Revenue Code are met, amounts deferred under the plan are treated as ordinary income upon distribution.

A sponsor’s contribution to a NQDC plan is only deductible for the tax year in which the employee is required to include the deferred amounts in gross income. Various funding strategies can help a sponsor to maximize the tax benefits associated with funding a NQDC plan.

**WHEN DOES A NQDC PLAN MAKE SENSE?** NQDC plans should always be seen as a supplement to a qualified retirement plan. As such, it is a benefit to the HCEs, who may be underserved by their qualified plan. HCEs may see their qualified plan contributions limited by statutory maximums or lower if ADP testing limits are imposed. In such cases, employees can benefit from a NQDC plan by having a larger portion of their retirement savings be tax deferred than would otherwise be available.

Sponsoring companies may also want to create tax-deferred accounts for their HCEs funded with employer contributions (as opposed to with employee deferrals). NQDC plans can accommodate performance-based compensation as well as retention awards. Given that vesting is not determined by ERISA, sponsors have a great deal of flexibility in structuring the awards.

NQDC plans may be less attractive when the only participants are the owners of the firm (e.g., partnerships). In any event, you should contact your tax and legal advisors with respect to the tax ramifications of establishing and maintaining a NQDC plan.

**WHO CAN PARTICIPATE?** NQDC plans are “discriminatory” in nature and as such they are generally limited to HCEs, “management” employees and “affiliates” of the sponsoring firm (i.e., board members). There are not clear guidelines, but it would be expected that the offer of participation would be limited to the top 10-15% of the employee population.

**CAN DISTRIBUTIONS BE ROLLED INTO A QUALIFIED PLAN?** No. Proceeds cannot be rolled into any form of a qualified plan. If allowable by the plan documents and subject to tax law requirements, participants may elect to re-defer their distributions for periods of not less than five years.

**ARE THERE ANNUAL ADMINISTRATIVE REQUIREMENTS?** As NQDC plans are represented as both an asset and liability of the sponsoring firm, sponsors should be able to understand their financial reporting requirements. Third-party administrators can also provide monthly ledger entries associated with the plan.

**How Morgan Stanley Can Help**

Morgan Stanley has the experience and resources to help you implement an efficient NQDC plan that will be seen as an effective benefit for your key executives.

**Evaluation of Needs**

Your Financial Advisor can work with you and your advisors to identify what type of NQDC plan will best benefit your company and employees.

**Investment Services**

We can help educate plan sponsors on plan investment menus and funding options, as well as provide investment education to plan participants so that they can make informed decisions regarding investment options/crediting rates.

**Plan Participation**

A NQDC plan is only effective if your HCEs appreciate the plan as a benefit to them. To that end we will support enrollment meetings and educational sessions.

NQDC plans are not subject to the Form 5500 reporting requirements associated with qualified plans. However, Department of Labor regulations require that certain NQDC plans (e.g., “top hat” plans) make a filing to affirm that they are not subject to ERISA, and, for public companies, the existence of (and liabilities related to) NQDC plans for executives or board members are generally disclosed in various securities and other regulatory filings.
The ability of an individual to defer income should be stated in the plan document adopted by the sponsor. The plan document may limit contributions. Tax laws are complex and subject to change. Morgan Stanley Smith Barney LLC ("Morgan Stanley"), its affiliates and Morgan Stanley Financial Advisors and Private Wealth Advisors do not provide tax or legal advice and are not "fiduciaries" (under ERISA, the Internal Revenue Code or otherwise) with respect to the services or activities described herein except as otherwise provided in a written agreement with Morgan Stanley. Individuals are encouraged to consult their tax and legal advisors (a) before establishing a retirement plan or account, and (b) regarding any potential tax, ERISA and related consequences of any investments made under such plan or account.