Time for NQDC plan deferral elections

If you're an executive or other key employee, your employer may offer you a nonqualified deferred compensation (NQDC) plan. As the name suggests, NQDC plans pay employees in the future for services currently performed. The plans allow deferral of the income tax associated with the compensation.

But to receive this attractive tax treatment, NQDC plans must meet many requirements. One is that employees must make the deferral election before the year they perform the services for which the compensation is earned. So, if you wish to defer part of your 2019 compensation, you generally must make the election by the end of 2018.

NQDC plans vs. qualified plans

NQDC plans differ from qualified plans, such as 401(k)s, in that:

- NQDC plans can favor highly compensated employees,
- Although your income tax liability can be deferred, your employer can't deduct the NQDC until you recognize it as income, and
- Any NQDC plan funding isn't protected from your employer's creditors.

While some rules are looser for NQDC plans, there are also many rules that apply to them that don't apply to qualified plans.

2 more NQDC rules

In addition to the requirement that deferral elections be made before the start of the year, there are two other important NQDC rules to be aware of:

1. Distributions. Benefits must be paid on a specified date, according to a fixed payment schedule or after the occurrence of a specified event — such as death, disability, separation from service, change in ownership or control of the employer, or an unforeseeable emergency.

2. Elections to make certain changes. The timing of benefits can be delayed but not accelerated. Elections to change the timing or form of a payment must be made at least 12 months in advance. Also, new payment dates must be at least five years after the date the payment would otherwise have been made.

Be aware that the penalties for noncompliance with NQDC rules can be severe: You can be taxed on plan benefits at the time of vesting, and a 20% penalty and interest charges also may apply. So if you're receiving NQDC, check with your employer to make sure it's addressing any compliance issues.

No deferral of employment tax

Another important NQDC tax issue is that employment taxes are generally due when services are performed or when there's no longer a substantial risk of forfeiture, whichever is later. This is true even though the compensation isn't actually paid or recognized for income tax purposes until later years.

So your employer may withhold your portion of the tax from your salary or ask you to write a check for the liability. Or your employer might pay your portion, in which case you'll have additional taxable income.

Next steps

Questions about NQDC — or other executive comp, such as incentive stock options or restricted stock? Contact us. We can answer them and help you determine what, if any, steps you need to take before year end to defer taxes and avoid interest and penalties.