Key considerations for making deferrals into a NQDC plan vs 401(k)

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A non-qualified plan is a type of tax-deferred, employer-sponsored retirement plan that falls outside of the Employee Retirement Security Act (ERISA) guidelines. Non-qualified plans are designed to meet specialized retirement needs for key executives and other select employees and can also act as a recruitment or employee retention tool. A non-qualified deferred compensation plan (NQDC) is an arrangement under which an employer provides deferred compensation to an eligible employee or independent contractor. Unlike qualified plans that are subject to discriminatory and top-heavy testing, non-qualified plans are exempt from these requirements.

Before deciding to enter into a NQDC plan, an employee should ask these important questions:

Do I annually maximize my contributions to traditional retirement plans? An employee should make the maximum contribution possible to a 401(k) or 403(b) plan each year before enrolling in a NQDC plan. IRS Section 401(k) and 403(b) governed plans are funded directly and are protected under the Employee Retirement Income Security Act, while a NQDC plans are not.

Will my tax rate change in the future and can I afford to defer compensation? An employee does not pay income tax on deferred compensation until they receive the deferred funds. Participation is more appealing if you expect to be in a lower tax bracket when you retire (or whenever you expect to receive a distribution). An employee should explore their cash flow needs and upcoming expenses to estimate whether they can afford to forgo expected income in the coming years. Once a deferral amount is selected (which must be done one year ahead of the deferral), the decision is irrevocable.

Is the company financially secure? Remember that a NQDC plan is based on the employer's ability to pay. Employees should feel confident that the employer will be able to honor this commitment down the line.

Does the plan allow a flexible distribution schedule? Some plans require employees to defer compensation until a specified date or retirement. Depending on the employee's personal situation and income needs, greater flexibility with distribution elections can be a significant advantage. Also keep in mind that they employer may force payments, such as a lump-sum distribution, in the future.

What investment choices does the plan offer? Some plans promise a fixed rate of return on deferred compensation, but that is rare. Instead, most base the growth of deferred compensation on the returns of specific notional investments. For example, some NQDC plans offer the same investment choices as the company's 401(k) plan.

There are risks associated with a NQDC plan and each employee must decide whether an NQDC plan is a good fit for their individual needs.

401(k) and NQDC Plan Differences

Feature	401(k)	NQDC
Yearly limit on amount participant can defer from income	Yes, Internal Revenue Code (IRC) limits apply	No IRC limits, but plan limits are possible
Must start taking out money at age 70½	Yes, by IRC mandate, unless still working at company where the 401(k) plan is, subject to 5% owner rule	No IRC requirements, but plan rules are possible
Can receive distributions of any amount and at any time for financial hardship, and, from age 59½ on, without a penalty tax	Yes, whether employed or not	No, but job separation and other events can trigger distributions before that age
Ability to take early withdrawal at any time, paying taxes and a penalty on the withdrawal amount	Yes, but only upon separation from service; a 10% additional tax may apply if under age 59½. Plan may permit inservice withdrawals without penalty after age 59½	No, with the possible exception of amounts deferred and vested before 2005
Funds protected from creditors in bankruptcy	Yes	No
Must get distribution upon job loss	No. If balance is under $5,000, the plan sponsor may cash out the balance but is not required to do so. Also, participants may keep balances in plan well after normal retirement age	No; Sometimes a job loss will trigger a lump-sum distribution, but this is not a general rule
The participant can take loans from the Plan	Yes, if plan allows	No
Tax deduction for the participant's Company	At time of deferral	At time of distribution or when the participant recognizes it as taxable income
Upon job loss, the participant can roll money over to an IRA or transfer to a new employer's qualified plan	If the termination is a distributable event under the terms of the plan	No
Flexibility in when and how the participant can withdraw money in retirement	Usually, but not required	Limited by up-front elections, plan provisions, and redeferral rules

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