DEFINED CONTRIBUTION PLAN

WHAT IS A DEFINED CONTRIBUTION PLAN?

A defined contribution plan is a type of nonqualified plan sponsored by an employer that promises certain key executives or independent contractors a tax-deferred benefit based on the value of an account at the time of payout. The design of the plan and the accumulation of the participant's account balance is derived from three major elements:

(1) **Source of Plan Contributions**. Contributions can be derived from employee deferral of compensation (e.g., base salary, bonus, commission) and/or company contributions (e.g., matching or discretionary).

(2) **Account Growth**. Various methods are used in determining growth on the plan contributions. The most common methods include a plan directed interest rate, participant directed "deemed" investments, or benchmarking the account value to a corporate owned asset such as a brokerage account or corporate owned life insurance policy.

(3) **Account Distributions**. Plans can be designed to pay out upon the earliest of separation from service, death, disability, change in control, a specified date or age, and/or an unforeseeable emergency.

NONQUALIFIED PLAN FINANCING

Nonqualified plans, by nature, cannot be formally funded (i.e., companies cannot set money outside the scope of general creditors for plan purposes). Most prudent companies, however, set aside (or "earmark") certain corporate assets to offset liabilities generated as a result of plan benefits. The most common methods for plan financing are corporate owned life insurance or corporate owned mutual funds. Plans are not required to have any assets earmarked for the plan as some companies fund out of current cash flows. If a corporate asset is used, it is typical that the participant's account growth is based on a similar method of growth as the corporate asset.

IRC SECTION 409A COMPLIANCE

Nonqualified plans are exempt from most of the provisions of ERISA because they are only available to highly compensated employees or a select group of management; however, IRC Section 409A sets forth rules that nonqualified plans must follow. Examples are below:

- The plan must be in writing and include the benefit amount/formula.
- Plan rules must specify the timing of deferral elections and the time and form of distributions.
- Deferral elections are generally irrevocable for a calendar year.
- Payments may not be modified or accelerated except under limited circumstances.
- Substitution of a payment of deferred compensation is prohibited.
- Plans must maintain documentary and operational compliance or risk becoming subject to significant tax and penalties.

KEEP IN MIND

- Nonqualified plans are required to be “unfunded” (i.e., benefits are not secured) and participants are general creditors.
- Participant balances are simply a “promise to pay” – there is no actual segregated account.
- Account balances cannot be rolled into another plan or an IRA to avoid taxation.
- The employer must accrue a liability on its books for the future obligation.
- FICA and FUTA taxes are due at the time of deferral or vesting.