



Early distributions from nonqualified deferred compensation plans

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Sometimes a participant in a nonqualified deferred compensation ("NQDC") plan needs to access their benefits prior to separation from service, but they don't know what their options are for doing so. Likewise, employers are not always sure if a distribution can be made before an employee terminates employment. In addition, some employers may need or want to change the terms of a NQDC plan, but are not sure what changes can be made without violating Internal Revenue Code ("Code") section 409A.

Here are some of the most frequently asked questions and answers to help guide employer, employees and their advisors.

For employees

Q: My employer may have to lay-off or reduce hours for some employees, and I might be impacted. Can I get any money out of my NQDC plan, if needed?

A: If your plan permits hardship distributions due to an unforeseeable emergency you may be able to withdraw an amount (including taxes that will be due on the withdrawal amount) that will alleviate the hardship. These rules are not like the hardship distribution rules for a qualified retirement plan, such as a 401(k) plan. To receive a hardship distribution from a NQDC plan, you must experience a severe financial hardship due to an illness or accident of your own, your spouse, or any dependent; an uninsured casualty loss; or imminent foreclosure or eviction from your home. In addition, and probably most importantly, a severe financial hardship due to any extraordinary and unforeseeable circumstances arising as a result of events beyond your control can also qualify you to receive a distribution from your plan. You will need to provide documentation to your employer to substantiate the financial hardship, and show that you cannot liquidate other assets without causing a hardship by doing so.

Q: If I take a hardship distribution will I have to pay tax on it? Is there a penalty for taking a distribution before age 59½?

A: Income taxes must be paid on any amount distributed. Unlike a 401(k) plan, there is no additional excise tax for taking money out before age 59 ½. Your employer will withhold tax on the payment and will report the payment on your W-2. You are permitted to withdraw the amount you need plus taxes associated with that needed amount.

Q: I am participating in a NQDC plan and would like to stop deferring salary this year because my spouse is no longer working. Can I stop deferring?

A: If your plan permits stopping deferrals in the middle of the year due to an unforeseeable emergency, You will need to provide documentation or evidence of the hardship to your employer as described above. In addition, if you take a hardship distribution from your 401(k) plan, you can stop deferring to your NQDC plan. You will not be permitted to begin deferring compensation until the next tax year or later, depending on your plan's provisions.

Q: I recently started a job with a new employer and have a large balance in my former employer's NQDC plan that is supposed to be distributed to me in a lump sum within the next 60 days. I'd like to delay the liquidation and distribution of my account. Is that possible?

A: Unfortunately, no. Because separation from service triggers a distribution, your former employer is required to make the distribution according to the plan provisions. You are not permitted to change the tax year in which proceeds are distributed.

Q: What will happen to my NQDC plan benefits if my employer becomes insolvent or declares bankruptcy?

A: In the event of the employer's insolvency or bankruptcy you will be among the unsecured general creditors with respect to your benefits. Sometimes, when a company is not liquidating, but is reorganizing to be able to continue operating, participants in a NQDC plan have a better chance of maintaining all or a portion of their benefits. If a bankruptcy occurs, you will want to consult with an attorney regarding your situation.

For employers

Q: We provide our key executives the opportunity to make deferral elections with respect to performance-based compensation in June for the annual bonus that is earned in that same year and paid by March 15th of the following year. We want to change the performance goals for this year before executives make their elections in June. Can we do that?

A: To permit deferral elections during the earning period, performance-based compensation must be contingent on satisfying pre-established company and/or personal performance criteria over a period of at least 12 months. The criteria must be in writing no later than 90 days after the service period begins. So, for a calendar year service period, the criteria must have been in writing by March 30th. If the criteria change after the 90 day period, or if the employer has discretion to award bonuses even if the criteria are not met, then deferral elections with respect to that compensation should have been made in the year prior to the compensation being earned.

Q: What happens if the company has to lay off or furlough employees who have account balances in the NQDC plan? Do we need to pay them out?

A: If you and the employee expect that the employee will return to work in the future, you probably don't have to pay them out. The question is whether the employee has a termination of employment that triggers a distribution. If the employee has a "bona fide" leave of absence, that will not trigger a distribution. All the facts and circumstances of the situation would need to be assessed to determine if the leave is bona fide. In addition, There will be no termination of employment (and a pay out) provided the employee has a contractual or statutory right to reemployment.

Q: If a participant in the NQDC plan is due to be paid a benefit and the company is experiencing a financial crisis, can the company delay the payment?

A: In general, when participants are due to be paid, the company must pay out benefits according to the provisions in the plan. One exception permits a delay in the payment if paying the benefit would jeopardize the ability of the company to continue as a going concern; however, the payment must be made in the first tax year of the employee in which the making of the payment would not have such effect.

Q: The company is in a financial bind; can it stop providing a match or contribution to a SERP this year?

A: Most SERPs have discretionary contributions; however, if the company's plan calls for a mandatory employer contribution, then participants' accounts should be credited with the mandatory amount. Keep in mind that the company does not have to set aside any assets to informally fund the SERP immediately (or ever).

Informal funding

Q: The company purchased company-owned life insurance (“COLI”) to informally fund the NQDC plan. Can the company use cash values to pay NQDC plan benefits? Can it use cash values for other purposes? What if the company surrenders the COLI policies?

A: COLI policies, like any other asset owned by the company, may be used for any purpose deemed appropriate and necessary. Depending on how long the policies have been in force, the company may take out loans or withdrawals from the cash value. If the policies are surrendered, the company will be taxed on the amount of the surrender proceeds that exceed premiums paid. To understand the ramifications of each of these options, please contact your financial advisor or insurance carrier before proceeding.

Q: The company established a rabbi trust that owns COLI policies and mutual funds. Can the company liquidate the policies or mutual funds and take the cash out of the trust?

A: You will need to review your trust document to determine whether the company can take assets out of the trust for any purpose other than paying plan benefits to participants.

Q: Can the company terminate the NQDC plan?

A: The company can terminate and liquidate the plan if the company has been dissolved and is no longer in business. A company can also terminate and liquidate a plan with the approval of a bankruptcy court. A plan can also be liquidated pursuant to a change in control of the company. In addition, the company may terminate and liquidate for any other reason provided (i) it is not due to a downturn in the financial health of the company; (ii) all other agreements that are similar must also be terminated and liquidated; (iii) no benefits can be paid within 12 months of the date the plan is terminated (e.g., the board resolves to terminate the plan); (iv) all benefits are paid within 24 months of the date the plan is terminated; and (v) the company cannot adopt a new plan within three years after the date the original plan was terminated. The rules regarding a plan termination and liquidation are complex and should be discussed with a knowledgeable advisor before proceeding.

Q: What if the company declares bankruptcy?

A: Assets owned by the company or by a rabbi trust will be subject to the claims of creditors, even though those assets were earmarked to pay benefits under the NQDC plan.



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