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Using Nonqualified Plans to Reduce 401(k)/403(b) Costs

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This article focuses on 401(k) and 403(b) plans that are in one of the following situations:

1. The plan failed ADP or ACP testing and must distribute excess amounts to its higher-ranking employees or make additional contributions to its rank-and-file employees.
2. Higher-ranking employees are limiting their salary deferrals in order to avoid triggering top-heavy minimum contribution requirements.
3. The plan must make employee contributions due to its top-heavy status and the salary deferral rates of its higher-ranking employees.
4. The plan is using a safe harbor design to pass top heavy, ADP, and/or ACP testing and the expense of the safe harbor contribution is significant.

In each of these situations, the plan sponsor is incurring the direct cost of contributing additional funds to the 401(k) or 403(b) plan, or is incurring the indirect cost of dissatisfaction from its higher-ranking employees who are unable to receive the full benefit of plan participation. Fortunately, a simply designed nonqualified plan (NQP) can resolve these issues.

Is This Time Sensitive?

Maybe. You can establish an NQP anytime, but if you have a calendar year plan that must distribute excess contributions by March 15 to avoid an excise tax, then you might prefer to establish an NQP to receive those excess contributions.

What Is an NQP?

An NQP is a retirement plan that does not satisfy all the requirements of ERISA or IRC ss. 401 or 403, giving certain flexibilities not enjoyed by 401(k) and 403(b) plans.

How Would an NQP Help?

NQPs are not subject to the tests referenced above. This means that high-ranking employees can salary defer and an employer can contribute to an NQP without triggering a funding obligation for rank-and-file employees. Taking this example to the extreme, an organization could establish an NQP for its high-ranking employees that allows them to salary defer and receive employer contributions or matching contributions into that NQP without triggering any financial obligations toward participants in the 401(k) or 403(b) plan. A more moderate approach would provide for an NQP to receive whatever excess contributions were made to a 401(k) or 403(b) plan, as determined by that plan's year-end testing.

How Else Do NQPs Differ From 401(K) and 403(B) Plans?

While there are many significant differences, most are not noticeable to the participant or even a plan sponsor that is relying on knowledgeable advisers. Following are the more noticeable differences that could be viewed as "drawbacks":

- **Tax deduction timing for the organization:** Organizations are generally entitled to a tax deduction for amounts going into a plan. Matching contributions, employer contributions, and salary deferrals are deductible to the organization when contributed to the plan, even though these amounts are not taxed to the employee until the employee removes those amounts from the plan, which can be many years later. NQPs are not entitled to this separation of time between the tax deduction to the employer and the inclusion in an employee's income. Instead, an employer is not entitled to a deduction for amounts going into an NQP until the amounts are paid or made available to the participant.

- **Tax deduction timing for the participant:** Participants are generally taxed on NQP assets when such amounts are paid or *made available*. The "made available" aspect means the employee cannot delay taxation for as long as is ordinarily available through a 401(k) or 403(b) plan. Those plans commonly make funds available when a participant attains age 59 1/2 and at any age after terminating employment. In these cases, the funds are available to these participants, but they may delay taxation by delaying actual receipt. If an NQP made funds available at age 59 1/2 and at termination of employment, then the amounts are taxable at the *earlier of* the participant attaining age 59 1/2 or terminating employment. For this reason, NQPs normally provide for automatic payments or a series of payments at a designated age (like age 65) or a designated time (like after termination of employment), and these amounts are not eligible for rollover to an IRA.

- **Pass-through problem:** Unlike 401(k) and 403(b) plans whose assets are owned by the plan, NQP assets are owned by the organization. Combined with the lack of an immediate tax deduction (discussed above), owners of pass-through entities (like S corporations and LLCs) will likely pay taxes on NQP contributions and earnings.

- **Distribution restrictions:** Because of the "made available" issue discussed above, it does not make sense for participants to delay distribution beyond the time amounts are initially available. Depending on the situation, an NQP might provide for payment after five years of service, at age 60, or upon termination of employment, but the payment date must generally be set when *contributions*

- **Deferral election timing:** Also because of the "made available" issue, salary deferrals to an NQP must generally be made soon after becoming initially eligible for the plan or before the end of the preceding year. Thus, an employer establishing a calendar year NQP on March 1, 2020, can give initial participants until March 30 to make deferral elections for 2020, and the elections for 2021 would need to be made by Dec. 31, 2020. In between those dates, no elections or election changes are permitted.

- **Nonprofits & IRC s. 457:** Unlike for-profit entities that can delay taxation by delaying when amounts are made available, IRC s. 457 generally provides that NQPs of nonprofit organizations are taxable to the participant once they are no longer subject to a substantial risk of forfeiture. The legal impact of IRC s. 457 is that more specific vesting and forfeiture provisions must be applied, making nonprofit NQPs less attractive for salary deferral purposes, but not necessarily for employer contribution purposes.

Recommended Next Steps

Now that we are in that time of year when plan sponsors will be receiving notices about excess contributions and may be frustrated with the costs triggered by allowing or restricting higher-ranking employees from participating, it is a good time to consider whether an NQP can be useful.

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