Practical Solutions for NQDC Plans

(October 2016)

This Issue of Practical Solutions for NQDC Plans explores 10 challenging areas of Non-Qualified Defined Contribution ("NQDC") Plan Administration. Some of the topics covered represent the more difficult NQDC issues I encountered during my 35 years in the Defined Contribution Practice at Willis Towers Watson and especially in the last 20 years working mostly with NQDC Plan consulting, compliance and recordkeeping. Future Practical Solutions will continue to focus on NQDC Plan issues and may include some challenging Qualified DC Plan issues as well. If you have any questions or suggestions for future articles, or comments on this issue, please email me at: RussMorgan@nqdcsolutions.com, or visit www.nqdcsolutions.com

1.) Payments to Former Employees – Overuse of the 25% Optional Federal Tax Withholding Rate – In an effort to streamline the processing of NQ Plan supplemental wage payments to terminated employees, many companies, payrolls, recordkeepers and rabbi trustees use a 25% default Federal Income Tax withholding rate on all annual payments of $1M or less. This 25% optional flat rate is actually only available if income tax was withheld from "regular wages" during the calendar year of the payment or the preceding calendar year. During those two years only, the 25% optional flat rate can be applied without regard to whether income tax has been withheld from the employee's regular wages or without regard to any elections made on the employee's W-4 Form.

- **Avoid Over-Withholding.** To avoid *"exacerbating the problem of over-withholding on wages paid to employees" (see IRB 2006-37*) after those first several years, for payments of $1M or less, providers must return to the employee's W-4 Form to determine the Federal Income Taxes to withhold. Based on the IRS 2016 Percentage Method Withholding Tables, use of the W-4 Form reduces the income taxes below 25% for annual payments of $214,000 or less for singles and $341,000 or less for marrieds. Most NQDC payments are below these amounts.
- **Avoid Under-Withholding.** However, based on those same 2016 Percentage Method Withholding Tables, returning to the W-4 Form actually "increases" the income taxes above the 25% optional flat rate for annual payments over $214,000 for singles and over $341,000 for marrieds. Under those 2016 Withholding Tables a maximum $1M payment to singles would be taxed at over 35% and a maximum $1M payment to marrieds would be taxed at almost 34%. Under-withholding, intentional or unintentional, must be avoided at all costs. Non-compliance may lead to possible fines for all those involved in the NQDC Plan tax processes and policies.
- **Exempt from Taxes.** Incredibly, former participants can also choose annually to be "Exempt from Taxes" on their W-4 Form. If you decide to accept these forms verify that they are fully completed, signed and dated correctly. Employees must return to their prior W-4 election If they do not claim the exemption in the following year.
- **>$1M Supplemental Wage Taxes.** If the NQ Plan payments exceed $1M in a tax year, the participant's W-4 Form election, even the "Exempt from Taxes" election request, is ignored and no longer applicable. Annual supplemental wages from all NQ Plans in excess of $1M are taxed at 39.6%, the highest current federal tax rate.
- **No W-4 ~~No~~ Problem.** No current W-4 Form is a problem for payments up to $1M made in the years when a W-4 Form is required. The default rate for no current/valid W-4 Form is not 25% but instead it requires withholding at the highest rate, as if the participant was single claiming no withholding allowances.

Author: Russell Morgan at NQDCSolutions, LLC.

The comments and opinions expressed in this article are those of Russell Morgan only. They are for informational purposes and should not be construed as legal advice. For legal advice, contact your legal counsel.

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- *In a nutshell, NQDC taxation is extremely complex. Taxes include, but are not limited to: Federal, State, Source State, Local, Social Security, Medicare Hi-Tax, Med-Tax, FICA, FUTA, Foreign, etc…*
- *Federal Income Taxes on NQ Plan supplemental wage payments must be withheld correctly. Federal withholding of a flat 25% in the years after a separation from service for payments of less than $1M was considered to be excessive and counter intuitive to the purpose of the economic stimulus under the American Jobs Creation Act of 2004 and was consequently limited to the first several years only.*

- *One area of concern involves the supplemental wage payment tax withholding from multiple payment sources, such as a Rabbi Trust for some and corporate payroll for other NQ payments. In this case, unless the NQ payment providers are talking and in-sync, income taxes on supplemental wage payments over and under $1M may not be withheld correctly.*
- *Part of my job at my prior employer, Willis Towers Watson, was to inform and train clients and other senior consultants on the complexities of NQDC Plan taxes. If you have a question on NQDC tax issues, please contact me at: RussMorgan@nqdcsolutions.com.*
- *A more complete article on NQ Plan supplemental income taxes will be available on NQDCSolutions.com in the future….*

2.) Lost Yearend Bonus Deferral Elections - Missing or incorrect yearend bonus deferrals can be a major 409A administrative and compliance issue and can occur for several different reasons:

- **The Payroll Shuffle.** NQDC participants tend to be a rather mobile group of employees. Some NQDC participants move between divisions/locations and/or payroll systems and can lose their yearend bonus deferral elections. The participant, new payroll provider or recordkeeper may never notice the missing yearend bonus deferral elections since the participant's current NQDC Plan base pay deferrals continue to be taken from their paycheck.
- **The Un-Informing Recordkeeper.** The recordkeeper may have noticed the zero yearend bonus deferrals but didn't inform anyone since not all NQDC participants receive yearend bonuses.
- **All Blanked Out.** In preparation for the new plan year annual enrollment election period, the recordkeeper and payroll may have zeroed out all of the prior year's NQDC deferral elections, including the evergreen elections and the multi-year bonus deferral elections. (Ex. Earned in 2019, paid in 2020/2021/2022.)

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- *NQDC Plan sponsors should confirm that all employee deferral elections are accounted for, and acted upon, at appropriate times during the year. Plan sponsors should review all employee deferral elections with payroll and the recordkeeper after the annual enrollment and again shortly after the first payroll period.*
- *If applicable, check with any new payroll providers following employee division/location/payroll transfers or payroll system changes to verify that all deferral elections were transferred correctly.*
- *The recordkeeper should also confirm any zero or missing yearend bonus deferrals with the plan sponsor's NQDC team shortly before and after the end of the yearend bonus period.*
- *Any changes to the employee deferrals (or payments, for that matter) should be reported to the NQDC compliance team who will most likely use the 409A Self-Corrections available under Notice 2008-113 to make any corrections before the end of the year.*

3.) NQDC Plans and Federal Insurance Contributions Act ("FICA") Tax Issues - FICA taxes may be withheld, or not withheld, correctly during the year for various reasons:

- **Stealth Vesting.** In some situations, payroll and the tax department may be unaware that participants became partially vested in their NQDC company accounts. This is commonly an issue with a recordkeeper who doesn't inform anyone that a FICA taxable vesting update event has occurred or when the NQDC team doesn't understand the significance of new vesting. If the vesting/tax event is missed, it will most likely lead to higher final FICA taxes for the participant, penalties for non-withholding for the participant and company, a participant lawsuit against the company and a lifetime membership in the IRS's Annual Audit Club for both parties.
- **Undefendable RORs**. While not a 409A issue as of yet, plans with individually designed fixed income rate funds, or other funds that are not pre-determined actual investments, may produce earnings rates of return ("RORs") that may be determined to be "unreasonable" or "excessive" under the FICA Tax Regulations. Those using excessive

RORs must timely FICA tax the difference between the government's annual mid-term applicable federal rate (1.81% on 1/1/16) and the excessive rate applied to the participant's NQDC accounts. (In the recent June 2015 NQDC Audit Guide the IRS listed the Moody's Average Corporate Bond Yield, currently at around 3.7%, as a reasonable annual rate of interest.)

- **No Losses Here.** Plans that guarantee that the participant's RORs will never go below zero, are also creating a funding arrangement with an unreasonable ROR and FICA taxable earnings.

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- *FICA taxes are currently a hot lawsuit and compliance issue with multiple paths to failure.*
- *The ground rules should be: If it comes into the NQDC Plan vested, FICA tax it. If it moves, i.e. newly vests, FICA tax it. If the earnings are too good to be true, FICA tax the difference.*
- *If FICA taxes are not withheld correctly, the entire future payment may be subject to FICA taxes, and additional penalties for both the company and the participant.*
- *A common fixed income fund ROR for start-ups is to credit the NQDC accounts with their corporate borrowing rate (albeit, not necessarily a reasonable rate), which can be as high as 8%+. In essence, they are borrowing their operating capital from the NQDC participants.*
- *If you apply an excessive investment rate that does not follow an actual investment, you must have that rate approved, at least every five years, by internal and/or external counsel and the Board of Directors.*
- *A more complete article on FICA taxes will be available on NQDCSolutions.com in the near future….*

4.) Last Payroll Period vs. First Payroll Period - All those who touch the NQDC Plan should be in-sync with regards to the last payroll period for current year and first payroll period for next year's deferrals under the NQDC Plan:

- **409A Periods.** Under 409A, if the Plan Document is silent with regards to defining the first and last payroll periods of the plan year then the payroll period "ending date" makes the determination. In this case, the first payroll period for the new year would be the first one ending in that new year. For example, the first <u>2020</u> payroll period would run from 12/23/<u>19</u> to 1/5/<u>20</u>, and all <u>2020</u> deferral elections would need to be made by 12/22/<u>19</u>.
- **Bifurcated Vision.** When a NQDC payroll period spans two calendar years, such as from 12/23/<u>19</u> to 1/5/<u>20</u>, some plans and payrolls split the wages, or bifurcate them, between the two years. In doing so, the deferral elections must also follow the bifurcated wages. For example, if bifurcated, deferral elections for the 12/23/<u>19</u> to 12/31/<u>19</u> partial payroll period must be made by 12/31/<u>18</u>. Deferral elections for the remaining 1/1/<u>20</u> to 1/5/<u>20</u> partial payroll period must be made by 12/31/<u>19</u>.
- **Recordkeeper's Buckets.** The recordkeeper should also be aware of the first and last payroll periods so the deferrals are placed in the appropriate class year deferral and payout buckets. For bifurcated situations, the recordkeeper should receive two distinct deferral files, with one containing the activity in the last payroll period (through 12/31) and the second containing the activity in the first payroll period of the new year (1/1 forward).
- **W-2 Tax and 409A.** In some situations, annual W-2 tax information may be based on payroll periods that are different than the 409A payroll deferral periods. Verify with payroll, tax and legal and add a summary to all processing manuals if this applies to your NQDC Plan.

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- *409A forced NQDC Plan providers to be meticulous, precise and 100% accurate. Errors are costly to the participant who is ultimately responsible for the NQDC Plan's full compliance with 409A.*
- *If all who touch the NQDC Plan can't come to an agreement on the first and last payrolls, it is time to get legal involved to interpret the Plan Document and to provide guidance to all providers.*
- *First and last payroll period errors can cause issues with deferrals, payouts, investments, taxes, etc…*
- *Correcting posting date issues can be timely, costly and embarrassing and will probably involve the 409A Self-Correction Program available under Notice 2008-113.*
- *A more complete article on payroll periods will be available on NQDCSolutions.com in the near future….*

5.) 401(k) Hardship Withdrawal Suspensions - Under the 401(k) Regulations, NQDC participants must suspend all 401(k) and NQDC deferrals following a 401(k) hardship withdrawal:

- **Must May.** Under the 401(k) Regulations to qualify for a 401(k) hardship withdrawal the employee must suspend all employee contributions to the 401(k) Plan and all other plans maintained by the employer for at least 6 months after receipt of the distribution. The 409A Regulations state that "….a [NQDC] plan may provide for a cancellation of [an employee's] deferral election……due to an unforeseeable emergency [from the NQDC Plan] or a 401(k) hardship distribution. The deferral election must be cancelled, not merely postponed or otherwise delayed. Any later [NQDC] deferral election is subject to the initial deferral election provisions."
- **Confusing Conundrum.** If the suspension of NQDC deferrals eliminates the 401(k) financial hardship, can the 401(k)/NQDC employee still qualify for the hardship withdrawal? If they can't qualify for the 401(k) Plan hardship withdrawal, do they still have a valid reason to suspend their NQDC deferrals?
- **Topic for Legal.** With no clear answer from the Regulations, legal needs to make the decision of suspending NQDC employee deferrals for those who take 401(k) hardship withdrawals and communicate that decision to all administrators: qualified and non-qualified, internal and external.
- **Non-Talkers.** Unfortunately, this may be an issue that is difficult to handle since, due to confidentiality issues, the NQDC folks may not talk, or want to talk, with the 401(k) folks on a regular basis and vice versa.
- **Just Not Normal.** It is also not normal for something that happens in the 401(k) qualified plan to affect something in the NQDC Plan but that is the case here. Normally there should be a Chinese wall between the two plans. But then again, "what happens in the 401(k) Plan stays in the 401(k) Plan"…..as they say.

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- *A clear "legal" decision on handling NQDC employee deferrals when the participant has taken a 401(k) hardship withdrawal should be contained in the NQDC Committee Notes, the Administrative Processing Guide, the SPD, the NQDC and 401(k) recordkeeper's procedures, and any other communication sources.*
- *401(k) hardship withdrawals have become readily available for almost everyone, including the NQDC participants. If you should have, but you did not stop the NQDC deferrals following a 401(k) hardship withdrawal, there is a chance that you just caused a major compliance issue under the 401(k) Plan.*
- *Building a wall between the qualified and NQDC Plans is best practice for most matters but not all. An open dialogue between the two teams must be established especially for issues involving hardship withdrawals.*
- *In some situations, the 401(k) recordkeeper handles most of the hardship withdrawal requests. If that is the case, then the recordkeeper needs to be responsible for alerting the NQDC team of any hardship withdrawals.*
- *A more complete article on 401(k) hardship withdrawals and NQDC Plans will be available on NQDCSolutions.com in the near future….*

6.) Requested Employee Deferrals not timely deducted from the Participant's Wages can be Accelerated Distribution Violations under 409A:

- **Non-Deferred Distributions.** In "409A terms" if a requested employee deferral is not taken properly from the employee's wages and deposited into the NQDC Plan then the employee has received an improper 409A accelerated distribution.
- **Invalid Reasoning.** While there are a handful of valid reasons to stop an employee deferral, for the most part it will most likely be determined to be a 409A accelerated distribution violation. This issue should be brought to the attention of the person(s) ultimately responsible for the overall compliance of the NQDC Plan.
- **Correct Me Please.** If the employee has received an accelerated distribution and they are still in the 409A correction window, you may be able to correct this using the 409A *Self-Correction Program under Notice 2008-113.*

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- *409A is about proper and timely posting of deferrals of income and proper and timely distributions. If you follow all the 409A rules and don't stretch the boundaries, there should be nothing keeping you up at night.*
- *Under 409A, missing deferrals are equivalent to paying someone from the NQDC Plan too early. Essentially they received money that should still subject to a "substantial risk of forfeiture" until it is vested and paid.*
- *Payroll and the NQDC team should be watching for changes to deferral amounts. In 401(k) Plans you have deferral increases and decreases throughout the year. In NQDC Plans, deferrals should be fairly consistent throughout the year and tend to increase with pay raises. Any decreases should be investigated.*
- *Another article on accelerated distributions will be available on NQDCSolutions.com in the near future….*

7.) Evergreen Enrollment Elections – New and Improved – Proceed with Caution:

- **Forever Enrolled.** Evergreen enrollment elections work great for basic annual deferral elections, static payout dates, consistent investment and distribution elections. Check with payroll, the NQDC recordkeeper and the NQDC team to make sure that all valid evergreen elections made it to the new year.
- **Irrevocable Issues.** Since most of the evergreen elections are irrevocable after 12/31, problems can occur with any program modifications, such as: Plan Document amendments, investment fund changes, new non-eligible former participants, payment election option changes, deferral category and any limit changes, etc…
- **Blissful Ignorance.** Problems can also occur when last year's participants are erroneously re-enrolled simply by ignoring the evergreen warning language in their annual enrollment materials or website. Those who skip past the annual enrollment, assuming that they have declined participation, may find themselves irrevocably auto-enrolled under the evergreen provision. As a reminder of their "default evergreen choice" it may make sense to send out a reminder notice that actually gets the attention of those who tend to ignore your important announcements.
- **Un-Green Pastures.** Make sure that all newly ineligible employees have had their evergreen deferral elections removed before the annual enrollment period begins.

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- *Efficiently administered evergreen elections are a wonderful addition to NQDC Plans. However, unless it is for relatively basic NQDC elections, and for a group of non-confrontational executives, the jury may still be out on its appropriateness for NQDC Plans. The NQDC eligible group is not necessarily the easiest to work with on the annual enrollment and the overall unique NQDC Plan provisions and requirements.*
- *It may be best to have the participants at least acknowledge the receipt of the annual enrollment notice/ email, containing the evergreen provisions, to help deflect any future uninformed claims by executives.*
- *Another article on evergreen elections will be available on NQDCSolutions.com in the near future….*

8.) The Beneficiary's Payout Elections:

- **Ben's Payment Options.** Most 409A Plans will have a set beneficiary payout provision after the death of the participant, with lump sums being the most popular. Some plans, however, permit the beneficiary themselves to choose their own payout elections and options.
- **Ben's Payment Changes.** If beneficiaries can make changes to the time and/or form of their payouts they are required to follow the same 409A payment election change provisions as participants. Beneficiary payment election changes must be made at least one year prior to the payout date, mature for one year and the payment must be delayed an additional five years.
- **Recent Legislation.** Please be aware that the proposed amendments to the 457(f)/409A Regulations, released in mid-2016, modified some of the options and timing of death payments to beneficiaries.

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- *Beneficiary payment elections in a NQDC Plan can be challenging. In most cases it may be best <u>not</u> to offer the beneficiaries the option to change their payout elections and instead pay them out as soon as possible.*

9.) Non-Qualified Employee Indicative Data and Indicative Data Changes – Updating the employee's NQDC Plan's indicative data, once a fairly simple task, has been made ridiculously complex under 409A.

- **One Data Source.** Using the same recordkeeper and data sources for the qualified and non-qualified plans can be detrimental to the integrity of the NQDC indicative data. For example, a location transfer may be coded as a termination/re-hire under the 401(k) Plan, while a termination code under the NQDC Plan may trigger a separation from service payout. Addresses and beneficiaries may also be different between the two plans.
- **Same Different Dates.** Some non-qualified plans will modify the participant's "dates" to enhance the executive's benefits. Using first and last days of the month, instead of actual dates, will increase a participant's age and service for vesting and benefit calculations. Original hire dates are sometimes substituted for re-hire dates.
- **Bonafied Term.** A termination or retirement under a 401(k) Plan may not qualify for a separation from service payment under a 409A Plan when the participant returns as a contractor doing essentially the same job as before they left.

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- *Be mindful of sources of data for the NQDC Plan. While it may be convenient to use the single source qualified plan recordkeeper's data, it can come with unforeseen consequences.*
- *It may be best to have the NQDC team provide the NQDC recordkeeper with the indicative data that is related to the benefit, vesting and payment calculations, such as: birth, hire, vesting and term dates, funds, payout choices, beneficiaries, etc...*
- *If possible, have the NQDC recordkeeper notify you of any changes to the NQDC Plan indicative data.*
- *Another article on sources of NQDC data will be available on NQDCSolutions.com in the near future….*

10.) The 6-Month Delay for the Specified Employee Group – Keeping track of the specified employee group is one of the most frustrating additional administrative challenges that grew out of 409A:

- **Specified Employee "Club Members".** Each year a whole new list of specified employee "club members" is created, late in the year for the next year. The 6-month payment delays are then applied to all specified employee's separation from service payments. Specified employees from last year, who did not qualify for club membership this year, are released and the 6-month payment delay is removed from their accounts.
- **All for One Delay.** In some situations, payments are made before they are formally reviewed. A 6-month delay on all separation from service payments can provide more time to complete a more detailed payout analysis.
- **200 not 300.** There is a provision in 409A that limits the specified employee group to 200 people, if an alternative definition is used to determine the specified employees. This can come into play when two, or more, organizations merge with more than 200 total combined specified employees. But why have the limit at all since you can delay the separation from service payments to 6-months for all NQDC employees, which could be well over 200.

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- *409A allows you to treat all participants as specified employees and delay all separation from service payments by 6-months. In essence, you don't have to keep up with the specified employee groups.*
- *If you include all employees in the specified group you also have a specific "set in stone date" to make all separation from service payments, on the first of the month following a 6-month delay. This also provides the NQDC team with ammunition to deny a request from the executive to accelerate the payout to the*

current tax year or delay it to the future tax year to reduce their tax burden. An acceleration or delay may work in a 401(k) Plan, but it can cause serious compliance issues in a 409A Plan.

- *Another article on specified employees will be available on NQDCSolutions.com in the near future….*

About the Author

Before starting NQDCSolutions, LLC, Russell Morgan spent almost 35 years working with large employers in the Defined Contribution Plan Practice at Willis Towers Watson in Dallas, Texas. During the past 20 years he provided Non-Qualified Defined Contribution ("NQDC") Plan administration services to many different sizes and types of firms with total combined NQDC Plan assets, at one point in time, close to $2B. In addition to 20 years of NQDC Plan administration services, he also led large plan NQDC compliance reviews, reviewed and designed NQDC Plans, created NQDC administration and compliance manuals and consulted with clients and senior consultants on all aspects of NQDC Plans. For the past several years, he was Willis Towers Watson's National Resource on all NQDC issues.

If you have any questions or comments concerning this topic or any other issues involving NQDC and 401(k)/403(b) Plans, please address them to RussMorgan@NQDCSolutions.com. Our website www.nqdcsolutions.com is now available where we will be listing our services and posting more articles and helpful suggestions on the administration of non-qualified and qualified plans.