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Planning For NQDC Distributions May Avoid State Taxes

Maximizing the Use of Sophisticated Administration Systems

Nonqualified Deferred Compensation (NQDC) Plans serve an increasingly important and integral role in the overall compensation and benefits packages of Senior Executives. Due to the flexibility of NQDC plans, not restricted by IRS limits on amounts that may be deferred into these plans, Executives may accumulate significant account balances with the purpose of supplementing their retirement incomes. As an example, with a Qualified 401(k) plan, the maximum most Executives may contribute in 2009 or 2010 is only $16,500. In contrast, with an NQDC plan, Executives may contribute almost unlimited amounts depending on the plan design. In this article we will discuss why the choice of a State is important to plan for distributions from NQDC plans and how such planning may be accomplished.

Senior Executives at all types of organizations can expect to relocate to various States during their working careers. As most Executives will know from experience, State taxes can vary significantly from State to State. A few States do afford the luxury of no income taxes, which can be a huge benefit when compared to States with very high income taxes. The advantage of an NQDC plan can be maximized if an Executive defers maximum compensation earned in States with high income taxes and then receives distributions in the nine (9) States that have no income taxes.

Although during their working careers the Executives’ choice of various States for relocation is dictated by their work commitments, most Senior Executives plan for retirement to a State of their choice. To the extent an Executive has some degree of flexibility in deciding the choice of the retirement State, selecting a State with no income taxes may yield substantial benefits for retirement distributions from their NQDC plan, if planned properly.

Example

To illustrate the significant impact to retirement income distributions, let us assume an Executive has accumulated an NQDC balance that will provide equal distributions of $100,000 over 10 years.

Now, let us compare the result in Chart I assuming the Executive receives those distributions in a high tax State like Oregon vs. a zero-tax State like Florida.

	Oregon	Florida
Annual Distributions (10)	$100,000	$100,000
Total Distributions	$1,000,000	$1,000,000
Federal Tax	($350,000) 35%	($350,000) 35%
State Tax	($110,000) 11%	($0) 0%
Net Income	$540,000	$650,000

The after-tax income received in Florida is projected to be 20% higher when compared to Oregon. This is a very big difference.

Chart II

Comparative Tax Rates - Nine States with the Highest Marginal Tax Rates and No Income Taxes as of December 1, 2009.

States with Highest Marginal Tax Rates	Rate	States with No Income Taxes	Rate
Oregon	11.00%	Alaska	0%
Hawaii	11.00%	Florida	0%
California	10.30%	Nevada	0%
Rhode Island	9.90%	New Hampshire	0%
Vermont	9.40%	South Dakota	0%
Maryland	9.40%	Tennessee	0%
Iowa	8.98%	Texas	0%
New Jersey	8.97%	Washington	0%
Maine	8.50%	Wyoming	0%

Applicable Tax Law

The tax rules applicable to distributions from NQDC plans are clearly codified without any ambiguity as to their applicability. Under §3121(v)(2)(C) of the Internal Revenue Code of 1986, as amended, distributions from NQDC plans are eligible for favorable tax treatment if they are received as annual equal periodic payments for either of the two durations:

1. Over the life or life expectancy of the Executive (or in the case of a distribution based on joint lives, based on the joint lives or joint life expectancy of the Executive and Executive's joint beneficiary), or

2. Distributions made over a period of at least 10 years.

In addition to other types of distributions, the applicable tax law applies to retirement distributions from an NQDC plan that is implemented specifically for providing retirement benefits due to qualified plan limits affecting such a plan.

Potential Issues to Watch Out For

1. **Receiving Distributions in a State with high income taxes**: the first and most obvious planning issue is to consider the impact of State income taxes. Choosing a State with no income tax, or very low income tax rate must be considered.

2. **Receiving less than Ten (10) Annual Distributions**: under the applicable tax laws, even those Executives who receive NQDC plan distributions in States with low or no income taxes face potentially adverse tax impact if they receive less than 10 annual distributions. With proper planning, this important condition can be managed.

3. **Impact of 409A Regulations**: NQDC plans are governed by 409A regulations, which mandate irrevocable elections of the distribution dates and forms of distribution when making a deferral. Furthermore, if subsequently an Executive wishes to re-defer a distribution, the re-deferral must be for at least another five years.

4. **Impact of Improper Planning Tied to Inflexible Administration Systems**: many NQDC plan administrators are not equipped to handle multiple accounts per participant with multiple distribution payouts. As a result, an Executive's deferrals may be placed into very few deferral accounts, which makes the process of managing future cash flows very restrictive. Without a sophisticated and flexible administration system, the process of managing multiple deferral accounts per participant cannot be accomplished.

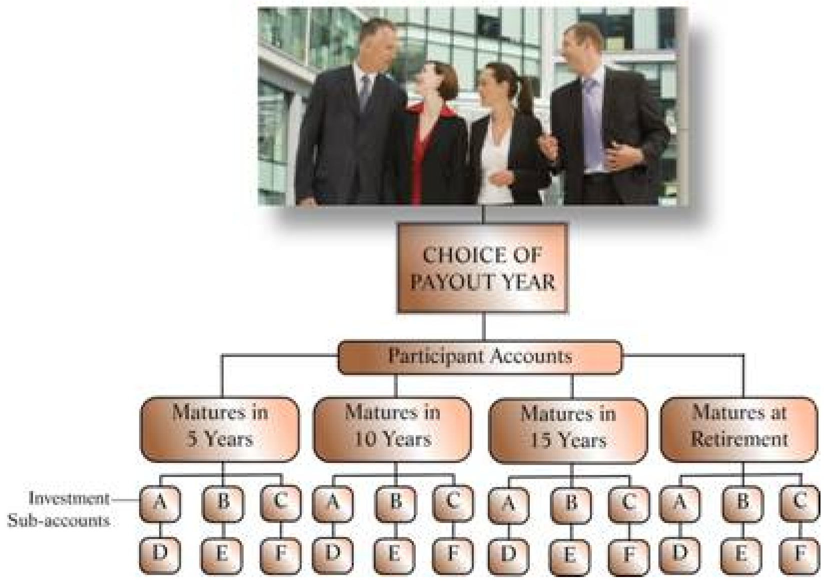
5. **NQDC Balances subject to claims of Employer's Creditors**: as with any nonqualified plan, the NQDC balances always remain subject to the claims of creditors in the event of insolvency of the employer. The Executive has to balance the duration of distributions to maximize tax advantages with the risk of the employer's insolvency.

6. **Source State vs. Benefit State**: under current regulations a retired Executive may be taxed only in the State where benefit is received. However, under the applicable tax laws the distributions received may not qualify for the exemption if certain conditions are not met and would thus be subject to the taxes of the source State (where income was earned). In order to prepare for the eventuality of being subject to income taxes of two or more States, it is necessary for the administration system to be able to track all deferrals and distributions by State.

The Solution - Nolan Financial's Sophisticated NQDC Administration System

As discussed above, in order to take advantage of the favorable tax rules for NQDC distributions in States with low or no income taxes, a sophisticated administration system is a necessary requirement. Only with a true NQDC system it is feasible to set up multiple deferral accounts, multiple distributions for each deferral account, track the source State and benefit State and re-defer each distribution with further levels of distribution dates. The end goal is to manage cash flows resulting in maximum tax efficiency with minimal risk.

Chart III below illustrates the multi-level functionality of Nolan Financial's NQDC plan administration system. Each deferral account shown below may be re-deferred for a minimum of another 5 years with a further level of distribution dates to manage cash flows. This system offers the full functionalities that employers and their Executives may utilize to benefit from the tax advantages offered in States with low or no income taxes.



Many NQDC plan administrators manage these plans on outdated systems that were designed for qualified plans. As a result, their administration systems are not equipped to handle the highly flexible requirements of an NQDC plan, especially after the enactment of 409A regulations.

Summary

In an era of expected increases in income tax rates, Executives have a readily available opportunity to mitigate the impact of taxes on their distributions from NQDC plans. Executives who may have already planned to retire to the nine States with no income taxes have the most to gain by undertaking a planned approach for their NQDC distributions. Other Executives contemplating on the choice of States for retirement have an opportunity to plan and base their decisions on important tax considerations highlighted in this article.

Although the ultimate tax impact is borne by the Executives, the decision to maximize the advantages afforded under applicable tax laws rests with the employers. It is the employers' duty to seek true NQDC plan administrators who can offer administration systems that are sophisticated and able to handle the complex requirements discussed in this article.

Nolan Financial is a fully independent firm specializing only in Nonqualified Benefits. Nolan Financial's administration system offers full capabilities that allow employers to offer the State-tax related advantages to their key executives.

If you have any questions or concerns about how your company may be impacted or would like additional information, please contact:

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