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Integrating Nonqualified Deferred Compensation with Qualified Plans

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Many large employers sponsor both qualified and nonqualified retirement income plans. Qualified plans allow tax deferred vested benefits beyond the reach of the employer's general creditors. Nonqualified plans allow tax deferred vested benefits only when the employer's benefit obligation is unsecured. Any assets earmarked to pay nonqualified benefits must be available to the employer's general creditors.

Two common nonqualified plan designs illustrate how qualified and nonqualified plans are typically interrelated. The first is a restoration-type nonqualified plan. Restoration plans are typically designed to restore the exact amount of benefit lost due to limits on qualified plans imposed by the Internal Revenue Code (IRC). These limits include the compensation limit ($260,000 for 2014)[1] and the elective deferral limit ($17,500 for 2014).[2] The combined effect of a qualified plan and its related nonqualified restoration plan is a level of benefits that would have been determined under the qualified plan but without limits imposed by the IRC. For example, an employer could restore a non-elective contribution that the employer would otherwise have made on recognizable contribution above the IRC compensation limit.

An offset design is another type of common nonqualified plan that also illustrates the interrelationship with a qualified plan. In an offset design, an initial target level of benefit is defined, and the target benefit is then reduced (offset) by the benefit provided through a qualified plan. The net resulting benefit amount is provided under the nonqualified plan. For example, an employer establishes a target retirement benefit for an executive of $25,000 per month. This amount is offset by the $10,000 per month that he receives from the qualified pension plan. The net amount of the nonqualified benefit is $15,000. Both restoration and offset designs illustrate the strong link that frequently ties qualified and nonqualified plans.

The remainder of this article addresses some of the federal income tax laws that apply to the interrelationship between qualified and nonqualified retirement plans in situations that are less obvious than restoration and offset arrangements. These tax laws control the definition of compensation used to determine benefits, the linking of amounts, the linking of timing of benefit payments, benefits paid in unforeseen emergencies and hardship, funding rabbi trusts, and deferring 401(k) refunds.

ACCIDENTAL QUALIFIED PLAN BENEFIT CUT

Because most qualified plans use compensation to determine contributions or benefits, defining compensation is important. Most qualified plans exclude nonqualified elective deferrals from the definition of eligible pay, even though permitted definitions of compensation for qualified plan purposes do not expressly require the exclusion of nonqualified elective deferrals. The regulations exclude employer contributions to deferred compensation arrangements to the extent such contributions are not included in gross income in the year of the contribution,[3] but employer contributions do not necessarily include elective deferrals. Furthermore, the regulations allow taxable in-service distributions from nonqualified deferred compensation plans to be included in compensation for qualified plan purposes.[4] The ability to include taxable distributions only implies (rather than requires) a need to exclude nonqualified elective deferrals. One thing is clear; including nonqualified elective deferrals in the definition of compensation for qualified plan purposes complicates discrimination testing. For example, a plan that includes nonqualified elective deferrals in eligible pay will generally not be able to rely on "safe harbors" to satisfy nondiscrimination rules that apply to qualified plans.[5] In addition, including nonqualified elective deferrals in a qualified plan's definition of eligible pay will often jeopardize that plan's ability to satisfy nondiscrimination rules through general testing.[6]

When qualified plans do exclude nonqualified elective deferrals from the definition of eligible pay, the impact on the amount of eligible

pay that is actually considered in the calculation of benefits under the qualified plan will depend on whether the residual pay (i.e., the pay remaining after the exclusion of nonqualified elective deferrals) is above or below the compensation limit that applies to qualified plans. As the following examples illustrate, an executive may need to manage his or her nonqualified elective deferrals to ensure that he or she is maximizing qualified plan benefits.

> **Example 1:** Sue is a participant in a qualified pension plan that provides her with a monthly retirement benefit of 2% times final average earnings. She earns $265,000 in wages for 2014 and had elected to defer $10,000 into the nonqualified plan. Because the qualified plan's definition of compensation excludes nonqualified deferrals, Sue's pension benefit reflects only $255,000 in compensation for 2014. If Sue had limited her elective deferral into the nonqualified plan to $5,000, her pension benefit would reflect the full $260,000 of compensation allowed under the compensation limit.

> **Example 2:** Bob is a participant in a 401(k) plan that matches 100% of qualified plan deferrals up to 3% of compensation. He earns $265,000 in wages for 2014 and elects to defer $7,800 in the qualified plan and $10,000 into the nonqualified plan. Because the qualified plan's definition of compensation excludes nonqualified deferrals, Bob's 401(k) match is calculated based on only $255,000 in recognizable compensation for 2014. The reduced compensation limits his match to $7,650, or 3% of $255,000. If Bob had limited his elective deferral into the nonqualified plan to $5,000, his 401(k) match would still reflect the full $260,000 of compensation allowed under the compensation limit. His resulting match would then be $7,800.

Why would an employee knowingly reduce compensation for qualified plan purposes to the point of reducing qualified plan benefits? Many employees who do so are probably unaware of their loss of benefits. In some cases, however, employees simply want to defer more than the 401(k) elective deferral limit ($17,500 in 2014) and their total compensation is too low to both receive the maximum matching contribution and achieve the overall deferral objective.

> **Example 3:** Betty earns $265,000 in wages for 2014 and wants to defer 10%, or $26,500. Her 401(k) plan allows her

> to defer up to the elective deferral limit of $17,500, so she defers the remaining $9,000 into the nonqualified plan. Her nonqualified deferral reduces her compensation for qualified plan purposes to $256,000. If Betty had limited her elective deferral into the nonqualified plan to $5,000, her compensation for qualified plan purposes would reflect the full $260,000 of compensation allowed under the qualified plan rules. A compensation level of $265,000 is too low to both defer $26,500 and avoid reducing compensation for qualified plan purposes below the compensation limit ($260,000 for 2014).

Employers that are concerned about this potential loss of qualified benefits respond in one of several ways. Some employers restore lost benefits through a provision in the nonqualified plan that provides a nonqualified employer contribution equal to the amount of matching (or non-elective) contribution lost (but see the later discussion of the contingent benefit rule that applies to 401(k) plans). Less frequently, employers may limit the amount of nonqualified plan deferral so that the individual's recognizable compensation under the qualified plan is never reduced below the current pay limit. This can be accomplished, for example, by delaying the commencement of nonqualified plan deferrals until the individual's recognizable compensation reaches the current year limit. The problem with this approach is that it may force the nonqualified plan participant to rely on salary paid later in the year as the source for nonqualified deferrals which in turn may cause a cash flow issue for the individual.

Employees who want to defer amounts in excess of the 401(k) limits but earn less than the compensation limit should consider Roth 401(k) contributions. Although most discussion of Roth 401(k) arrangements focuses on the potential to avoid higher tax rates in retirement than at the time of deferral, Roth 401(k) contributions increase after-tax retirement income. For example, a $17,500 contribution to a Roth 401(k) consumes more gross compensation than a $17,500 contribution to a traditional 401(k), but the future value of the Roth balance may be more valuable than the future value of the traditional 401(k) balance provided the individual's individual income tax rates have not dropped significantly. A distribution from a Roth 401(k) generally incurs no additional tax,[7] whereas a distribution from a traditional 401(k) plan is taxable. Even employees whose compensation exceeds their employer's compensation eligibility threshold might prefer Roth 401(k) contributions over nominal amounts of nonqualified elective deferrals when benefit security is a concern. An employee who elects Roth 401(k) contributions must

be comfortable with devoting a greater amount of current income to the same nominal amount of retirement savings, because the sacrificed current income includes both the amounts contributed and the income taxes on that income.

LINKING AMOUNTS

Internal Revenue Code section 409A, which is the primary source of federal income tax guidance for nonqualified plans, specifically allows the linking of nonqualified benefit amounts to qualified benefit amounts in the context of both nonaccount balance and account balance plans.[8] For nonaccount balance plans, such as traditional defined benefit supplemental executive retirement plans (DB SERPs), this is welcome tax guidance. An example in the 409A regulations illustrates an offset design, similar to the one described earlier in this article, in which the employee's failure to elect a subsidized early retirement benefit results in a permissible increase in the nonqualified benefit.[9] The same example continues by assuming an amendment of the qualified plan, which decreases the nonqualified benefit. This too is permissible. Note in both cases the total benefit payable to the employee from both the qualified and nonqualified benefit plans never changes and neither action results in a 409A violation.

The 409A regulations also provide relief for "excess benefit plans," which is a 409A term for all non-elective 409A arrangements that restore benefits lost to IRC limits.[10] The relief takes the form of an exception to the general rule that an election to defer compensation must be made before the compensation is earned.[11] Because of the nature of excess benefit plans, an employer may not know that an employee has earned a benefit until after the benefit is earned. The 409A regulations allow a one-time opportunity to specify the time and form of payment for all excess benefit plans in the first thirty days of the year following the year in which excess benefits are first earned. Excess benefit plans include both account balance and nonaccount balance plans, and the one-time exception applies to all excess benefit plans. **Note**: excess benefit plans (as well as other forms of nonqualified plans) should provide a default form of payout to avoid the possibility of penalties under 409A for providing deferred compensation without a timely specified time and form of payment. Also, some companies solicit excess plan payment elections in the prior year for all eligible employees, knowing that these employees may not actually receive excess benefits, in order to avoid the 30-day time crunch.

Though the 409A guidance provides relief with certain combinations of qualified and nonqualified plans, it also sets an indirect trap

for 401(k) plans integrated with nonqualified plans. Although the 409A regulations allow limited flows of benefits between nonqualified plans and qualified elective deferral plans (e.g., 401(k), 403(b), and 457(b) plans),[12] the 401(k) contingent benefit rule expressly forbids such arrangements.[13] The often misunderstood 401(k) contingent benefit rule, which applies only to 401(k) plans, prohibits any benefit from being conditioned (directly or indirectly) on whether an employee makes elective contributions to the 401(k) plan. The 401(k) regulations illustrate the extent of this rule with an example in which employees defer 10% of compensation and may allocate the deferral in any way they choose between the 401(k) plan and the nonqualified plan.[14] As the example explains, "because the maximum deferral available under the nonqualified deferred compensation plan depends on the elective deferrals made under the cash or deferred arrangement, the right to participate in the nonqualified plan is a contingent benefit for purposes of this paragraph (e)(6)." Because violation of this contingent benefit rule causes the 401(k) plan to lose its qualified plan status, the stakes are high.

Fortunately, the contingent benefit rule applicable to 401(k) plans includes several exceptions. For example, matching contributions within the 401(k) plan are permissible.[15] ERISA excess benefit plans are also an exception, but such plans are rare.[16] Unlike 409A excess benefit plans, ERISA excess benefit plans include only arrangements that restore benefits lost to IRC section 415.[17] ERISA excess benefit plans do not include arrangements that restore more commonly lost benefits, such as benefits limited by the compensation limit under IRC section 401(a)(17) and the elective deferral limit under IRC section 402(g).

For nonqualified elective deferral plans, the important exception is the maximum 401(k) deferral exception.[18] Any nonqualified deferred compensation benefit that is contingent on the maximum 401(k) deferral is not a violation of the contingent benefit rule. The maximum 401(k) deferral starts with the elective deferral limit under IRC section 402(g), which is $17,500 for 2014. Discrimination testing can reduce the actual deferral percentage (ADP) for highly compensated employees (HCEs).[19] The maximum elective deferral by HCEs affected by ADP testing is less than the regular 402(g) limit. If the 401(k) plan permits employees age 50 and over to make catch-up contributions, the maximum 401(k) deferral for contingent benefit rule purposes includes the maximum catch-up contribution.[20] If the 401(k) plan permits employees to contribute to a Roth version of the 401(k), electing the Roth version is not a requirement of making the maximum 401(k) contribution in this context.

In practical terms, employers that rely on the maximum 401(k) deferral exception to the contingent benefit rule have two choices. Employers can require that the 401(k) maximum deferral election be irrevocable, or

employers can assume that any nonqualified plan participants elect the maximum 401(k) deferral regardless of their actual elections. Assuming the maximum qualified deferral is the preferred approach because it simplifies the calculation process, reduces administrative complexity, and reduces risk of violating the contingent benefit rule. Relying on actual 401(k) elections, which are usually revocable, allows the possibility of a reduced 401(k) deferral election that increases the nonqualified deferral. As illustrated in the 401(k) contingent benefit regulations, any flows between the qualified and nonqualified allocations violates the 401(k) contingent benefit rule, even when total benefits remain constant.

PROHIBITED LINK OF TIME OR FORM OF PAYMENT

Whereas tax rules permit certain linking of *amounts* of nonqualified benefits to amounts of qualified benefits, linking the *form or timing* of benefits generally violates IRC section 409A.[21] Qualified plans permit significantly more flexibility in the timing of benefit payments than nonqualified plans do. For example, a retiree can wait until after retirement to choose the start date of pension benefits. In addition, a retiree may often choose between a pension lump sum and an annuity up until the date of the first payment. Likewise, subject to certain required minimum distribution rules, 401(k) balances can be withdrawn on demand after retirement.

In contrast, 409A restricts distributions from nonqualified plans to six events: separation from service, disability, death, specified time, change in control, and unforeseeable emergency.[22] Furthermore, nonqualified plans do not have to offer all the flexibility that 409A allows. Although employers that sponsor restoration and offset plans might be tempted to link the time and form of nonqualified benefit payments to the related qualified plan benefits, 409A explicitly prohibits such a link. Although 409A allows participants to change elections as to time or form of payment, 409A imposes significant restrictions on doing so. Any change in time or form of payment is effective no earlier than twelve months after the new election.[23] Any change in a payout election in the event of separation from service, specified time, or change in control requires a minimum five year delay from when the benefit would have otherwise been paid.[24] Finally, the payout of all annuity or installment payouts payable at a specified time becomes irrevocable once the initial payment is less than twelve months away.[25] When 409A rules force the delinking of time and form of payment for the qualified and nonqualified components of restoration and offset arrangements, benefits amounts are adjusted to reflect the effect of interest, investment earnings, or actuarial equivalence as appropriate.

UNFORESEEN EMERGENCIES AND HARDSHIP WITHDRAWALS

Tax law also controls distributions (and cessation of deferrals) for unforeseen emergencies and hardship withdrawals. An unforeseen emergency is a distribution from a nonqualified plan permitted by IRC section 409A.[26] A hardship withdrawal is an in-service distribution permitted from a 401(k) plan.[27] The two distribution events share certain characteristics but differ in important ways.

Both 409A unforeseen emergencies[28] and 401(k) hardship withdrawals[29] allow distributions to pay for medical expenses, property damage, avoidance of foreclosure on (or eviction from) a principal residence, and funerals. Both require employees to consider insurance reimbursements, liquidation of assets, and cessation of deferrals (if allowed under the plan) to mitigate the need for a distribution.[30] Both also allow the distribution to include "reasonably anticipated" taxes on the distribution in determining the gross amount of the distribution.[31] 401(k) hardship withdrawals are subject to the 10% additional tax on early distributions from qualified plans to the extent that the distribution does not qualify for an exception under IRC section 72(t) (e.g., on or after the employee attains age 59 ½).

Tax rules do not require employers to offer unforeseen emergency distributions from 409A plans or hardship withdrawals from 401(k) plans, but employer discretion differs by plan type. 401(k) plan documents must include objective standards for hardship withdrawals if the plan offers hardship withdrawals.[32] In contrast, 409A allows employers to reject unforeseen emergency claims by participants.[33] Employers that anticipate selective approval of requests for withdrawals for unforeseen emergencies should include such a provision for this discretion in the plan document to minimize ERISA claims. Employers can add unforeseen emergency as a 409A distribution event to accelerate payment of benefits without violating 409A,[34] but making such a change at the behest of a particular employee might be viewed as subterfuge.

In spite of the similarities between unforeseen emergencies in 409A plans and hardship withdrawals in 401(k) plans, their criteria for a distribution differ. An unforeseen emergency is a narrower term than hardship and emphasizes the unforeseeable nature of such events. For example, unforeseeable emergency excludes home purchases and college education expenses,[35] whereas hardship includes these events on account of the "immediate and heavy need" caused by such events.[36] Despite the broader scope, hardship withdrawals impose restrictions that don't apply to unforeseen emergencies. For example, hardship withdrawals from a qualified plan require the employee to consider borrowing from

commercial sources.[37] Also, hardship withdrawals from a qualified plan are limited to the principal amount of elective deferrals made under the plan.[38] A distribution from a nonqualified plan on account of an unforeseen emergency does not require either of these actions.

As stated earlier, when determining the need for (and amount of) a distribution to address both 409A unforeseen emergencies[39] and 401(k) hardship withdrawals[40] the employee must take into account the cessation of deferral when permitted under the plan. However, 409A and 401(k) differ in their provisions for cessation of deferrals. 409A plans allow employer discretion in approving cessation of deferrals for unforeseen emergencies, hardship distributions, or both.[41] 409A allows the cancellation of deferrals following both unforeseeable emergencies and hardship distributions.[42] For example, a 409A plan could allow an executive to cease deferrals upon a hardship distribution for a home purchase in spite of the fact that a home purchase does qualify for a distribution for an unforeseeable event. The cessation of deferral provision does not have to be in the 409A plan document.[43] When a 409A plan does allow a distribution for an unforeseen emergency, the (otherwise irrevocable) deferral election is cancelled for the applicable deferral period, not merely postponed.[44]

In contrast, 401(k) requires a six month moratorium on elective deferrals,[45] which include both qualified and nonqualified elective deferrals.[46] This important detail is often missed. . For example, the guidance on hardship withdrawals appears to require the cessation of nonqualified deferrals even when the nonqualified plans does not include a provision for cessation of deferrals. When the hardship withdrawal occurs in the first half of the year, the nonqualified plan may be able to catch-up with higher nonqualified deferrals after the end of the six month. When the hardship withdrawal occurs in the second half of the year, the employer should cancel the nonqualified elective deferral for the current year. Any nonqualified deferrals for the following year should begin no earlier than six months after the 401(k) hardship withdrawal.

An event that qualifies for as unforeseen emergency and a hardship raises the issue of order of payment when both the 409A plan and the 401(k) plan allow the distribution. In this situation, the distribution comes from the 409A plan first, because the 409A rules on unforeseen emergencies allow participants to ignore the availability of qualified plan funds.[47] In contrast, the 401(k) rules require both the cessation of 409A deferrals[48] and the distribution of available 409A funds[49] in determining an immediate and heavy need for a 401(k) hardship withdrawal. Certain situations create the benefit plan equivalent of a "Catch-22," or unsolvable logic puzzle of which came first, the chicken or the egg.

Example 4: Bill has made elective deferrals to both a 401(k) plan and 409A plan. Both plans allow for cessation of deferrals (for hardship and unforeseen emergency distributions respectively). At the time of his irrevocable deferral election under 409A, he believed his son would attend an in-state college on a scholarship. Later, Bill is surprised to learn that Harvard accepted his son's application and wants $30,000 for the first semester's tuition, fees, room, and board. Bill is thrilled about the idea of Harvard graduate in the family but feels a little short on cash. Under the tax rules a distribution could be taken from the qualified plan but not the nonqualified plan. However, to get money from the qualified plan, he will need to stop his nonqualified plan deferrals first. The nonqualified plan allows cancellation of a deferral election for any unforeseen emergency or hardship withdrawal. Because the remaining amount of Bill's nonqualified deferral election for the current year is $100,000, cancelling that deferral election provides him enough cash after taxes to pay the Harvard bill which in turn would eliminate the hardship. Under the 401(k) rules, Bill no longer needs a hardship withdrawal because the 409A deferral cancellation has provided sufficient funds. Under the 409A rules however, Bill is not eligible for a cancellation of deferral because college education is not an unforeseeable emergency, and Bill does not qualify for the hardship withdrawal if stopping the nonqualified plan deferrals is taken into account. In desperation, Bill considers a request of $1 as a hardship withdrawal from the 401(k) plan.

RABBI TRUST FUNDING

Contributing to a rabbi trust is another example of how an interrelationship between qualified and nonqualified plans may arise. (A rabbi trust is a grantor trust used to finance a nonqualified plan, and the terms of the trust usually restrict the use of trust assets to the payment of nonqualified plan benefits, especially after a change of control.)[50] IRC Section 409A creates an issue when contributions are made to a rabbi trust when a qualified pension plan within the controlled group is underfunded.[51] IRC Section 409A requires that contributions to a rabbi trust for the benefit of an "applicable covered employee" (ACE) during a "restricted period" are treated as transfers of property under Section 83 and presumably taxed when the underlying accrued benefit is

vested.[52] When contributions to a rabbi trust are not formally allocated by subaccounts for each executive, the IRS could assign contributions first to ACEs to the extent of any benefits to which the ACEs have a legally binding right (including currently unvested benefits). 409A defines a restricted period as any of the following periods:[53]

- Any period during which any of the employer's single-employer defined benefit pension plan was "at risk"
- Any period in which the employer is in Chapter 11, or
- Six months before and after the termination of an underfunded pension plan.

A defined benefit pension plan is "at risk" if it the plan fails certain funding ratio tests for the preceding plan year.[54] Because the preceding plan year's funding ratio determines whether a plan is "at risk,"[55] employers have as much as a one year delay between the date at which the funding ratio is calculated and the start of the "at risk" period. Because pension actuaries calculate funding ratios at the beginning of the plan year, the employer has the remainder of the plan year to anticipate the start of the "at risk" period and potentially prefund the rabbi trust if necessary. When funding levels in the qualified plan rise to the point where the qualified plan is no longer "at risk," the employer can "catch up" on any missed contributions to the rabbi trust.

409A defines ACE as an individual *described* under IRC section 162(m)(3) or any individual *subject to* section 16(a) of the Securities Exchange Act of 1934 (officers and directors of a public company).[56] ACE status at termination of employment continues after retirement.[57] "Covered employees" described under IRC section 162(m)(3) include an individual acting as CEO during the year and executive officers named in the company's proxy by reason of their level of pay (applies only to public companies). (Ironically, the CFO is not a covered employee as a result of the IRC's failure to adjust to a change in SEC proxy rules.)[58] Since a CEO is included as a "covered employee" by reason of the duties performed and not by reason of inclusion in the proxy, the ACE definition will include the CEO even if the employer is not an SEC registrant (e.g. tax-exempt organization).[59]

In situations where an employer has a qualified pension plan and also has a rabbi trust the employer should review the terms of the rabbi trust to determine if a problem might arise with discontinuing contributions during an at-risk period. Employers that want to avoid making contributions during restricted periods should accelerate funding

of rabbi trusts before the restricted period begins or catch-up missed contributions after the restricted period ends. Employers that want to contribute to rabbi trusts *during* restricted periods should consider rabbi trust subaccounts to allow contributions for non-ACEs during restricted periods without crediting accounts of ACEs. Employers with rabbi trusts and "at risk" pensions should particularly watch out for recurring rabbi trust funding of elective deferral arrangements and change of control provisions that automatically trigger contributions to the rabbi trust.

Employers with both "at risk" pensions and recently purchased corporate owned life insurance (COLI) face even greater challenges. Efficiently funded COLI requires consistent premiums in the early policy years, and a restricted period could threaten the planned premium pattern. Subaccounts by individual participant might allow rabbi trust contributions for non-ACE participants, but COLI cash values do not necessarily align well with rabbi trust subaccounts. These employers might consider the possibility that a rabbi trust provides more psychological benefits than real benefit security. Employers with COLI outside a rabbi trust enjoy flexibility that does not always exist with rabbi trust owned life insurance.

DEFERRING 401(K) REFUNDS

A final example of the interrelationship between qualified and nonqualified plans is the indirect deferral of 401(k) refunds through the nonqualified plan. Refunding excess contributions to highly compensated employees (HCEs) allows certain 401(k) plans to pass discrimination testing (i.e., actual deferral percentage test).[60] Many employers prefer refunding excess contributions over other ways of passing the discrimination tests applicable to 401(k) plans.[61] To be clear, the 401(k) rules require that employers refund such amounts in cash,[62] which is taxable in the year of the refund.[63] The deferral of the refund is indirect because a separate elective deferral in the nonqualified plan achieves the same practical result as explained below.

When the actual deferral percentage (ADP) test limits elective deferrals by HCE's to less than the basic elective deferral limit ($17,500 for 2014), the 401(k) rules allow employers to recharacterize the excess as a catch-up contribution if the employee is age 50 or older (and the employee has not exhausted the otherwise available catch-up limit of $5,500 for 2014).[64] Otherwise, the employer can refund excess contributions in cash by March 15 to avoid a 10% excise tax (paid by the employer).[65] The 401(k) plan reports distributed excess contributions on Form 1099-R for the year of distribution with no required withholding.[66] A timely irrevocable election to defer an equal amount of salary at

the time of the 401(k) distribution effectively defers both the refund and taxes on that refund and thus minimizes the change in the individual's taxable income for that year.

> **Example 5:** Mary's employer, ABC Inc., wants executives to be able to defer the full 402(g) limit ($17,500 for 2014) but understands that excess contributions must be distributed in cash. ABC allows her to defer 2015 salary equal in amount and timing to any distribution of 2014 excess contributions distributed in 2015. Mary makes an irrevocable election to defer such compensation by December 31, 2014. In early March 2015, ABC distributes $1,000 in excess contributions through a regular payroll to be reported on a 2015 Form 1099-R with no withholding. ABC processes a 409A deferral of $1,000 in the same payroll and withholds FICA from other net pay. The $1,000 elective deferral will reduce Mary's 2015 W-2 wages. Mary's net pay is the same as if she had deferred the excess contribution directly into the 409A plan. Mary receives a Form 1099-R for the excess deferral and a Form W-2 that reflects an equal reduction in taxable income. The W-2 does include the 409A deferral in FICA wages, but Mary pays FICA tax on those wages regardless of her 409A elective deferral.

Some advisors express concern that the facts in Example 5 create a late deferral election because the substance of the transaction is a deferral of compensation earned in 2014. Employers that are concerned with this substance over form argument should consider requiring an irrevocable election to defer such compensation by the end of the year preceding the year of the 401(k) excess contribution (i.e., December 31, 2013 in Example 5).

SUMMARY

The examples above illustrate the opportunities and pitfalls surrounding the interrelationship between qualified and nonqualified retirement plans. Restoration and offset arrangements in particular illustrate this interrelationship. Employers that offer both qualified and nonqualified plans should pay attention to the details of this interrelationship to avoid accidental losses in qualified benefits, 409A failures, and disqualification of the 401(k) plan. Employers that manage the interrelationship carefully benefit from maximizing the role of both types of plans in delivering an important benefit.

NOTES

1. IRC § 401(a)(17)
2. IRC § 402(g)
3. Treas. Reg. § 1.415(c)-2(c)(1)
4. *Ibid*.
5. Treas. Reg. § 1.415(c)-2(d)
6. Treas. Reg. § 1.414(s)-1(d)
7. IRC § 402A(d)
8. Treas. Reg. § 1.409A-2(a)(9)
9. Treas. Reg. § 1.409A-2(b)(9), Example 14
10. Treas. Reg. § 1.409A-2(a)(7)(iii)
11. Treas. Reg. § 1.409A-2(a)(3)
12. Treas. Reg. §§ 1.409A-2(a)(9)(iii) and (iv)
13. Treas. Reg. § 1.401(k)-1(e)(6)(i)
14. Treas. Reg. § 1.401(k)-1(e)(6)(vi), Example 2
15. Treas. Reg. § 1.401(k)-1(e)(6)(i)(A)
16. Treas. Reg. § 1.401(k)-1(e)(6)(iii)
17. Section 3(36) of ERISA defines an excess benefit plan as "a plan maintained by an employer solely for the purpose of providing benefits for certain employees in excess of the limitations on contributions and benefits imposed by section 415 of the Code on plans to which that section applies, without regard to whether the plan is funded." Most restoration benefits are now caused by the compensation limit under section 401(a)(17) of the Code.
18. Treas. Reg. § 1.401(k)-1(e)(6)(iii)
19. Treas. Reg. § 1.401(k)-2
20. *See* the October 27, 2009 issue of Deloitte's Washington Bulletin, *IRS Personnel Share Unofficial Comments on Compliance Issues to ABA Employee Benefits Committee*, "Catch-up contributions are considered part of the maximum elective deferrals under IRC § 402(g) for purposes of the carve-out from the contingent benefit rule under Treasury Regulation § 1.401(k)-1(e)(6)(iii). The carve-out allows nonqualified deferred compensation to be dependent on an employee's having made the maximum deferrals under IRC § 402(g), as with certain 401(k) wrap plans. The informal IRS view is that catch-up contributions must be included in determining whether an employee has made the maximum deferrals under IRC § 402(g)."
21. Treas. Reg. § 1.409A-3(j)(5)
22. IRC § 409A(a)(2)(A)
23. Treas. Reg. § 1.409A-2(b)(1)(i)
24. Treas. Reg. § 1.409A-2(b)(1)(ii)
25. Treas. Reg. § 1.409A-2(b)(1)(iii). Technically, plans may treat each installment in a series as separate payment events unless the payments are part of a life annuity. *See* Treas. Reg. § 1.409A-2(b)(2)(iii). However, treatment of installment payments as separate payment events is unusual.
26. IRC § 409A(a)(2)(A)(vi)
27. IRC § 401(k)(2)(B)(i)(IV)

28. Treas. Reg. § 1.409A-3(i)(3)(i)
29. Treas. Reg. § 1.401(k)-1(d)(3)(iii)(B)
30. Treas. Reg. §§ 1.409A-3(i)(3)(i) and 1.401(k)-1(d)(3)(iv)(B)
31. Treas. Reg. §§ 1.409A-3(i)(3)(ii) and 1.401(k)-1(d)(3)(iv)(A)
32. Treas. Reg. § 1.401(k)-1(d)(3)(i)
33. Treas. Reg. § 1.409A-3(i)(3)(iii)
34. Treas. Reg. § 1.409A-3(j)(2)
35. Treas. Reg. § 1.409A-3(i)(3)(i)
36. Treas. Reg. § 1.401(k)-1(d)(3)(iii)(B)
37. Treas. Reg. § 1.401(k)-1(d)(3)(iv)(C)(5)
38. Treas. Reg. § 1.401(k)-1(d)(3)(ii)(A)
39. Treas. Reg. § 1.409A-3(i)(3)(ii)
40. Treas. Reg. § 1.401(k)-1(d)(3)(iv)(C)(3)
41. Treas. Reg. § 1.409A-3(j)(4)(viii)
42. *Ibid*.
43. Treas. Reg. § 1.409A-1(c)(3)(iv)
44. Treas. Reg. § 1.409A-3(j)(4)(viii)
45. Treas. Reg. § 1.401(k)-1(d)(3)(iv)(E)(2)
46. Treas. Reg. § 1.401(k)-1(d)(3)(iv)(F)
47. Treas. Reg. § 1.409A-3(i)(3)(ii)
48. Treas. Reg. §§ 1.401(k)-1(d)(3)(iv)(E)(2) and 1.401(k)-1(d)(3)(iv)(F)
49. Treas. Reg. § 1.401(k)-1(d)(3)(iv)(E)(1)
50. IRS Rev. Proc. 92-64, 1992-2 C.B. 422
51. IRC § 409A(b)(3)
52. IRC § 409A(b)(3)(A)
53. IRC § 409A(b)(3)(B)
54. IRC § 430(i)
55. IRC § 430(i)(4)
56. IRC § 409A(b)(3)(D)
57. IRC § 409A(b)(3)(D)(i)(III)
58. IRS Notice 2007-49
59. IRC § 162(m)(3)(A)
60. Treas. Reg. § 1.401(k)-2(b)(2)
61. Treas. Reg. § 1.401(k)-2(b), Also *see* PLR 200116046 ("wrap plan"), limiting ADR to ADP for HCEs, and safe harbor 401(k) plan in IRC § 401(k)(12)
62. Treas. Reg. § 1.401(k)-2(b)(2)(v)
63. Treas. Reg. § 1.401(k)-2(b)(2)(vi)
64. Treas. Reg. § 1.414(v)-1(b)(1)(iii)
65. Treas. Reg. § 1.401(k)-2(b)(5)(i)
66. *See* IRS instructions for Form 1099-R, particularly the section on "excess contributions"