Nonqualified Deferred Compensation – Tax Noncompliance Is Costly

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Nonqualified deferred compensation (NQDC) can be found in a wide variety of plans, agreements, and arrangements. Employers and employees need to satisfy federal tax rules governing such plans, agreements, and arrangements or suffer significant financial penalties.

Generally, NQDC exists anytime a contractual promise is made by a service recipient (employer) to a service provider (employee or independent contractor) to pay compensation in a later taxable year for the performance of services. Therefore, NQDC may arise under employment agreements, bonus or severance agreements, and equity compensation arrangements (e.g., stock options, deal bonuses, and phantom share/unit awards).

Under federal tax law, NQDC plans, agreements and arrangements must comply with technical rules both with respect to the terms of the arrangement and in their operation. Failure to comply with the legal requirements can result in substantial negative tax consequences, such as a 20% penalty income tax, income recognition in a taxable year prior to the taxable year in which the NQDC is payable, and an interest-based tax reflecting the delayed payment of tax on the NQDC. These significant adverse tax consequences resulting from a failure to comply with the applicable tax rules fall principally on the service provider, though responsibility and liability for such tax law noncompliance may also fall on the service recipient. Tax law compliance for all NQDC arrangements is certainly the key and in the interest of both the service provider and service recipient.

It is strongly recommended that you review your NQDC arrangements to ensure they are in compliance with applicable tax law and costly noncompliance tax penalties can be avoided.

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