DEFINED BENEFIT PLAN

WHAT IS A DEFINED BENEFIT PLAN?

A defined benefit plan is a type of nonqualified plan sponsored by an employer that promises certain key executives or independent contractors a tax-deferred benefit based on a specified amount or formula. The design of the plan will typically be one of three common forms:

(1) **Specified Amount**. The dollar amount of the benefit is defined. For example, the participant will receive an annual benefit of $50,000.

(2) **Percentage of Compensation**. The benefit amount is derived from a formula which is defined as a specific percentage (e.g., 60%) multiplied by the participant's final (or final average) compensation (which could include salary, bonus, commissions, fees, etc.).

(3) **Service Based**. The benefit amount is derived from a formula which credits an amount for each year of service performed. The amount earned for each service period could be a specified dollar amount (e.g., $1,000 per year of service) or a percentage of compensation (e.g., 2% of final salary per year of service).

NONQUALIFIED PLAN FINANCING

Nonqualified plans, by nature, cannot be formally funded (i.e., companies cannot set money outside the scope of general creditors for plan purposes). Most prudent companies, however, set aside (or "earmark") certain corporate assets to offset liabilities generated as a result of plan benefits. The most common methods for plan financing are corporate owned life insurance or corporate owned mutual funds. Plans are not required to have any assets earmarked for the plan as some companies fund out of current cash flows.

IRC SECTION 409A COMPLIANCE

Nonqualified plans are exempt from most of the provisions of ERISA because they are only available to highly compensated employees or a select group of management; however, IRC Section 409A sets forth rules that nonqualified plans must follow. Examples are below:

- The plan must be in writing and include the benefit amount/formula.
- Payments may not be modified or accelerated except under limited circumstances.
- Substitution of a payment of deferred compensation is prohibited.
- Plans must maintain documentary and operational compliance or risk becoming subject to significant tax and penalties.

KEEP IN MIND

- Plans can be designed to pay out upon the earliest of separation from service, death, disability, change in control, a specified date or age, and/or an unforeseeable emergency.
- Nonqualified plans are required to be "unfunded" (i.e., benefits are not secured) and participants are general creditors.
- Participant balances are simply a "promise to pay" – there is no actual segregated account.
- The employer must accrue a liability on its books for the future obligation.
- FICA and FUTA taxes may be due at the time of vesting.