

Deferred compensation plans and the lifetime income stream

Participants in nonqualified deferred compensation plans have many different distribution options regarding when and how their benefit is ultimately paid. While the Internal Revenue Code (IRC) provides for a wide variety of possibilities such as annuity distributions or life-expectancy installment payments, plan sponsors generally limit distribution options in deferred compensation plans to lump-sum payments or limited-duration annual installments. This is because plan sponsors want to minimize administrative expenses and capitalize on their compensation deductions.

Furthermore, because deferred compensation plans are “unfunded” for the purposes of the Employee Retirement Income Security Act of 1974 (ERISA), these plans are contractual obligations between the employer and plan participants. The balances residing with the employer must be *subject to creditor risk* until the account balance is distributed to them.

Therefore, participants should not approach deferred compensation plan distribution elections in the same way they would for an ERISA-protected plan, like IRC Section 401(k) or 403(b) plans. Deferred compensation plans can instead be viewed as a tool to “bridge the gap” between termination of employment and commencement of ERISA-protected benefits and Social Security benefits, not as a lifetime income stream.

Because deferred compensation plans are not protected benefits like Social Security and IRC Section 401(k) or 403(b) plans, many participants prefer to receive their deferred compensation plan distributions first. Such an approach allows for IRC Section 401(k) or 403(b) plan benefits to continue to accrue tax-deferred growth. Additionally, this strategy allows the participant to delay and maximize Social Security benefits whenever they ultimately commence.



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