

Deferred compensation plans and the lifetime income stream

Participants in nonqualified deferred compensation plans have many different distribution options from which to choose, meaning many choices as to when and how their benefit is ultimately paid. While the Internal Revenue Code provides for a wide variety of possibilities, like annuity distributions or life-expectancy installment payments, plan sponsors generally limit distribution options from 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.

Further, 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 nonqualified plan distribution elections the same way they would in an ERISA-protected plan, like a 401(k) or 403(b) plan. Instead, deferred compensation plans should be viewed as a tool to “bridge the gap” between termination of employment and commencement of ERISA-protected benefits and Social Security benefits, rather than as a lifetime income stream.

Because deferred compensation plans are not protected benefits like Social Security and 401(k) or 403(b) plans, most participants prefer to receive distributions from deferred compensation plans first and exclusively. Such an approach allows for 401(k) or 403(b) plan benefits to continue to accrue tax-deferred growth, as well as allows the participant to delay and maximize Social Security benefits when they are ultimately commenced.



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