LEGAL UPDATES

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Service

Employee Benefits & Executive Compensation

Attracting and Retaining Key Executives through Deferred Compensation Plans

Deferred compensation plans offer highly compensated and key employees an opportunity to earn performance awards, defer compensation and taxes until a later date, reduce certain payroll taxes, informally find executive life insurance agreements, and help facilitate buy-in for business succession plans.

In the current economic environment businesses are feeling pressure at all levels of employment, especially in their efforts to retain executive leadership and to attract new executives. The question employers are left with is how to tackle the challenge of key personnel are leaving jobs voluntarily amid an already tight labor market and other novel operational worries—such as supply-chain issues—that have emerged since the onset of the pandemic.

While the challenges associated with product scarcity and clogged supply chains evade easy answers, there is one simple approach that could materially improve a business's chances of landing and retaining talented executives: the implementation of a deferred compensation plan.

What is a deferred compensation plan?

A deferred compensation (DC) plan is an agreement, method, or arrangement between an employer and an employee—or service recipient and service provider—to pay the service provider compensation in the future.

The DC plan rules apply to employees and other "service providers," including directors and independent contractors.[1]

DC plans can provide for employee-only elective contributions, employer-only elective contributions, or both employee and employer contributions. DC plans

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are “nonqualified,” which means that there is a significant amount of flexibility in establishing the plan terms, as long as certain legal requirements are met.

In simplified terms, DC plans provide corporate clients with a way to offer additional benefits to help attract and retain key employees and facilitate business succession; however, it is important to be highly conversant with the variety of approaches one could take to a DC plan during the plan development phase, as well as the advantages and disadvantages of all types of informal funding mechanisms typically used in plans.

DC plans can provide for a single benefit, such as lump-sum payment after retirement, upon reaching a stated event or milestone, or at a specified time or date in the future. Plans can also be structured so that the employee can select from various benefit payment options, such as a choice between benefit payments after three, five or seven years.

Why should an employer implement a DC plan?

DC plans can help attract and retain key employees by providing additional benefit incentives and awards for both performance and length of service.

Like qualified plans, DC plans are primarily implemented because of the tax preference received through the Internal Revenue Code. Under a properly structured plan, employer contributions and employee deferrals are made tax-deferred. Tax is also deferred on investment yield and investment reallocation, resulting in a tax-preferred investment environment. Income tax is typically recognized when distributions are made to the plan participant.

In essence, DC plans allow companies to defer payments and related taxes into later years, which can help with cash flow and tax-planning issues. There is significant flexibility for employers in determining the plan parameters, vesting schedules, and awards criteria.

DC plans are exempt from most Employee Requirement Income Security Act (ERISA) requirements and related reporting requirements. This means there are no limitations on the amounts that can be deferred and no minimum distribution rules. Specifically, rules governing DC plans require discrimination in favor of a select group of management of highly compensated employees. As long as the DC plan is “a plan which is unfunded and maintained by an employer primarily for the purpose of providing deferred compensation for a select group of management or highly compensated employees”, the plan is exempt from ERISA’s minimum participation and vesting rules, its funding rules, and its fiduciary responsibility rules (including the trust requirement).

The key takeaway for employers is that DC plans must comply with the rules of Internal Revenue Code Section 409A, which are fairly simple to navigate with the assistance of an experienced employee benefits attorney.

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What are the tax consequences of DC plans?

Taxation of DC plans depends on whether the plan is "funded" or "unfunded."[2]

Under Section 409A, deferred compensation is includable in an employee's taxable income when the amount is paid (or becomes available) to the employee. As with other compensation, employers report the distributed amount as taxable compensation. If a DC plan provides for contributions and "earnings" on the contributions, both the contributions and the earnings are taxable compensation.

While a DC plan offers long-term tax-deferred savings for employees, the deferral also applies to the employer's tax deduction. The employer taxes a deduction at the time the employee includes the deferred amounts in his or her taxable compensation.

Under a qualified retirement plan—such as a 401(k) plan—employers deduct expenses in the year they remit payments to the trust, even though employees will not recognize income until later years, upon receipt of distributions from the plan. Under a DC plan, employers can only deduct the benefit when the employee includes such benefit in the employee's taxable income. The deductible amount is the total amount included in the employee's taxable compensation, including any earnings on the compensation.

How do payroll taxes apply to DC plans?

The DC plan rules impose federal (and generally state) income tax withholding requirements in the year(s) in which the employer distributes deferred compensation to the employee. For employees or former employees, employers report the DC plan distributions on Form W-2.

Under most DC plans, there exists a special rule for the FICA taxes related to Social Security and Medicare withholding. Specifically, employers generally take into account DC amounts as FICA wages at the later of: (1) when the employee performs services; or (2) when the employee vests in the right to receive the deferred amounts. Thus, FICA taxes typically apply to a DC before the employee receives payment and is subject to income tax. As an added benefit, any earnings accruing under a DC plan after the vesting dates are not subject to FICA taxes.

Note that the special FICA taxes rule does not apply to a "short term deferral," which is a benefit payment made within the year of vesting or no later than two and a half months after the year of vesting. Normal payroll tax withholding applies at the time of distribution for a short-term deferral.

What are the key considerations for employers when establishing a DC plan?

When considering establishing a DC plan, an employer must determine the company's overall business strategy. DC plans can be used to achieve many business goals, including:

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Compensation/bonus deferral

Tax deferral

Key employee retention

Business succession planning

Establishing performance objectives and awards

Providing supplemental retirement benefits

Many companies establish more than one type of DC plan to achieve several different business objectives.

Because DC plans are "nonqualified." there are many factors that the employer can dictate—as long as the plan complies with Section 409A—including:

Eligible participants—generally only highly compensated employees

Vesting

Payment amounts and/or formulas

Performance objectives

Timing of payment(s)

Form of payment(s)

How important is Section 409A compliance?

DC plans generally provide greater flexibility than qualified plans in many respects; however, employers must strictly comply with the Section 409A rules. Failure to comply with Section 409A results in immediate income taxation to the service provider, plus a 20 percent excise tax and a "premium interest tax" on the taxable amount. Employers should consult experienced legal and professional counsel, including those with ERISA and Section 409A experience, to insure compliance with the applicable rules.

Contact us

If you have any further questions or require more information regarding this alert, please contact Emily Langdon or your Husch Blackwell attorney.

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[1] This article uses the term “employee” to refer to all service providers of an employer.

[2] Almost all DC plans in the United States are unfunded. This article only covers unfunded plans.

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