NON-QUALIFIED DEFERRED COMPENSATION AS AN EMPLOYEE RETENTION TOOL

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Even in a labor market and greater economy ravaged by coronavirus disease (COVID-19), good help is still hard to find. Business owners might be focusing on how to navigate the pandemic and keep the company alive, but the threat of a competitor poaching an enterprise's best people looms in the background. Small businesses are particularly vulnerable to losing their best people because a larger competitor could offer a lucrative package to entice even the most loyal employee to jump ship. In the face of this problem, what can owners do to better ensure their top talent will stay aboard for the long haul? Enter deferred compensation, known colloquially as "golden handcuffs."[1]

Deferred compensation plans come in two flavors: "qualified" and "nonqualified." A qualified deferred compensation plan allows an employee to put her money into a trust separate from the assets of the employer. Examples include a defined benefit plan or § 401(k) (defined contribution) plan.

The other variety of deferred compensation plan, created by observing the rules in § 409A of the Code,[2] is a nonqualified deferred compensation (NQDC) plan. Section 409A was added to the Code by the American Jobs Creation Act of 2004 as a response to Enron executives who had accelerated their deferred compensation (without a corresponding income tax bill) before the company's last gasps in bankruptcy court. Prior to the enactment of § 409A, deferred compensation was taxed when received, not when awarded.

HOW NQDC WORKS: TAX FUNDAMENTALS

Although § 409A is meant to punish abusive deferred compensation arrangements, the statute provides a framework for setting up an NQDC plan without incurring tax penalties. A compliant NQDC plan allows the employer to place a portion of an employee's compensation for services aside, where it grows tax-deferred; the employee does not recognize taxable income on the deferred compensation, but the employer does not receive an up-front deduction. The employer makes a nominally unfunded promise to pay the employee the deferred compensation at a future date, at which point the employee will recognize the corresponding income, and the employer will incur a deduction. Unlike qualified plans, the funds deferred by the employee remain assets of the employer to be used without restriction, though the employer must of course be mindful of its future obligation to the employee. As a trade-off, unlike qualified plans, any funds set aside are also recoverable by the employer's creditors; in the event of bankruptcy or insolvency, the employee is just another unsecured creditor.

HOW NQDC WORKS: TAX FUNDAMENTALS (CONT.)

Section 409A governs NQDCs and provides rules to follow when setting up and operating an NQDC plan.

The rules work simply:

- The plan must be in writing, and a simple contract may suffice.
- The plan must clearly set forth the amounts and timing of the deferred compensation.
- The plan cannot permit acceleration of the timing or schedule of any plan payment unless authorized by the Treasury Regulations.
- The plan must provide that any deferred compensation may not be distributed earlier than any one of the following six events:
    - Separation from service;
    - Disability[3];
    - Death;
    - A specified time (pursuant to a fixed schedule) preset under the plan at the date of deferral;
    - A change in the ownership, effective control, or asset ownership of the employer; or
    - The occurrence of an unforeseeable emergency.[4]

If an NQDC plan fails any of § 409A’s requirements, all compensation deferred under the plan for the taxable year and any prior tax year is included in gross income for the taxable year of failure, increased by interest and a penalty equal to 20% of the compensation required to be included in gross income. The employer reports deferred compensation items from an NQDC plan in Box 12a of IRS Form W-2 (for employees) or Box 14 of IRS Form 1099-MISC (for independent contractors). These boxes would contain not only the recognized amounts from the deferred compensation itself, but also any penalties and interest from violating § 409A. The existence of an NQDC plan does not seem to have a material impact on employee classification issues, given the Service’s acknowledgment a plan might exist for either type of arrangement.

HOW NQDC WORKS: ERISA FUNDAMENTALS

Most NQDC plans are considered “top-hat” plans for ERISA purposes. Top-hat plans are so named because they are unfunded plans “maintained by an employer primarily for the purpose of providing deferred compensation for a select group of management or highly-compensated employees (HCEs).”[5] Even the most advanced tax and employee benefit practitioners are sometimes unsure whether or how to disclose a simple, single-employee NQDC plan to the Department of Labor at all, but our experience has confirmed that these plans meet the definition of top-hat plans.

Top-hat plans are exempt from most, but not all, ERISA compliance requirements, but the notice and enforcement provisions of ERISA still apply to top-hat plans. The Department of Labor passed a final regulation in August 2019 requiring top-hat plans to file an electronic statement with the Department disclosing the plan’s key features and information.[6] Although the August 2019 final regulation streamlined the reporting requirement, the obligation existed prior to the final regulation, but the Department of Labor offers a Delinquent Filer Voluntary Compliance Program in which an employer may disclose late with a maximum penalty of $750.[7]

Top-hat plans’ exemption from the substantive requirements of ERISA usually helps employers in litigation [see, e.g., Sikora v. VPMC, 876 F.3d 1110 (3rd Cir. 2017)] especially because ERISA pre-empts state law claims under top-hat plans [ERISA § 514; see Ingersoll-Rand Co. v. McClendon, 498 U.S. 133 (1990)], but this means any causes of action arising under a top-hat plan will be litigated in federal court. ERISA litigation, even regarding top-hat plans not subject to the substantive requirements of ERISA, can bring up more complex issues than garden-variety commercial litigation [see, e.g., Comrie v. IPSCO, Inc., 636 F.3d 839 (7th Cir. 2011)]. Also, retaining counsel knowledgeable in ERISA issues will be even more expensive than normal.

DESIGNING & EXECUTING THE NQDC PLAN

The beauty of the NQDC plan is its low setup costs make it accessible for small businesses. The typical NQDC plan is a five- or six-page contract between employer and employee containing standard provisions ensuring compliance with § 409A. (In this context, “employee” is used interchangeably with “independent contractor.”) The employer and employee agree upon the amount of compensation deferred and the vesting schedule. An attorney memorializes the terms, and after the employee might retain counsel of her own to review the agreement, the parties execute a final version.

DESIGNING AND EXECUTING THE NQDC PLAN (CONT.)

An NQDC plan is an unfunded promise to pay by definition, but the employer typically sets aside a reserve to satisfy its financial obligations under the plan. The employer has several options when deploying the reserve, including blue-chip equities, high-quality corporate and municipal bonds, Treasury bills, and life insurance. All are viable, but we prefer using life insurance for the following reasons:

- The policy allows the employer to offer a death benefit as an extra feature of the NQDC plan, which can be used to pay survivors of the employee or offset traditional “key man” insurance costs to help with replacing the economic value the employee provides to the entity (e.g., sales, intellectual capital).

- Certain cash value life insurance policy structures will provide a minimum return on investment, or even underlying guarantees. These are backed by heavily regulated and well-capitalized financial institutions.

- The death benefit–and, in certain states, the cash value–of life insurance policies receives enhanced protection from creditors. (See generally NY Ins. Law § 3212.)

- Life insurance gets special treatment from both the Code and ERISA. The Code does not tax the “inside buildup” of cash value in a permanent life insurance policy when owned by business entities (unlike equities, annuities, and other common marketable securities), nor does it tax the receipt of life insurance death benefit. (See generally §§ 72, 101. Both sections have exceptions, though a simple NQDC plan administered properly would not project to trigger any of them.) Funding benefits with life insurance contracts will not be considered “funding” for purposes of ERISA, meaning any NQDC plan for which an employer uses life insurance to protect its obligations will still be considered unfunded.[8]

- Working with a life insurance company grants the employer and its attorneys access to the insurance company’s internal subject matter experts and template library, significantly increasing attorney efficiency and decreasing the chances of attorney error.

When an employer uses life insurance as the funding vehicle of choice for an NQDC plan, advisors typically choose a “limited-pay” whole or universal life insurance policy with some level of loss protection on the cash value if underlying sub-accounts or investments go awry. This is usually done to avoid the corporation being “underfunded” when the time comes to make policy disbursements to meet contractual obligations under the NQDC plan.

The limited-pay whole policy will usually require a predetermined timeline of contributions, and after all payments are made, the policy will be considered “paid-up.” With careful design, the business can also avoid the punitive tax treatment of modified endowment contracts (MECs). [Modified endowment contracts do not receive the same tax benefits as non-MECs because the Code considers MECs to be investments, not insurance. §72(e)(10).]

The attorney and the accountant then work together to populate the Department of Labor’s top-hat plan electronic disclosure statement and either IRS Form W-2 or Form 1099-MISC. This cooperation continues until the NQDC plan expires.

NON-TRADITIONAL PLANNING APPLICATIONS OF NQDC PLANS

The traditional use of an NQD-C plan is to retain non-owner key employees in businesses large and small. If an employer tabs an employee in the middle ranks of an organization for an important future role in the top echelons of the company, the employer will want the employee to stay aboard until she is ready for the envisioned role, but the employer will be reluctant to increase salary or award a large bonus for any number of reasons. These reasons could include upsetting the organization's salary structure, inducing employee complacency, or preserving the company's assets.

The NQDC plan serves as the bridge between the time the employee might be worthy of a major leap in responsibility in the coming years and the time she is actually ready to make the leap. During this crucial period, the employee can be lured away to a competitor through a lucrative offer, which would squander the investment the employer made in the employee and dissipate the institutional knowledge the employee built in the years working for the employer. With an NQDC plan deferring significant compensation for several years, the employee will think twice about taking an offer that would start her back at square one in a new company and may not even result in more overall compensation in the long run. (Section 409A also allows deferred compensation to vest upon a change in control of the employer, which might be another factor in helping to retain employees unsure of their place in the event of a reorganization.)

Besides their most frequent use as golden handcuffs, NQDC plans also have niche applications that might prove very useful to the right client. For instance, attorneys cannot enter into agreements that restrict their right to practice law, which means attorneys are prohibited from entering non-compete agreements.[9] This makes lateral recruiting of attorneys a fiercely competitive market with aggressive headhunters constantly seeking opportunities. An NQDC plan could serve as a non-compete in substance, allowing law firms to both reward and retain their standout practitioners.

In both law and other professional firms, the long-term viability of an enterprise could rest on a successful business succession plan. The requirement of owners to hold a license limits the exit strategies for a professional firm. Whereas a traditional business could find a third-party buyer anywhere, a professional firm must either look to its competitors or the next generation of its staff. And when a professional firm wants to make an orderly transition of power to the latter, an NQDC plan is the perfect way to allow the senior generation to ride off happily into the sunset. The NQDC plan provides funding for the younger staff to buy out the retiring partners, all paid for through investments treated as assets of the firm until the time for a buyout has come. Think of the NQDC plan as a hedge, similar to how buy-sell plans use traditional life and disability insurance arrangements to protect against unforeseen adverse events.

CONCLUSION

This primer illustrates the reasons why NQDC plans are accessible to small businesses and their advisors, and we urge readers to add NQDC plans to the toolbox when addressing client issues relating to employee retention and business succession. When deployed for a closely held business, NQDC plans come with simple compliance, streamlined setup, and manageable professional service costs. Non-traditional uses of NQDC plans could prove to be elegant solutions to difficult problems in specific industries.

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[1] There are other industry terms for NQDC plans, including "Rabbi Trusts" (so named because the seminal client in the arrangement was a rabbi).
[2] All statutory references are to the Internal Revenue Code of 1986, as amended, unless otherwise specified.
[3] A participant is considered "disabled" if she is unable to engage in substantial gainful activity by reason of any medically determinable physical or mental impairment which: (1) can be expected to result in death, (2) can be expected to last for a continuous period of not less than 12 months, or (3) by reason of a medically determinable physical or mental impairment lasting no less than 12 months, is receiving income replacement benefits for a period of no less than 3 months under an accident or health plan provided by her employer.
[4] An "unforeseeable emergency" is a severe financial hardship to the participant resulting from an illness or accident suffered by the participant, her spouse, or dependent (as defined by § 152(a)), the loss of the participant's property due to casualty, or other similar extraordinary and unforeseeable circumstances arising as a result of events beyond the control of the participant. Distributions made under the unforeseen emergency category may not exceed the amounts necessary to satisfy such emergency plus amounts necessary to pay taxes reasonable anticipated as a result of the distribution. Any distribution made under the unforeseen emergency category must take into account whether the participant's hardship may be relieved through reimbursement or compensation from insurance, other source, or liquidation of the participant's assets. Such liquidation must not otherwise cause severe financial hardship.
[5] § 414(q) defines HCEs as one of either: (1) a five-percent owner of the employer during the testing period, or (2) an employee receiving a threshold amount of compensation (currently $80,000, indexed for inflation).
[6] 84 FR 27952; 29 CFR § 2520.104-23. The electronic statement submission website can be found here.
[7] The DFVCP web page can be found here.
[8] ERISA § 403; DOL Adv. Op. 81-11A. The importance of maintaining unfunded status is to avoid § 409A penalties; any plan considered funded by specific assets must be qualified under the Code to receive any preferential tax treatment.
[9] New York Rules of Professional Conduct, Rule 5.6(a)(1).