

An Employer's Quandry: How do we get more Deferred Compensation to Executives?

A GUIDE TO EXECUTIVE DEFERRED COMPENSATION

In business, it is often difficult enough to determine what salaries and short term benefits to pay executives and owners in order to procure and retain the talent necessary to thrive in a particular industry. Beyond salary and basic benefits however, many employers are "missing the boat" on opportunities to offer deferred compensation to executives that can both (a) provide benefits above and beyond simply salary and bonus structure, which may distinguish an employer from its competitors; and (b) provide incentives for key employees to continue to provide services to the employer for years to come. Furthermore, these same employers may be missing opportunities to set money aside for retirement. In this article, I will refer generally to these opportunities as "executive deferred compensation."

Clearly, Congress and the Internal Revenue Service have made it increasingly complicated to offer executive deferred compensation. That is, there are more restrictions than there ever were before. That notwithstanding, there exist many ways to structure such compensation, though practically all of the deferred compensation structures fall under one of the following two types: (1) deferred compensation through a qualified retirement plan (e.g., 401(k), profit sharing, money purchase plans); or (2) nonqualified deferred compensation plans (e.g., supplemental executive retirement plans ("SERPs"), supplemental 401(k), deferred bonus plans).

Qualified Plans

Participation in a qualified retirement plan, such as 401(k), profit sharing and money purchase plans, is a very common benefit offered by employers to ALL full-time employees. However, many executives and owners are frustrated that they are not able to contribute enough money (or have enough money contributed by the employer on their behalf) into these plans because:

(a) The IRS salary deferral limitations are too low. For 2012, the salary deferral limitation is \$17,000 (\$22,500 for individuals age 50 or older). And for ALL contributions on behalf of an individual (salary deferrals plus employer contributions), the limit is \$50,000 for 2012; or

(b) There is not enough participation in the plan from "rank and file" employees. The nondiscrimination testing requirements of the Internal Revenue Code limit the salary deferrals and matching contributions of "highly compensated employees" ("HCEs", i.e., owners and highly paid executives and officers) to be a certain percentage of such contributions of "non-highly compensated employees" ("NHCEs") These tests are commonly referred to as the ADP (average deferral percentage) and ACP (average contribution percentage) tests. Accordingly, if not enough NHCEs participate in the plan, or if they do not defer enough of their own compensation, then the HCEs will be limited in how much they can contribute.

(c) Profit sharing contributions are subject to similar nondiscrimination testing requirements that make it difficult to make much higher profit sharing contributions for HCEs than for NHCEs.

There are some alternatives available to employers that can allow owners and executives to defer more salary into a qualified plan AND allow proportionately more employer contributions to owners and executives than for “rank and file” employees. Of course, there are positives and negatives associated with these alternatives, as set forth below:

(a) **401(k) Safe Harbor Approach.** If an employer is having trouble passing the ADP and ACP tests, and thus the employer’s HCEs are limited in their salary deferrals and matching contributions, the plan could be modified to be a “safe harbor” plan. This means that the employer makes contributions to ALL eligible employees of either: (i) at least 3% of each employee’s annual compensation; or (ii) matching contributions of 100% on the first 3% of compensation and a 50% match on deferrals between 3% and 5% of compensation deferred by the employee.

PROS: “Safe harbor” 401(k) plans are exempt from the ADP and ACP tests, which means that the employer’s HCEs will not be limited in their own salary deferrals and matching contributions by NHCEs’ salary deferrals and matching contributions. Accordingly, only the statutory limits would apply to the HCEs (\$17,000 in salary deferrals (\$22,500 for individuals over age 50) and \$50,000 in total contributions for 2012).

CONS: The 3% contribution to ALL employees is obviously costly. Further, this contribution must generally be fully vested upon contribution. Recent legal changes do allow employers to make these contributions subject to a 2-year vesting schedule, if the employer uses automatic enrollment and automatic “escalators” for employee salary deferrals.

(b) **“Permitted Disparity” Formula.** Permitted disparity, commonly referred to as “Social Security Integrated” takes into account the inequity of benefit accruals under the Social Security system. That is, Social Security benefits, as a percentage of pay, are larger for individuals with earnings below the

Social Security wage base (\$110,100 for 2012). Under an integrated allocation formula, additional contributions of up to 5.7% can be made to employees earning in excess of the Social Security wage base. The employer may elect a dollar figure lower than the Social Security wage base, but the integration percentage must be decreased accordingly.

PROS: The employer is able to make up to an additional 5.7% contribution to all employees earning more than the Social Security wage base.

CONS: The employer may not distinguish between employees in this allocation. That is, every employee in the plan earning more than the Social Security wage base must receive the extra allocation. This could be problematic for an employer that has only a select few executives that it would prefer to provide with a higher contribution.

(c) **Cross Testing.** The Code’s nondiscrimination provisions that relate to profit sharing contributions allow an employer to utilize an “alternative” testing method that allows the employer to select a particular group of employees for a higher profit sharing contribution. This testing method is commonly referred to as the “cross testing” method whereby benefits are measured by the projected amounts that will be available to participants upon retirement instead of measuring actual contributions to the plan. Accordingly, because a younger employee has much more time for earnings to accrue and more years of presumed contributions to receive (before reaching normal retirement age) than an older employee, larger contributions are allowed for an older employee to achieve an eventual benefit that would be similar to the projected benefit of a younger employee.

PROS: Allows higher contribution for a select group of employees. Often, an employer will identify management employees, executives and owner-employees in this group to allow for increased contributions.

CONS: The employer will be allowed to contribute proportionately more to the identified group than to the other employees, but the employer will, nevertheless, usually be required to contribute more to the other employees than it normally would. Thus, this can be an expensive alternative.

(d) **Defined Benefit/Defined Contribution Plan Combination.** Unlike a “defined contribution” plan (401(k), profit sharing, money purchase plans), “defined benefit” plans pay benefits based on employees’ age and years of service – not annual contributions that are invested by the employee. Often, implementation of a defined benefit plan in addition to a 401(k) or profit sharing plan will allow for increased benefits for older employees, including executives and owners.

PROS: The limitation on benefits in a defined benefit plan is generally higher than that of a defined contribution plan. That is, the maximum annual retirement benefit under a defined benefit plan is the lesser of: (a) 100% of pay; or (b) \$200,000 for 2012. This arrangement is particularly useful in cases where the individuals that the employer would like to compensate have many more years of service than other employees.

CONS: Defined benefit plans require annual funding and the “cost” to the employer of funding the plan can be quite high. That notwithstanding, because the contributions are deductible to the business, the funding requirement can be a good problem to have in year in which profits are high.

For some employers, changes such as these to their qualified plans will make a big difference in retirement savings. Most retirement plan vendors/trustees are familiar with these concepts, and some plans may be easily altered. Others may be more complex and may require the help of an employee benefits attorney.

Nonqualified Deferred Compensation Plans

Instead of, or in addition to, deferred compensation through a qualified plan, some employers could benefit greatly from utilization of “nonqualified deferred compensation plans.” Nonqualified deferred compensation is simply an arrangement, outside of a qualified plan, such as a 401(k) plan, whereby the employee earns compensation in one year, but that compensation is not actually paid to him/her until more than 2 ½ months after the end of that year. Such arrangements are available only for a select group of management employees (including executives, of course), and require a one-time filing with the IRS called a “top hat filing.”

The same “pros” and “cons” generally exist with any type of nonqualified deferred compensation plan. They are:

PROS: Unlike qualified plans, nonqualified plans are not subject to the Code’s discrimination rules or annual contribution limitations. That is, nonqualified plans can be offered to particular owners and executives, at the discretion of the employer. Further, there are no annual dollar limitations on contributions or deferrals. Finally, assets in these plans can be invested and therefore accrue earnings.

CONS: Also unlike qualified plans, the amounts that are contributed to a nonqualified plan are includible in the employer’s general assets, and therefore subject to the claims of the employers creditors. That is, nonqualified plan assets are not truly “held in trust” like qualified plan assets. However, such assets can be held in what is called a “rabbi trust,” in which the employer contractually agrees that such assets will not be used to pay any other benefits. Such a trust does not shield the assets from creditors, but it does establish certain contractual rights by the participants. Notwithstanding, a participant in a nonqualified plan cannot be absolutely certain that he/she will be paid his/her benefits until they are actually received. Further, some owner employees will not

be able to participate in a nonqualified deferred compensation plan because they have too much control over the business income. That is, the IRS will not allow an owner employee to utilize a nonqualified deferred compensation arrangement to simply re-characterize business profits as nonqualified deferred contributions to him/herself. Finally, unlike qualified plan assets, the increased value of non-qualified plan assets will, under most circumstances, be taxable to the employer because they are still considered assets of the employer.

Notwithstanding that such arrangements are more “risky” than qualified plans, non-qualified plans can be very helpful in providing extra deferred compensation to owners and executive, particularly for employers that anticipate continued financial solvency. In many cases, these arrangements are used as “golden handcuffs” to provide incentives for executive employees to stay with the employer for the long term. In addition, they are commonly used as “golden parachute” arrangements whereby an executive is paid out extra compensation following retirement.

Some of the following are good examples of non-qualified deferred compensation arrangements that are available to employers:

(a) **SERPs (golden handcuffs/golden parachute arrangements).** SERPs generally set forth amounts that are payable to executive employees after they retire, often determined by a percentage of the executive’s final year of salary. These plans can also include performance-based incentives based on the employee’s or the company’s performance. SERPs are often referred to as “golden handcuffs” or “golden parachute” arrangements because the SERP benefit is contingent upon the employee staying with the employer for a certain number of years or until a certain age. They act as handcuffs for the employee to keep them from seeking other employment and as a parachute to ease them softly into retirement.

(b) **Supplemental 401(k) Plans.** As discussed above under qualified plans, owners and

executives are often limited in how much they are able to contribute to a 401(k) plan because of the ADP and ACP tests and because of the annual elective contribution limits (\$17,000 for 2012, \$22,500 for individuals over age 50). Rather than implementing a “safe harbor” 401(k) plan, some employers implement a supplemental 401(k) plan whereby employees that want to defer more than they are allowed under a qualified plan can, prior to the plan year, make an election to defer as much as they want (up to 100% of their compensation).

(c) **Deferred Bonus Plans.** Similar to Supplemental 401(k) Plans, a designated group (including executives and, in some cases, owners) can be allowed to make an election, prior to the start of the plan year, to defer all or a specific percentage or amount of his/her bonus that is to be earned in that plan year. The election must be irrevocable, however, and the payment of the bonus must be set at a fixed date in the future (e.g., 2 years following retirement of the employee). In the meantime, the bonus will be considered an employer asset, but can earn interest which will not be taxable to the employee until it is paid out (depending on the type of investment, earnings may be taxable to the employer).

(d) **Stock Option Plans.** Stock Option Plans allow executives to purchase actual Company stock at a certain, fixed price. Of course, the value of such options depends entirely on whether and to what extent the value of the Company stock increases. Stock Option Plans were extremely common (and valuable) during the tech boom in the late ‘90s and early ‘00s, and remain a viable option today. These plans can offer Incentive Stock Options (which result in capital gains tax treatment) or Nonqualified Stock Options (which result in ordinary income tax treatment).

These and other types of nonqualified deferred compensation plans have long been subject to “constructive receipt” principles of the Internal Revenue Code (“Code”). Now, they are subject to stricter regulation by the IRS through a relatively

new section of the Code called Section 409A. These new rules certainly do not preclude an employer from implementing nonqualified deferred compensation arrangements; however, an employer's failure to abide by the rules can result in severe and adverse tax consequences including immediate taxation of the compensation, plus a 20% additional tax, plus interest from the year in which the amounts were first deferred.

The IRS issued Final Regulations interpreting Section 409A in 2007. Nonqualified deferred compensations plan documents should have been updated to reflect these Regulations by December 31, 2008. Although not an exhaustive list, here are some of the "hot button" issues that the Regulations addressed:

(a) **What is covered?** 409A and the Final Regulations generally apply to any arrangement whereby an employee has a legally binding right during a year to receive compensation that has not been actually or constructively received and that is payable in a later year. However, there are some specific exceptions:

(i) "Short term deferrals" which are paid to the employee within the 2 ½ months following the end of the employee's or employer's taxable year (whichever is later) are not subject to 409A.

(ii) "Separation Payments" are not subject to 409A. The Final Regulations define such payments as amounts that are paid because of involuntary separation and that do not exceed two times the lesser of the employee's annual compensation or the Code Section 401(a)(17) limit (\$250,000 for 2012). Only amounts in excess of this limit would be subject to Section 409A.

(iii) Certain Nonqualified Stock Options and Stock Appreciation Rights ("SARs") are not subject to 409A. To meet this exception, a stock option: (1) must be granted for not less than the fair market value of the underlying stock at the date of grant; (2) must be taxable; and (3) must not include any

feature for the deferral of compensation. SARs issued by a publicly traded company meet this exception if: (1) the SAR's exercise price is not less than the fair market value of the stock on the date the right is granted; (2) only shares of stock may be delivered upon exercise; and (3) the right does not include any feature for the deferral of compensation.

(iv) If the aggregate amount of separation pay paid to an employee does not exceed the Code Section 402(g) limit for the year of separation (\$17,000 for 2012), such amounts are not subject to 409A.

(b) **When may benefits be paid?** There are strict rules on when benefits may be payable under a nonqualified deferred compensation plan subject to Section 409A:

(i) Payments may be made no earlier than a fixed date or under a fixed schedule, or upon any of the following five events: (a) a separation from service; (b) death; (c) disability; (d) change in control of the employer; or (e) an unforeseeable emergency.

(ii) A payment is considered made on a fixed date if it is made by the end of the year in which the fixed date (or one of the five aforementioned events) occurs, or if later, by the 15th day of the third month following the fixed date or event.

(iii) Payments can be deferred by the employee if the deferral election is made no later than the end of the year prior to the year the compensation is earned. For a newly eligible participant, such election must occur within 30 days after the date the participant first became eligible.

(c) **Can benefits be accelerated?** Generally, payments subject to Section 409A may not be accelerated but there are a few exceptions:

(i) Payments made within 30 days before the fixed date are allowed;

(ii) Payments made as part of a settlement between the employee and the employer of an arm's length bona fide dispute are allowed, but only if the payment is reduced by at least 25% from what the employee would have otherwise received.

(iii) Payments that substitute for the payment of deferred compensation, such as securing a loan given to an employee by an offset of or a reduction in an amount deferred under a deferred compensation plan or providing a bonus simultaneously with the relinquishment or forfeiture of a deferred amount.

Clearly, Section 409A has had, and will continue to have, a major impact on the design of nonqualified deferred compensation plans. That notwithstanding, these plans continue to be a very useful tool for recruiting, retaining and fairly compensating executive employees.

Tax exempt and governmental employers' deferred compensation arrangements may be subject to restrictions in addition to Code Section 409A. Code Sections 457(b) and 457(f) often apply to these arrangements and are quite different in their application from Code Section 409A. ■

If you have any questions regarding qualified retirement plans or nonqualified deferred compensation plans, please contact Attorney Timothy L. Stewart at tls@dewittross.com or (262) 754-2869.

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