Beware: Deferred Compensation Plans May Not Be What You Think

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Our firm has seen a resurgence of non-qualified deferred compensation plans in privately held companies. Many of these companies want to provide special benefits for their higher compensated workforce, but they are often misguided and misinformed on leading-edge benefit design.

Too frequently the business owner is sold on a concept of providing lucrative retirement benefits to a select group by either an investment or insurance provider who may be motivated by the commission made on the sale of the product that finances the plan. This back-end approach can create serious long-term issues and cost a company considerable expense.

The Plan Must Be Unfunded

Deferred compensation, supplemental executive retirement plans, 401(k) mirror plans, and other types of non-qualified retirement programs have common requirements to assure industry compliance. One of the most important yet frequently overlooked requirements is that, in order to be exempt from ERISA rules, the plan must be unfunded. Essentially, non-qualified plans are nothing more than an employer's promise to pay a future benefit. All non-qualified plans, including those deferred compensation plans in which 100% of the proposed benefit is from employee deferrals of compensation, are unsecured. They are an asset of the company and are *always* at risk to business creditors.

Although the plan is unfunded, a vehicle can be established to accumulate dollars for the ultimate payment of the obligation. The two, however, must remain unlinked in the eyes of the law.

The Employees Cannot Be Owners

Because the non-qualified plan and the ultimate benefits to be paid are the obligations of the company itself, it's important that the employees have no incidents of ownership in any assets of the plan. When an employee has such ownership or becomes entitled to a distribution, he or she is taxed in full on the benefit.

This critical point is often overlooked by enthusiastic participants searching for a way to shelter income from taxation and enthusiastic insurance and investment salespeople. Unfortunately, deferred compensation plans have been established using individual brokerage accounts and allowing the employee to choose his or her own investments. This jeopardizes the integrity of the plan and can expose the employer and employees to unintended tax consequences.

If the plan is financed, the company should remain in control of the investment or insurance products, which should be owned and controlled by the company. To make the plan more employee-friendly, the company may offer the participant “global” choices and then mirror those with actual investments. For example, the company might allow the employee to direct how much of his account balance he wishes to invest in a certain bond or stock index. Those indexes are then tracked and the employee receives an earnings rate on his account that reflects its performance.

Don’t Be Caught Unprotected

Many employees participating in non-qualified plans, especially in smaller companies, don’t realize that these plans are simply promises to pay and are unsecured. If the company goes under, so do the benefits. There is no protection for values accumulated in non-qualified plans such as there is in qualified plans.

Several types of trusts can be used to help provide assurance that the employer cannot use funds escrowed for non-qualified benefit payouts for other reasons, but they cannot protect employees in the event of company bankruptcy. For this reason, employees and especially owner-employees of small, privately held companies should clearly understand the issues and implications before implementing a true deferred compensation plan. Certainly, if it is only employer money at risk for the benefit of the employee, he or she may be less inclined to worry about the risks.

What’s on the Company Books?

Whether the plan is informally funded or unfunded, the future benefits to be paid must be reported annually on the company’s books as a liability. Depending on the financial circumstances of the company, this additional accounting liability may detrimentally impact credit rates and access to necessary funds for business needs.

Some products may be more beneficial than others for financing the ultimate benefits with minimal tax implications and hits to earnings. In some instances, life insurance, typically variable universal life insurance, may offer significant advantages to other financing alternatives including mutual funds and individual stock portfolios. As with any product, though, it’s important to understand it fully in order to know if it’s suitable for the needs of your company. Certain insurance companies specialize in executive benefit products and offer significantly more value than others for the non-qualified plan marketplace.

Who’s in Charge of the Plan?

Proper non-qualified plan administration is essential, but also frequently overlooked. Many employers are unaware of their responsibilities in this area. Because non-qualified plan administration is such a specialized area of expertise, we highly recommend that the services of a reputable administrator be sought to avoid tax surprises.

It’s also essential that any employees offered non-qualified benefits be limited to a select group of management or highly compensated employees (called a “top-hat” group) of your organization. The determination of whether the benefits are offered to a select group is a facts and circumstances determination.

A Plan for Success

Complete satisfaction – for employer and employees – can only be assured by covering all your bases up front. Begin first by identifying the goals of your plan.

1. Are you, the employer, looking to provide special benefits for a few select individuals because they can’t maximize deductible contributions to the company’s retirement plan?
2. Do you hope to use the plan to attract talented employees or to retain your current employees?
3. How long do you hope to handcuff the employee to your company before paying him or her benefits?
4. Do you want to contribute to the plan or simply allow the employee to defer his own money?

Once you’ve answered these questions, you form the foundation for a plan that will survive well into the future with minimal complications. Next, choose an advisor or team of advisors who can help you properly implement the plan. Choosing a highly qualified investment or insurance provider to finance the plan is the final step. Unfortunately, that’s where business owners usually begin.

Deferred compensation and other non-qualified plans can offer benefits for high-achieving employees and their employers; however, be sure to seek out expert advice before wading into the retirement plan waters. If you’re interested in investigating these beneficial programs, call us. We can help.