

Ammunition in the War for Talent: Nonqualified Deferred Compensation Plans

by Carl Kleimann, president of Odyssey One Source, Inc.

Historically, the employee perk known as deferred compensation has been utilized almost exclusively by large employers. And within these large organizations, it has typically been reserved for only the highest-paid corporate executives.

A nonqualified deferred compensation plan allows an employee to defer some or all of his or her income until some future date or event, depending on the plan and the employee's election at the time of the deferral. For example, an employee who earns \$150,000 annually may elect to defer, say, \$50,000, thereby reducing his or her taxable income in the current year to \$100,000.

Employers can also make plan contributions that are "above and beyond" an employee's pay and that may require that the employee forfeit these benefits if they jump ship or leave to join a competitor. In either case, the employer must defer its corresponding tax deduction until the compensation is distributed from the plan to the employee.

These plans can be structured to include both cash compensation, such as salary and bonuses, as well as noncash compensation, such as stock options. Section 409A of the Internal Revenue Code sets forth the rules for deferred compensation and, among other things, requires that there be a risk of forfeiture by the employee and that any plan benefits remain subject to the general creditors of the employer.

Even so, for a highly compensated employee in the highest tax bracket, the ability to defer income and its associated taxes can be an extremely attractive perk. This becomes more evident when you consider that a qualified plan, such as a 401(k), greatly limits the amount that a *highly compensated* employee can defer. The maximum annual 401(k) deferral for 2008 is \$15,500 and is

likely much less for a *highly compensated* employee due to IRS non-discrimination rules.

The Internal Revenue Service (IRS) currently defines a "highly compensated employee" as someone who earned more than \$100,000 in the preceding year or owned more than 5 percent of the business during any part of the current or preceding year. For someone earning a six-figure income, a 401(k) plan is of limited value as either a retirement or a tax-planning tool.

Labor Market Calls For New Approach

Changes in the economy as well as the labor market are prompting small businesses to compete more aggressively for talent. According to the Small Business Administration, small businesses accounted for 60 percent to 80 percent of all net job growth during the decade from 1995 to 2004. In 2004, the most recent year for which data are available, small businesses accounted for 100 percent of all net job growth.

As a result, the demand for talent among small employers is at an all-time high. And as Baby Boomers retire and the labor market continues to tighten, competition for this shrinking talent pool is heating up like a sauna. If attracting and retaining highly skilled and talented employees is integral to the success of your business, consider a nonqualified deferred compensation plan as a way to flex your muscle and compete with the big boys.

You Don't Have to Be An Expert to Implement

Like other employee benefit plans, nonqualified deferred compensation plans are subject to myriad rules and regulations. Earlier this year, the IRS finalized new regulations that address plan distributions, acceleration of

benefits, and deferral elections by employees. For example, under these new rules, deferred compensation may not be distributed earlier than (1) the date of separation from service; (2) the date the participant becomes disabled (as defined in Sec. 409A); (3) the participant's death; (4) a specified time or fixed schedule set forth under the plan at the date of the deferral of the compensation; (5) the date of a "change in ownership" of the employer (as defined in the regulations); or (6) the occurrence of an unforeseen emergency (as defined in Sec. 409A).

An abundance of firms specialize in the implementation and administration of these plans, so you don't have to go it alone. Salary deferrals are typically invested in interest bearing and/or equity accounts, and most plan administrators offer investment advisory services in order to maximize investment earnings for plan participants. And, if structured properly, these investment earnings are not taxable to the employer, yet, may be tax deductible at the time of distribution.

Weigh the Advantages And the Risk

Since deferred compensation is not tax deductible until distributed to the participant, you should consult your tax advisor to evaluate its tax impact on your business. For companies in a low corporate tax bracket, this may represent a marginal cost, if any. And remember, you do not lose the deduction, but rather defer it until a later date. Once the compensation is ultimately distributed, the entire distribution is tax deductible. If this strategy allows you to attract and retain the best employees for your business, it may prove to be a very wise investment.

❖ Carl Kleimann serves as president of Odyssey One Source, Inc., a Texas-based Human Resources Outsourcing firm dedicated to freeing companies from HR-related issues and challenges. Kleimann lives in Houston and has recently served as president of the industry's national trade association. He is a frequent author and speaker on behalf of the industry. He can be reached at ckleimann@odysseyonesource.com.