



**TOPIC:** Non-Tax Benefits of Deferred Compensation Plans for Employers.

**MARKET TREND:** With the improving economic climate, key employees that had previously been limited in employment opportunities and hesitant to search for new jobs are now willing to explore changing employers. Employers need incentives to both attract and retain key employees.

**SYNOPSIS:** Key employee deferred compensation programs are effective vehicles to incentivize and retain key personnel. To rationalize the implementation of these programs, it is important to understand and appreciate that these programs provide benefits not just for employees but also for employers. Program design options and benefits are voluminous and provide employers with extensive flexibility to meet the specific desires and needs of the employer and the employee. Programs can include delayed vesting schedules, benefit structures based on the long-term financial success of the business, and confidentiality and non-compete clauses.

**TAKE AWAYS:** When consulting with employer-clients on employment matters, advisors can provide value by helping to evaluate the effectiveness of key employee deferred compensation programs in meeting an employer's practical business needs. These programs can provide several non-tax benefits to employers, including targeted incentives for employee recruitment, "golden handcuffs" for employee retention, a vehicle for enforcing employee non-compete covenants and confidentiality agreements, and opportunities for retirement and business succession planning. Life insurance also can serve as informal financing for implementation of these programs.

**MAJOR REFERENCES:** [Internal Revenue Code \("Code"\) § 409A](#)

Key employee compensation is experiencing resurgence in today's business environment. As the economy improves and employment opportunities increase, key personnel are considering moves that did not exist even a few months ago. Business owners and boards are searching for

vehicles to incentivize and retain these key people. To rationalize the implementation of deferred compensation programs, it is important to understand and appreciate the practical benefits these programs can provide for employers\*

### *BEST BUSINESS REASONS FOR KEY EMPLOYEE COMPENSATION PLANS*

#### **Employee Retention: "Golden Handcuffs"**

Employers want to retain experienced, valuable employees. One way to improve the chances of retaining its key personnel is to create financial incentives - as "golden handcuffs" - that encourage the key personnel to stay. The financial incentive can be created by delayed "vesting" of benefits. For example, a plan might provide that, for every year of service, the employee is entitled to a benefit equal to a percentage of compensation (e.g., 5%) and that the employee is vested over a period of years of service (e.g., 20% vested after each year of service until he is completely vested after five years). The lengthier the vesting schedule, the greater the financial cost to the employee of resigning and going to work for the competition, particularly if the vesting schedule tends to mirror a potential exit (e.g., sale or initial public offering (IPO) of the company).

A vesting structure which has become popular is a rolling vesting structure, under which each annual contribution is vested over a specified period of time, typically three or five years. The thought is that the vesting period is short enough to provide a current incentive for the employee to perform well, but still acts as a golden handcuff because resignation at any given time will cause the employee to forfeit a portion of each recent contribution.

An employer could structure a program so that the executive must work until retirement age (or any other age) or a specified event in order to receive any benefits. Alternatively, the program could provide that the employee receives no benefits if he resigns or is terminated for "cause" before attaining a specific age or event. Note that programs often provide the employee will be 100% vested if the termination of employment occurs because of: (1) permanent disability, (2) death, (3) change in control of the employer or (4) termination without cause.

#### **Employee Recruiting: Targeted Incentives**

***The incentives under a key employee deferred compensation program can include deferred bonus amounts or equity awards triggered by a company's sale or IPO. They can be set amounts earned over time, or performance-based, earned upon the achievement of specified criteria (e.g. sales volume, return on equity, liquidity events, etc.), either on a team or individual performance basis.***

***Many owners of private companies do not wish to award actual equity, so equity-type awards, such as stock appreciation rights and phantom stock or units that mimic stock appreciation without ownership rights and that are paid in cash, can be granted.***

#### **Employer Protection: Enforcing Non-Compete Covenants & Confidentiality Agreements**

Most employers have trade secrets, know-how, customer lists, employee information and various other proprietary information that they wish to retain as confidential since disclosure would provide significant benefit to competitors. In addition, key employees may have developed important relationships with customers and/or suppliers. If a key employee with those contacts leaves to work for the competition, some customers may take their business to the competition, or the competitor may try to recruit other employees.

An initial step to protecting confidentiality is for employers to enter into covenants not to

compete and confidentiality agreements with key employees. These agreements normally will provide that if the employee violates the terms, the company is entitled to obtain injunctive relief in addition to monetary damages. However, non-compete covenants are not enforceable in some states, such as California. Even where they are not prohibited, non-compete covenants are generally disfavored under state law, such that there is substantial uncertainty with respect to their enforceability.

That said: (1) such agreements are often given more weight when a key employee has received the benefit of a compensation plan to sign the agreement, and (2) the provisions can be inserted into the key employee compensation plan terms. Thus, given the uncertain enforceability of noncompete covenants and confidentiality provisions in employment agreements, an employer may want to use a deferred compensation program to provide a further incentive to prevent the former employee from engaging in competitive activities or disclosing confidential information. Any limitations and uncertainties under applicable state laws may be avoided in the context of such a program.

Accordingly, an employer's deferred compensation program may provide that the employee will immediately forfeit any right to any future benefits under the program if he engages in any competitive activity, regardless of when or where the competitive activity takes place. This provision in the program could create a financial incentive for the employee to refrain from the competitive activity.

### **Retirement/Ownership Transition: Succession Planning**

Many private employers not only need to retain key personnel for current operational success, but to avoid an ownership vacuum when the principal owner(s) wish to retire. Similar to the discussion of the golden handcuffs above, a key employee deferred compensation program can be designed to retain and transfer ownership interests to a management team in advance preparation for owner retirement.

### **Funding: Flexible Financing**

While nonqualified deferred compensation programs cannot be actually "funded" under law, the value of amounts earned can be invested to provide funds to cover future liabilities. Investment preferences can be requested from employees. The liability for benefits can be effectively offset through the purchase of life insurance on the employees, which generally is not subject to tax on the policy cash value or death benefit while accruing to the benefit of the employer.

### **TAKE AWAYS**

- \* When consulting with employer-clients on employment matters, advisors can provide value by helping to evaluate the effectiveness of key employee deferred compensation programs in meeting an employer's practical business needs.
  - \* These programs can provide several non-tax benefits to employers, including targeted incentives for employee recruitment, "golden handcuffs" for employee retention, a vehicle for enforcing employee non-compete covenants and confidentiality agreements, and opportunities for retirement and business succession planning.
  - \* Life insurance also can serve as informal financing for implementation of these programs.
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\* Any nonqualified deferred compensation program must be designed to satisfy the requirements of Code § 409A, which primarily dictates deferral and distribution limitations.

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