Six Cash-Saving Tips for Deferred Compensation Plans

DCPs are very flexible tools, so don't miss out on opportunities to use them to maximum benefit.

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A typical nonqualified deferred compensation plan (DCP, also known as a 409A plan) allows key employees to defer salary, bonus and cash incentives. Some employers allow deferral of restricted stock units as well. As with 401(k) plans, gains on the deferral are also not taxed until distribution (although a 401(k) has deferral limits and a DCP does not).

Here are six cash-saving tips for DCPs:

1) One-Offs

Trying to find a way to counter that employment offer your key employee just received from a competitor? Do you need to design a one-time retention bonus for a small group of key employees after a change in control? Want to bonus a key employee even though the bonus targets weren't met? A discretionary contribution to a DCP account balance can meet a variety of corporate objectives by using vesting. An employer contribution can vest over time, be based on meeting employer objectives, be structured as discretionary contributions, or a combination of those. Flexibility, creativity and discrimination are your friends here. Don't have the cash and don't want to use equity? See "Delayed Funding" below.

2) Specific Incentives for Key Employees

Pay for performance gets a lot of press, but what is really being done about it? Many bonus checks are still being received by employees that did not change behavior. While most employers with DCPs don't normally think about using the plan as an incentive tool, it can be extremely effective for that purpose.

Here's an example. A high-tech firm gathered a team of 12 key programmers (also key employees) in a room to discuss an upcoming project. The employer knew that the sooner it went to market with the new design, the more revenue would be generated. So it put $50,000 into each programmer's DCP account and parked it in a money-market fund. If the team finished the project in less than six months, the money would vest to those programmers — no time limit and no other strings attached.

To say the DCP offer succeeded would be an understatement. The employer emphasized achieving results as quickly as possible. The 12 programmers displayed exceptional teamwork and dedication, completing the project in three months. The employer willingly paid $600,000 to reap tens of millions in revenue via an earlier release date.

At vesting, the programmer could take the cash or leave it in the DCP and reallocate out of the money market into the other fund choices. But the design was completed in three months and the employer made great profits. In essence, it was an advance profit-sharing plan.

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3) Specific Incentives for All Employees

Another employer wanted to change behavior with a much larger group to achieve a much broader goal. Every employee was to contribute toward reaching the stated corporate target of $2 billion in revenue within a five-year period. (Usually, only “key employees” are eligible to defer income into a nonqualified DCP. There is, however, a type of nonqualified plan, called a non-ERISA DCP, in which all employees to participate. The plan cannot reference retirement or look like a retirement supplement.) Each division was given goals that together, if reached, would achieve the target. At the end of each year, if a milestone goal was met, an employer contribution was made to the employees’ DCP accounts. Goals not met in one year could be made up in the following year(s). These employer contributions did not vest until the end of the fifth year, ensuring that employees remained motivated and were more likely to stay with the companies until the goal was achieved. Key employees were able to defer their balance past the fifth year. All others received their balance at the end of the fifth year.

4) Sign-On Bonuses

One client reported that incorporating sign-on bonuses into its DCP has resulted in savings of $300,000 per year.

Historically, the firm paid key employees sign-on bonuses that would vest after two years. Yet the bonus was paid up front, with the firm telling the employees that it would recover the money if they left early. It’s a fairly common practice in the technology field, but companies rarely follow through on their vow of recovery, as the cost to pursue the claim often means the effort isn’t worth it. This firm was no exception.

Improving on that situation, the firm now adds the sign-on bonus to the DCP account as an unvested balance, which is forfeited upon early departure. The key employee can track the unvested balance online. This minor change has resulted in substantially lower turnover, while solving the issue of unrecovered sign-on bonuses.

5) Retire Key Employees

When an employer prefers to retire certain key employees to make room for new talent, vesting DCP balances can be a valuable pretax negotiation point with the potential retiree. Whenever there is an unvested balance, it can be given to a key employee to help assist his or her retirement.

If unvested balances don’t exist, then a company contribution to the DCP with an installment payout mechanism can be used in lieu of severance or to enhance a retirement benefit.

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6) Delayed Funding

Employer contributions are not required to be currently funded. In fact, one strategy is to book the employer contribution in a participant's money-market fund until it vests. This appears as an unvested balance in the participant's account. As a result, an employer can wait until vesting occurs to make the actual contribution (and delay the impact on current cash flow). At that point, the participant can reallocate the money-market balance into other investment options.

Independently of all these tactics, the account balance is in a very efficient savings/investment vehicle. Pretax amounts earning tax-deferred interest until being distributed at a participant's elected time is advantageous for both the employer and employee. Participants can usually reallocate investments periodically and have some control over the payout date if their needs change.

Using the current DCP administrator's platform, employers can meet many other corporate objectives with pretax dollars, minimal service difficulty and no up-front cash.

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