NQDC Plans and Key Employee Retention

The strongest labor market in 50 years makes an NQDC plan a valuable attraction and retention tool.

By Nicko Burnett and Terry O'Prey for PSCA's NQDC Committee.

"The only thing that is constant is change." Those words, written by Heraclitus, could not be truer of the current labor market in the United States. For decades, there has been a common mantra of the middle class: *find a good job at good company, and you will be rewarded for your loyalty.* However, throughout the last ten years, that mantra has been upended. Data from the Bureau of Labor Statistics tells a clear story: Millennials switch jobs more than any other generation, are less engaged in their careers, and care less about the success of the companies for which they work than any generation before them.

The resulting attitude and movement that follows weighs financially on the US Economy. Estimates from Gallup say that the cost of millennial job movement is costing US companies $30.5 billion annually. Exacerbating the issue is that unemployment is at its lowest level in more than 50 years, giving employees the additional bargaining power to seek higher wages and better benefits.

With all that negotiating power, employers must be increasingly creative in finding ways to attract and retain key talent. Some tech firms in Silicon Valley have turned to more perk-style benefits, like free meals, childcare, and laundry, designed to make employees' lives easier. However, employees soon realize these benefits are an excellent strategy for keeping them on campus longer each day. The more common and effective methods of attraction and retention include large bonuses and stock options with vesting schedules, but these inevitably lead to what can turn into nasty clawback fights if an employee decides to leave after receiving the money.

At a time in which millennials (born from 1980–1996) are moving into management ranks, it is crucial to have a flexible tool to attract top talent and retain it as well. While Non-Qualified Deferred Compensation Plans (NQDCPs) are no novel idea, some plan sponsors are not utilizing them to effectively combat these trends and issues. NQDCPs are incredibly flexible tools at the disposal of plan sponsors for creating custom benefits and compensation packages to the benefit of both the employee and the employer.

What is a Non-Qualified Deferred Compensation Plan (NQDCP)?

- A written agreement between a sponsoring employer and its Highly Compensated Employees (HCEs), (and/or outside non-employee directors) permitting company contributions and voluntary pre-tax deferral of otherwise currently taxable compensation.
- Deferred dollars grow tax-free until a future specified date or event such as retirement, termination, scheduled date, death, disability, or change of control — payments are subject to income tax when received.
- NQDCPs provide HCEs with a significant and tax efficient additional savings opportunity to effectively plan for their financial future.

What's Driving Interest in NQDCPs?

Qualified retirement plan regulations restrict contributions and distributions:

- 401(k) contribution cap $19,500/Age 50 and over cap $26,000 (year 2020)
- $285,000 is compensation limit for calculating contributions (including match)
- Pre-age 59½ and post-age 70½ distribution penalties/requirements
- Company's desire to attract, retain, and motivate key employees.
- Good platform for long term incentives including vesting and sign-on bonuses.
- Participant's desire to manage current and future taxable income while efficiently saving for future needs.

See Exhibit 1 for an abbreviated comparison of 401(k) plans and NQDCPs for your reference:

Attracting Top Talent

A recent study by the Federal Reserve Bank of Philadelphia confirmed what society had theorized for years: it is

Exhibit 1: 401(k) Plans and NQDCP Comparison

Plan Items	401(k) Plans	NQDCP
Eligibility is limited to only a select group of management or highly compensated employees (HCE's)	No	Yes
Permits pre-tax deferral of compensation & earnings until benefits are received	Yes	Yes
Government limits on contributions	Yes	No
Participants can schedule penalty-free distributions to be paid at any age before or after separation from service	No	Yes
Company contributions can have different terms and conditions by participant or group of participants	No	Yes

human nature to try to "keep up with the Joneses." In other words, we desire what our neighbors have. In a 2018 plan sponsor survey conducted by Prudential, 92 percent of medium and large-sized companies already offer a non-qualified plan. Without a NQDCP, an employer is already behind most of their competition in hiring management level employees, leaving potential employees with something to be desired in their benefit package. The omission is only intensified if the target employee is a current contributor to a plan and now has no way of continuing his or her savings practice. NQDCPs have become a necessary piece of the benefit offering for companies of all shapes and sizes.

Once a plan is in place, plan sponsors can utilize plan provisions to structure additional attraction possibilities. Sign-on bonuses have long been utilized by employers to extract key talent from competition to join their own ranks. Predictably, a vesting schedule is usually attached to the sign-on bonus to ensure loyalty to the firm. However, regardless of the strength of the vesting provision, clawing back a sign-on bonus if an employee leaves can be messy and difficult. NQDCPs allow employers to place the sign-on bonus in the plan, effectively holding onto the sign-on bonus and making it available to the executive as it vests. Simultaneously, the plan allows the employer to avoid a messy clawback scenario and the employee to defer taxes and invest the bonus immediately.

Retaining and Incentivizing Key Employees

On the opposite side of attracting new talent, employers must also be concerned with retaining the talent they already have. It bears repeating — the labor market is as strong as it has been in 50 years, giving talented employees more options when it comes to their careers and places of employment. NQDCPs can assist in this pursuit while keeping risk at a minimum. Retaining, incenting, and engaging employees are linked in many ways. A highly incentivized employee is also highly engaged in their work and more likely to remain at that company.

NQDCPs provide several avenues by which to incentivize employees through the different types of company contributions. An effective approach is tying the amount and or vesting of the incentive to the performance of the company, a division, a product/service, or the individual performance of the employee.

Flexibility

Above all, NQDCPs provide a plan sponsor with the flexibility to compensate different employees in different ways, something not allowable with most other employee benefits. This ability to provide targeted excess benefits to a small number of key employees gives plan sponsors more arrows in the fight to attract, retain, and incentivize those employees — thereby maintaining the success of the company.

This flexibility can be incredibly important when incentivizing and engaging employees. Every company has a different culture and way of conducting business, and each industry faces different challenges with retaining talent. With NQDCPs, the plan sponsor can weave that culture into the devices used to incent or retain employees. Would you compensate a salesperson and a developer in the same way even if they worked at the same company? In the same way, a plan sponsor can be selective about the ways in which different employees are incentivized. That same salesperson is going to be much more likely to stay at the company if they have compensation at risk for leaving prior to employer-defined conditions being met.

NQDCP Design Considerations

Designing a plan to meet the goals and objectives of any plan sponsor requires the following questions to be answered:

1. Who can participate?
2. What types of compensation can be deferred?
3. How are annual deferrals allocated?
4. Will the company make contributions?
5. What investment options will be offered?
6. What are the distribution options?
7. What happens if there is a change in control?
8. Will the plan be informally funded?
9. If funded, will the plan utilize a rabbi trust?

A key feature available to recruit, retain, reward, and ultimately retire your key employees are company contributions and incentive compensation/bonuses. Company contributions and incentive compensation may be, but are not limited to, the following:

- Mandatory or discretionary
- Uniform or discriminatory (i.e., Company can make different levels of contributions for different employees)
- Tied to 401(k) makeup contributions
- Long Term Incentives
- Sign-on bonus (for recruiting)
- Retention bonus

By utilizing a NQDCP for company contributions and incentive bonuses, distributions may occur at the time of vesting or later, eliminating the risk of clawback. NQDCPs provide plan sponsors the highly effective attraction and retention mechanism of cash compensation with the flexibility to structure it on their terms.

NQDCPs Provide Solutions

In summary, a properly designed NQDCP offers companies and their key executives' solutions to enhance their performance and employment experience. See below for a summary of solutions to issues facing employers and HCEs:

- Restore lost pre-tax deferral opportunity and company match due to IRS limits in the 401(k).
- Level playing field to attract and retain key employees.
- NQDCPs can be designed, implemented, and administered with little financial impact to the company.
- Provide flexibility for unique and customized company contributions to motivate key employees.
- Help participants reduce impact of high personal income tax rates:
  - Lower current taxable income.
  - Choose and/or change the timing and method of future distribution payments to assist with tax planning and future needs.
  - Take advantage of state source tax rules to potentially eliminate some state income taxes completely.
  - Efficient wealth accumulation tool.

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