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Potential Pitfalls in Deferred Compensation Plans

When participating in a deferred compensation plan, you may defer a portion of an employee's income to payout at a later date; making deferred compensation is often an intriguing way to put off the tax burden. However, weighing the benefits and drawbacks can help you determine if deferred compensation fits your overall financial plan well.

A "qualified" deferred compensation plan must comply with the rules and regulations of ERISA (e.g., 401(k) plans). "Nonqualified" plans give employers more flexibility. The employer can choose which employees receive deferred compensation benefits, and employers may treat those chosen differently. Furthermore, the benefit promised need not follow many of the rules applicable to qualified plans.

What happens if the employer or employee wants to change the plan after it becomes effective?

For example, ABC, Inc., and employee Joe Smith enter into a non-qualified deferred compensation plan. The annual benefit is calculated based on ABC's income each year. The benefit vests each year that Joe remains employed, and the entire amount only becomes payable at the end of year ten if ABC still employs Joe. It is now the beginning of year ten, and ABC is concerned about cash flow due to recent downturns in its financial health. Joe and ABC agree that instead of the cash payment at the end of year ten, the plan will be terminated, and Joe will be given stock in a year or two instead when the financial health of ABC is expected to improve significantly.

The parties are in agreement, so everything is good, right?

Both sides are happy because Joe gets an equity stake, and ABC is unburdened from the cash payment coming due, right? Well… Internal Revenue Code §409A allows for the termination or modification of a plan and the forfeiture of benefits by the employee, but there are limitations. Generally, unless certain exemptions apply, the modification or termination of a plan will be a "plan failure," which results in income acceleration and penalties: total amounts deferred under the plan become includible in the employee's gross income and are also subject to an additional 20% penalty. To terminate a plan without failure, several requirements must be met. One condition is that termination not be due to a "downturn" of the employer's financial health. All other similar plans must also be terminated, and a similar plan can not be adopted for three years. Any vested benefits

cannot be paid within 12 months of the termination, but all payments must be made within 24 months of termination. Thus, termination of the ABC plan hurts Joe because the cash payment still must be made, and the termination will be due primarily to a downturn in ABC's financial health.

What if Joe instead offered to forfeit the benefit?

Forfeiture generally will not have any tax consequences. But, if there is a "substitution"

following the forfeiture, the tax and penalty might be triggered. Typically, additional taxes will be imposed if a substitution accelerates or changes the time of payment in a manner that does not comply with 409A. For example, Joe forfeits the right to receive unvested deferred compensation of $5,000. Then, ABC pays Joe a one-time bonus of $5,000. However, income tax Regulations suggest that substitute payments will be okay, but such payment will still be taxable as if the original benefit is received. In such cases, payment in stock instead of cash might not trigger the penalty. The difference between this substitute payment and the improper substitution of the bonus is that Joe does not forfeit any deferred compensation. Rather, only the form of the payment is changed. But, if Joe accepts stock in lieu of cash, he will have to pay the tax on the benefit received without receiving any money from ABC to pay such tax!

Finally, what if ABC and Joe merely agree to defer payment of the benefit amount for a few years?

Since Joe expects the benefits at the end of the current year, any deferral triggers a plan failure. To not be a plan failure, the deferral must be for at least five years and cannot have been made within one year before the benefit becomes payable. So, Joe's and ABC's options are limited. If Joe is willing to accept stock and pay the tax on the benefit amount without cash, such payment should be okay. But clearly, there is no excellent option that benefits both sides.

This simple example shows that deferred compensation plans may not be as flexible as employers might think once they are put in place. It is essential to plan (no pun intended) ahead when offering an employee deferred compensation. The employer must consider whether it will have cash available to make the payments and whether it will be able to make any changes to the plan- with or without the employee's consent.