Deferred Compensation Plans: Options and Considerations

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Businesses often consider how to reward and retain top talent and incentivize productivity without offering equity, an ownership interest in the business. An executive deferred compensation plan allows an employer to supplement an executive's base salary over a longer horizon—either after retirement or over a period of years. We have outlined three different options below, all of which are intended to reward executives based on productivity and results and to retain those executives by structuring a payout over time.

(1) Nonqualified Deferred Compensation (NQDC) Plan

- Overview: A NQDC Plan, also known as a supplemental executive retirement plan (SERP), is a non-qualified plan structured to avoid the limitations placed on other qualified retirement vehicles, such as a 401 (k). By being a non-qualified plan, the company can limit participation to a select group of executives, make larger contributions, and require more service for the vesting of benefits. Contributions are typically subject to the employer's discretion based on performance objectives. As part of deferring payment to an executive to a future time, the tax owed on this extra income is deferred as well. These plans may be appealing for executives who are maxing out contributions to qualified plans.
- Issuance and Vesting of Benefit: Funds are typically put in a "Rabbi Trust" to ensure they remain subject to a substantial risk of forfeiture. This means the funds are not subject to tax when set aside for the executive because the funds are still subject to the company's creditors. Companies can establish substantial vesting requirements (g., 20 years). They can also forfeit the benefit on violation of certain restrictive covenants or misconduct (like termination for cause).
- Payment Triggers: Permissible payment events include the following:
    - A fixed date
    - The executive's separation from service

- → The executive's death
- → The executive's disability
- → A change in control
- → An unforeseeable emergency

Typically, plans will provide for payment upon the later of two events (e.g., the later of separation from service or age 55).

- → Value of the Benefit: The benefit amount is typically a formula-based annual monetary contribution.
- → Terms of Payment: Generally, payments commence on a participant's separation from service (or the later of separation and an age, such as 55), in a lump sum or an annuity. Executives often have a choice regarding the form of payment (for example, lump sum or periodic installments) and may have a choice of the payment commencement date. Payments may be accelerated in the event of death, disability, or a change in control.
- → Administration. Employers can administer these plans themselves, but they often engage the services of a third-party administrator, who could assist with providing a form plan document, creating the rabbi trust, and calculating the benefit.
- → Tax Treatment. Employers cannot deduct amounts, as they are contributed to the plan's trust and trust assets are taxed. Benefits earned under a SERP are generally not taxed until distribution. However, the executive is subject to FICA tax on SERP benefits.

(2) Long-Term Incentive Plan (LTIP)

- → Overview: An LTIP rewards employees for meeting certain performance goals that are vital to the company's success, but may not necessarily be tied to share price or company value. The annual benefit under an LTIP can be calculated for each executive and is payable or vests over a period of years, typically three to five. For example, you could calculate an award in Year 1 that is payable in Years 2 through 6 at 20 percent each year. Then, layer a Year 2 bonus that is payable over Years 3 through 7. In this example, it is not until Year 5 that the executive is receiving a "full" benefit. Alternatively, half the award could be payable in Year 5 and the other half in Year 6.
- → Issuance and Vesting of Benefit: An LTIP is very structured. For example, if the executive reaches his or her productivity goal in Year 1, they receive a bonus of X, payable over Y years. It could be structured so that you have ultimate discretion over the amount of the benefit.
- → Payment Triggers: The executive would be entitled to benefit so long as they were employed as of Dec. 31 of the year at issue. In other words, if the executive leaves the company before it vests, he or she forfeits the unvested portion of the award.
- → Value of the Benefit: It would be a cash payment, often a percentage of base salary, so there would be no need for business valuations.
- → Terms of Payment: The plan can require the executive to sign a general release of claims against the company and its owner as a prerequisite for payment, and can also require the execution of restrictive covenants (non-compete, non-solicitation, confidentiality, or non-disparagement).

- Administration: The employer would establish a committee to administer the plan. There would be some internal record-keeping requirements.
- Tax Treatment: The employer gets a deduction when the award is paid to the executive, and the executive is taxed on receipt. Unlike an SERP described above, the executive does not receive a substantial tax deferral benefit, since vesting and payout are typically close in time.

(3) Phantom Share Plan

- Overview: A Phantom Share Plan is an account-balance plan that measures return on equity measured by reference to shares of company stock. The plan will involve grants of "phantom shares" (i.e., not actual equity) to the participants to provide them certain economic assurances and incentives to better align the interests of such key executives with the interests of its owner. Plan participants will not be equity owners (e., members) for LLC law, tax law, or other purposes, but the plan will be intended to provide to the participants compensation opportunities that mimic certain aspects of equity ownership with respect to certain transactions.
- Issuance and Vesting of Phantom Shares: There are various ways to structure how phantom shares are issued and vested, according to your objectives. For example, shares can be issued pro-rata to eligible executives or tied to productivity. The plan can provide for issuance only in the event of certain economic conditions and on executive performance. Vesting can be immediate or over a period of time. The plan could also tie vesting to performance (g., the executive must remain employed for 18 months and the business must have an increase in net income of X percent or X dollars from net income earned in a given year to vest in the initial grant). If the executive leaves prior to the payment trigger, then (s)he forfeits the benefit in full.
- Payment Triggers: The plan could incorporate a variety of payment triggers appropriate for the business. The most commons are:
  - Sale of the company or other change in control
  - Executive reaching retirement at age 65 or older
  - Death or permanent disability
  - Termination of employment without cause or by the executive for "good reason"
  - Vesting on a certain date; g., five years from execution of the agreement
- Value of the Benefit: Once a triggering event occurs, the amount of the payout per a Phantom Share Plan is usually based on the per-share value of the company. Except for public companies, the employer would likely need a business valuation when a triggering event occurs. Additionally, the company should plan for its cash obligations when payment is triggered.
- Terms of Payment: Payment can be made in a lump sum or payable over a specified, limited period. The plan can also require the executive to sign a general release of claims against the company and its owner, as well as restrictive covenants (non-compete, non-solicitation, confidentiality, or non-disparagement) as a prerequisite for payment.
- Administration: The plan would create a governing committee for administrative and interpretive control of the plan.

- Tax Treatment: The employer receives no deduction until obligation vests and is paid. If an employer sets aside funds to pay a benefit, those earnings would be taxable to the employer. The executive defers taxation until payment is received or is no longer subject to forfeiture.

These are a few of the options for employers to use as a tool for executive compensation, incentives, and retention. Various other tools are also available, from employee stock options to individual retention agreements. It is important that in preparing any type of written plan or agreement that you carefully draft all relevant documents with consideration of their legal and tax implications. Among other things, Nexsen Pruet prepares plans and agreements for our clients that meet the following expectations:

- Achieve company objectives for performance incentives, executive retention, and/or tax deferral;
- Agree with the company culture and existing executive agreements and compensation policies; and
- Avoid unintended tax consequences or liability.

Please contact the Nexsen Pruet Employment & Labor Law team to discuss your employee agreements, policies, and plans.