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Employee Benefit Plan Review

Reducing Costs

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Q As the sponsor of a non-qualified deferred compensation plan, are there ways to reduce the costs associated with the plan?

A Non-qualified deferred compensation plans can be a significant component of a total rewards program for key personnel. For highly compensated personnel, deferring income until a later date can be very important. Deferral of income can postpone the taxation of the deferred income to years in which the service provider (e.g., an employee) may be in a lower tax bracket, such as after retirement. Additionally, spreading the receipt of compensation out over a number of years may prevent a service provider from falling into a higher tax bracket in any one particular year.

However, non-qualified deferred compensation plans can be expensive for employers to maintain. There are ways to reduce costs associated with maintaining and offering such a plan, such as limiting or eliminating notional investment options or rates of return under the plan, "freezing" the plan to new participants and/or future deferrals, or terminating the plan entirely.

A non-qualified deferred compensation plan typically specifies a rate of return on deferred amounts or the types of notional investments from which participants may select. However, plans typically provide sponsors discretion to change these options on a prospective basis. Plan sponsors can reduce the expense burden of a plan by shifting toward lower promised rates or lower-yielding investments, such as money market funds. It is important that plan sponsors be careful to abide by the terms of their plan, but shifting to lower yield options can significantly reduce the expense burden of maintaining a plan.

Another option that sponsors may consider is freezing a plan so that, on a prospective basis, no new participants may join the plan and/or no additional deferrals may be made. While this would not eliminate the expense associated with amounts already deferred, it would limit ongoing expenses. Depending on the terms of a particular plan, a plan sponsor may be able to both freeze the plan and lower the yields on existing deferred compensation amounts. Such a strategy would effectively cap the expenses to a reasonably determinable amount.

A strategy of last resort is to terminate a non-qualified deferred compensation plan entirely, if the plan sponsor is legally able to do so. Non-qualified deferred compensation plans are subject to Section 409A of the Internal Revenue Code of 1986, as amended (the Code). Code Section 409A is highly technical and requires both documentary and operational compliance. It also contains rules regarding the termination of a deferred compensation plan. Failure to comply with the strict rules of Code Section 409A can result in material adverse tax consequences to taxpayers, including, for example, the immediate taxation of participants' deferred compensation, interest on the underpayment, and a 20 percent excise tax.

Under Treasury Regulation Section 1.409A-3(j)(4)(ix)(C), a plan sponsor may terminate and liquidate a non-qualified deferred compensation plan in its discretion if: (1) the termination and liquidation is not proximate to a downturn in the sponsor's financial health; (2) all similar arrangements are also terminated; (3) no payments in liquidation of the plans are made within 12 months of the date all action is taken to terminate the plans; (4) all payments are made within 24 months of the date all action is taken to terminate the plans and (5) the sponsor does not adopt a new plan that would be aggregated with any terminated plans within three years of the date all necessary action is taken to terminate the plans. Where these criteria are met, a plan sponsor may terminate the plan and eliminate expenses entirely without the adverse tax consequences of failure to comply with Code Section 409A.

However, plan sponsors that contemplate terminating a non-qualified deferred compensation plan should be aware of the consequences to plan participants of such termination. When a non-qualified deferred compensation plan is terminated, participants immediately recognize ordinary income equal to the aggregate amount of their deferrals. This may upset participants who planned to recognize their deferred income over multiple years or at a later time. This concern may be mitigated by, for example, offering participants a cash bonus to offset a portion of this unexpected tax liability. However, plan sponsors should be aware that any cash bonus is also subject to ordinary income at the time it is received.

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