

Common objections to deferred comp—and how you can respond

Nonqualified deferred compensation plans seem like an obvious win-win, right? Employers get a tool to help recruit, retain, reward, and retire key employees. And participants get the ability to save above qualified plan limits.

But objections can come up. Here are some of the most typical ones—and effective ways to counter them.

Plans are too expensive.

Thanks to the 2017 Tax Cuts and Jobs Act (TCJA), plan affordability should be less of an issue for employers. Corporate tax reductions decrease their cost to sponsor a nonqualified plan with voluntary deferrals. Plus, the tax cuts might have a positive impact on their cash flow.

Employers may also object to the lack of a current income tax deduction for the plan sponsor. But while they give up a current tax deduction, the total amount of each distribution is deductible upon payment of benefits. The result isn't a lost tax deduction—it's a delayed deduction—that will potentially be larger than one taken at the time of contribution due to the benefit increasing over time.

Employers have flexibility when it comes to plan financing. They can use tax-advantaged assets to help offset the delayed deduction for plan benefits. Sponsors can also carry the value of the future tax deduction as a deferred tax asset, which can help offset the costs of the plan as it grows.

Why defer compensation in a high-tax environment?

The TCJA lowered individual income tax rates, but because they remain high for top brackets, you may still get questions about the benefits of pre-tax savings. When determining whether deferred comp makes sense for a participant, two factors should be considered:

- The participant's time horizon
- The difference between the tax savings participants enjoy by deferring now and the tax paid when benefits are distributed later

Even in a high-tax environment, deferred comp can be advantageous over long time periods due to compounding of tax-deferred earnings. And when deferred comp benefits are taken in retirement, the tax rate will often be at a participant's "effective" tax rate (total tax paid divided by total taxable income on the distribution). This is typically much lower than their "marginal" rate while deferring.

Participants won't receive benefits in the case of bankruptcy.

Deferred comp plans are unfunded contractual obligations of the plan sponsor to participants. This means assets financing the plan are subject to creditors of the organization in cases of bankruptcy.

Because of this, participants may voice concern about not getting promised benefits. But will that really happen? Here are some things to consider:

- **Participants are key employees** who usually have the best knowledge of how an organization is performing. If they feel confident about the organization's performance, bankruptcy and a potential loss of benefits shouldn't be an issue.
- **Employers can set up a grantor trust.** This won't protect against creditors, but it can help prevent money financing the plan from being used by sponsors for other purposes.
- **Bankruptcy can take many different forms**, from reorganization to liquidation. And the outcome to participants may range from no benefits lost to a full loss of benefits. In other words, bankruptcy doesn't necessarily mean participants will lose their benefits.
- **Internal Revenue Service Code Section 409A** offers additional ways to mitigate risk. For example, participants have the option of accessing benefits when they leave the organization. Employers can also terminate the deferred comp plan at any time, allowing participants to receive lump-sum payments 12 months later.
- **Plans can be designed to provide participants with early access** to benefits before retirement via in-service distributions.

It's unfair for key employees to receive their own special benefit.

Deferred comp plans might be perceived as a way to unfairly reward key employees. But the reality is qualified plans discriminate against highly compensated employees (HCEs). HCEs often can't defer the same percentage of their income as non-HCE employees. And sometimes they're not even able to save up to qualified plan limits due to failed testing. A deferred comp plan can help level the playing field and allow all employees to save for retirement at the same levels.

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