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NQDC Plans Help Dealers Attract and Retain Top Talent

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Many dealerships cite their employees as the most significant factor fueling their success. So how can owners attract the best employees and have greater confidence that their top performers won't jump ship to join a competitor?

Without a doubt, culture and job satisfaction play a considerable role. But for many employees, compensation is the most compelling consideration — and for many executives, a standard benefits package is insufficient to persuade them to accept a job offer or to safeguard against them accepting a competitor's offer.

If you wish to offer more than the standard benefits package, nonqualified deferred compensation (NQDC) plans can provide an additional incentive to key executives and key employees.

Tax-Deferred Wealth-Building

Most simply, an NQDC plan is a deferment of compensation to a future date. This compensation can take many forms, including regular salary or bonuses.

From an employee's standpoint, this type of arrangement is beneficial in part because, as long as the compensation is deferred, it does not count as earned income and, as such, is not currently taxed. In this way, the funds can increase, tax-deferred. In addition, employees may feel more valued by an organization that gives them the opportunity to build wealth in addition to their normal salary.

For the dealership, offering NQDC plans can be advantageous because they are not subject to the IRS requirements for "qualified" plans (such as profit-sharing or 401(k) plans). Nonqualified plans must meet the requirements of Internal Revenue Code (IRC) Section 409A, but are otherwise quite flexible and can be established for one employee or many employees.

Nonqualified plans can have flexible terms when it comes to vesting, funding, appreciation, payout, and the plan document. Following is a more detailed explanation of each.

Vesting

With a nonqualified plan, dealerships can establish a vesting schedule specific to each individual in the plan or they can establish a single vesting schedule that applies to all participants. This flexibility can be important when a dealership is offering a plan to individuals of different ages; the vesting schedule for a 35-year-old employee may look different than the vesting schedule offered to a 60-year-old employee.

A plan can also have separate vesting schedules for each year to provide additional motivation to an employee to stay with a company. For example, if an employee is fully vested in the year one deferral but only 50 percent vested in the year two deferral, he or she may be more inclined to stay with the company until the year two deferral is 100 percent vested.

In addition, the plans often establish specific guidelines for changes in the vesting schedule in the event of death, disability, change in control (when the dealership is sold), or involuntary separation of service (if the employee is terminated).

Funding

Because they are nonqualified, NQDC plans have no funding requirements. A dealership can choose simply to pay the employee out of current cash flows when the employee qualifies for payout. Often, however, dealerships do set aside funds so the cash will be there when the time comes. The amount deferred each year can be determined by a formula, or it can be entirely discretionary. The funding amount can also vary by participant or can be consistent across all participants.

Appreciation

Once again, NQDC plans are flexible when it comes to appreciation of deferred funds. A plan document could state that deferred and vested funds will be paid out without any growth factor attached, or the plan could allow for a flat growth rate, such as 3 percent per year.

Another option is for the plan to tie its growth to the performance of an actual investment such as a bond fund or a fund that comprises the same 500 stocks that compose the Standard & Poor's 500 index. Or, the growth could be tied to the growth in value of the dealership. For example, if the dealership value grows by 5 percent, the funds that year also would grow 5 percent; if the dealership value grows by 10 percent, the funds that year would grow 10 percent.

Payout

The plan document must specifically articulate, at the commencement of the plan, how (timing and schedule of payments) and when (at a particular age or upon becoming fully vested, for example) the employee will receive the funds. In some cases, dealerships allow employees to provide input on when they will receive the funds, all of which must be spelled out in the plan document when the plan is established.

Plan Document

A dealership could have just one universal plan document – as with the vesting schedule, the funding, and the growth of funds – or multiple individual plan documents that cover the employees that are eligible to participate in the plan.

While NQDC plans offer a great deal of flexibility, as previously described, these plans must satisfy three requirements:

1. The deferred compensation arrangement between the dealership and the employee must be entered into before the compensation is earned.
2. The deferred compensation cannot be available to the employee until a previously agreed-upon future date or event.
3. The amount of the deferred compensation cannot be secured (in other words, it must remain available to the dealership's creditors).

The deferred compensation arrangement between the dealership and the employee must be entered into before the compensation is earned.

Nonqualified retirement plans are governed by IRC Section 409A, which lays out rules related to the timing and schedule of deferral elections and distributions. All nonqualified plans must comply with Section 409A rules or risk losing the tax-deferred status of the plan and subjecting participants to having all vested plan deferrals declared immediately taxable at a participant's regular tax rate plus a 20 percent penalty tax (potentially an additional tax representing earnings on the hypothetical underpayment of taxes from the year of vesting to the year of the 409A violation).

Drawbacks to Bear in Mind

Despite the benefits of NQDC plans for both employees and employers, these plans have a few drawbacks, including the following:

- Unlike with 401(k) plans, participants cannot take loans on an NQDC plan.
- NQDC funds may not be rolled over into an individual retirement account or other retirement account.
- To be eligible for tax deferral and exemption from the *Employee Retirement Income Security Act of 1974*, NQDC plans are required to be unfunded, meaning there is no guarantee the compensation will actually be paid in the future.
- Similarly, as NQDC funds are not segregated from dealership assets, they are subject to creditors' claims in a corporate bankruptcy.

There are ways to set aside assets – for example, rabbi trusts – that will be used for future payment and to help ensure that the dealership cannot go back on its word, but monies in this grantor trust would remain a part of the dealership's assets and still be subject to creditors.

To assess whether an NQDC plan is a good fit for your dealership, the following questions can serve to begin the discussion.

- Do you need today, or will you need in the future, a unique, long-term incentive to recruit and retain top talent to your dealership?
- Would key employees be interested in accumulating more money on a pretax and tax-deferred basis?
- Are you having issues with your retirement plans, under which key employees are limited in the amount of 401(k) contributions they can make due to nondiscrimination requirements?
- Are key employees worried about having adequate savings from standard retirement plans and Social Security?

If you answered “yes” to any of these questions, a nonqualified deferred compensation plan (either alone or in combination with a qualified plan) may be an attractive benefit program for your dealership.

Learn More

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