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How to Use Golden Handcuffs

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Golden handcuffs, or golden handshakes, are agreements between businesses and their key managers that reward loyalty, promote retention and help owners get a better return on their businesses. If you are a corporate manager or own a business, you need to know the right way to use the cuffs.

A golden handcuffs strategy can make a management position so attractive that it would be financially irresponsible to leave it, thereby protecting your top talent from rival companies trying to poach them.

How do big publicly traded companies pay their executives lavish compensation? Traditional defined contribution plans like 401(k), 403(b), 457, Simple and SEP IRA have non-discrimination requirements. That means that they must be equally accessible to all employees. They can lose their tax-deductible status if the assets in the plans are overwhelmingly concentrated in the highly compensated employee accounts. This is known as having a top-heavy plan. The Internal Revenue Service and Department of Labor frown upon it.

The solution is a nonqualified deferred compensation plan (NQDC) designed solely and exclusively for owners, senior management and key employees. An NQDC plan does not have to comply with the bulk of ERISA regulations and there are no IRS reporting requirements. The business must still file Form 5500 with the Department of Labor; however, if the business sends the DOL a letter notifying it of the presence of the plan, no further filing is necessary. For more information, you can go here.

Most golden handcuffs plans are discreetly offered as extensions to executive employment contracts with an explicit future promise to pay arrangement. Typical arrangements include:

- **Salary reduction and bonus deferral arrangements** often take the appearance of 401(k)-style accounts. An executive can defer salary and bonus annually into them. The company can match contributions to incentivize use of the plan. The money can be withdrawn at retirement or any other future point, and the executive can bolster his or her retirement savings using pre-tax dollars.

- **Supplemental Executive Retirement Plans (SERPs)** are top hat retirement programs funded entirely by the employer. Upon retirement, the SERP assets can foster a pension-style income for the key employee.

- **Excess Benefit Plans** are NQDC plans that provide benefits solely to employees whose benefits under the employer's qualified plan are limited by IRS Code § 415, including stock options with a vesting period of three years or less. Many key managers owe sizable income tax to the IRS corresponding to their considerable salaries. This allows key employees to defer most or all of their annual salaries, allowing the employee to pay capital gains taxes linked to the income from the options rather than income tax.

To fully reap these rewards, the key employee must fulfill the designated terms and conditions of the golden handcuffs agreement. Usually this requires staying in the executive position for a set number of years or completing a specific major project.

If the key employee quits before becoming fully vested, they can lose the matching dollars contributed to the plan by the company. Worse yet, there will likely also be a big tax bill as a result of receiving a lump sum of income.

How do companies fund golden handcuffs plans? Many businesses elect to do this with corporate-owned life insurance. Other options include a private annuity contract, company stock, or earnings from a company investment portfolio.

How can a life insurance policy be tapped to make payments to a living person? Loans are made against the cash value of the policy, or withdrawals from the policy. Such loans are commonly tax-free, and withdrawals are also tax-free to the extent of the premiums paid toward the coverage.

Insurance funding offers the business the potential for tax savings and cost recovery. If an executive puts away $15,000 annually into an NQDC plan for 20 years at 7% interest, in 20 years he or she will end up with $658,000. If those assets enjoy tax-deferred growth from insurance funding, the business can save 35% in federal taxes on the gains in that period. If the executive passes away with the company still owning the life insurance policy, the company would collect a sizable death benefit. More information about the advantages of COLI can be found here.

NQDC plans are commonly unsecured, meaning that if a company goes belly-up, a golden handcuffs plan may amount to an empty promise. Bankruptcy and poor cash flow may delay or reduce payments to the key employee. Someone may take over the company, or its owners may have a change of heart. Some firms these risks by establishing trust funds with banks and trust companies.

An NQDC plan is usually not a good idea for a small family business due to tax reasons. When a closely held business sponsors a NQDC plan, it canî deduct employee contributions to it until the year the employee recognizes income. If it sponsors a qualified retirement plan, such as a profit-sharing plan or a 401(k), it can deduct the contributions before the worker has to recognize them as income.

Using golden handcuffs can help align key employees with the long-term success of the company, and make them think twice about before taking that tempting offer they received from your competitor.

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