

Deferred Compensation Plans

Deferred compensation plans are agreements whereby an owner defers some portion of their existing wages until a specific future date. Salary earned in one period is paid at a future date. There are both qualified and nonqualified deferred compensation plans.

A Life insurance policy can be used to finance a deferred compensation plan. The deferred wages can be used to pay premiums on cash value life insurance. The cash worth can then be available at retirement as a supplement to other income or, if the insured dies prior to retirement, the insured's elected beneficiary will receive the policy's death benefit.

The disadvantages of any qualified plan include:

- the amount of the employer's contributions are limited
- nondiscrimination requirements prohibits an employer from providing benefits for highly compensated employees to the exclusion of other employees
- regular reporting requirements

The advantages of a nonqualified plan are:

- the amount of the employer's contributions are not limited
- the employer can pick and chose among the recipient employees without regard to years of service, salary level or any other criteria
- allows a business to provide benefits to officers, executives and other highly paid employees
- there are no significant filing or reporting requirements
- a nonqualified plan is less expensive to set-up than a qualified plan

Reminder: There are special timing rules related to FICA taxes and income taxes.

Qualified plan receives favorable tax preferences under the Internal Revenue Code:

- distributions are generally eligible for rollover to an IRA or other qualified plan, thereby permitting further tax deferral.
- the employer is entitled to a tax deduction for the amounts contributed to the plan;
- the benefits grow on a tax deferred basis until they are actually paid under the plan; and,

Reminder: Employers should have an IRS ruling regarding the tax status of a qualified plan.

A nonqualified plan does not receive favorable tax treatment:

- under the doctrine of constructive receipt the benefits are taxable to the employee at such time as the employee has the right to receive the benefits without regard to when the benefits are actually paid. The taxpayer does not actually have to take possession of the funds.
- the employer is not entitled to tax deductions until such time as the benefits are actually paid to the employee

Any agreements and insurance policies within a business must be integrated with the overall plan and objectives of the business. Careful consideration must be given to the selection of the plan which is right for your business and to the method of funding your plan.