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Voices Multiple uses of a deferred compensation plan in the workplace

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If your business clients want to reward employees for their loyal service after a five-, 10- or 20-year period and keep them around for longer, a deferred compensation plan can work well.

Should they wish to provide a financial incentive to encourage an employee to stay with them for a number of years, they can use a deferred compensation plan that acts as a "golden handcuff" because it's only available if the employee meets certain pre-set conditions related to the completion of an employment requirement.

Why should one of your business owner clients consider using such an arrangement? The DCP gives an employer an opportunity to do something special, to reward an employee or group of employees for their past or future service on a discretionary basis. This is done by allowing that specially selected employee to defer a portion of their current income to supplement their retirement income. If the employee doesn't have the financial ability to defer any part of their current income, the employer can lend the employee the money. If the employer chooses, the amount can match a particular employee's deposits.

The deferral to supplement an employee's future retirement income can be arranged on a pre-tax or after-tax basis. If the deposits are made on a pre-tax basis, the distributions will always be significantly larger than if they were made on an after-tax basis, as the tax on the funds distributed now have the ability to grow tax deferred in their deferred compensation plan, for the next 20 to 30 years rather than in the government's tax coffers. In addition to the larger future payout, there are also some current benefits, including payroll tax savings and the 3.8 percent Medicare tax savings for both the employer and the employee.

The objective in designing a DCP should always be to use the lowest available tax bracket, corporate or personal. A strategically designed deferred compensation plan often creates such alternate beneficial options when it comes to choosing between the employer's lower tax bracket and the employee's higher tax bracket. Lastly, in a closely-held business, the employer can also be the employee and take advantage of those benefits and savings themselves.

The Newport Group, an organization that offers group benefits, surveyed Fortune 500 companies last November and found that 92 percent of them offer a deferred compensation plan to their employees.

The top three reasons for doing so were to provide a competitive compensation program (83 percent), allow executives to accumulate assets to supplement retirement needs (72 percent) and retain valued executives (63 percent).

Although there are no surveys about implementing DCPs in the closely held business marketplace, their use there is equally effective. They should be implemented if for no other reason than to provide tax relief for the owners of the business

No matter which of the DCP options you or your client may be interested in, you'll likely be using an investment vehicle such as a mutual fund or life insurance. According to a recent Newport Group study, 73 percent of nonqualified deferred compensation plans at Fortune 500 companies in the U.S .are funded with corporate-owned life insurance, as are 82 percent of supplemental executive retirement plans, or SERPs. Life insurance policies can build up a significant amount of cash value on a tax-deferred basis, the sum of which can then be used to fund tax-free distributions from the deferred compensation plan to the employee at some point down the road, assuming no AMT complications.

Before we look at some of the uses, their intended benefits and the mechanics of how these strategies work, let's first define a deferred compensation plan. It's a contractual agreement between a corporation or other employer, and one or more of its key executives. The corporation promises to pay benefits in the event of death, disability or retirement, provided the executive is employed by the corporation at the time the benefit becomes payable. The typical deferred compensation plan is drawn up through a written agreement between two parties and should contain the benefits to be provided by the employer and the requirements executives must fulfill before they can receive these benefits.

In a nonqualified deferred compensation plan, the employer can discriminate in regard to whom it chooses to provide the benefit. While there are no governmental reporting requirements, for the first time, the 2017 New York State corporate tax Form CT-3-S and partnership tax Form IT-204 ask the question: "Were you required to report any nonqualified deferred compensation?" Perhaps that has something to do with the increased popularity of the DCP.

Let's look at a situation in a C corporation where an employee or employer might consider a traditional deferred compensation plan to provide supplemental retirement income. For example, a 45-year-old employee could choose to defer $25,000 of pre-tax income into a deferred compensation plan funded with a life insurance policy that will continue to grow its cash value on a tax-deferred basis until the employee reaches age 65. At that point, after 20 years the employee will have paid in $500,000. Then on the 25th year, at age 70, that employee could begin to draw out an annual income of approximately $139,000 income tax-free for the next 15 years until age 85, all the while having been covered for approximately $1 million of life insurance coverage.

The main reason why life insurance is so often the funding vehicle of choice is because a policy can be strategically designed so the deposits not only accumulate on a tax-deferred basis, but the income that's ultimately distributed to the employee can be on a tax-free basis. With life insurance, the employee has the ability to make a series of withdrawals from its cash value up to basis and then switch over to loans that never have to be repaid, as long as the death benefit survives the employee.

Employers can determine whether they select a traditional plan where employees pay for and own the policy themselves, or a nontraditional plan in which the employer will make a loan to the employee and by using a split dollar arrangement, still allow the employee to take full advantage of the inherent tax benefits at distribution. For example, the employer could lend the $25,000 annual deposit to a selected employee. In that situation employees would only have to pay the tax on the $25,000 they didn't actually receive. If the employer chose, they could also lend the employee the tax on the income, often referred to as a double bonus in a nontraditional DCP. In that case the death benefit is used to repay the corporation for any of its expenditures, with the balance going to the employee's family.

While only an employee of a C corporation is eligible to participate in a DCP, an employee of a Sub S, LLC or any other pass-through can enjoy the benefits of the new tax law by establishing a nonqualified SERP. For example, individuals who have maxed out their 401(k) contributions but would still like to defer some additional current income to supplement their retirement years could continue to make nondeductible deposits to a nonqualified SERP. In doing so, they could continue to take advantage of the tax-deferred accumulation aspects of a 401(k) plan, while also having the ability to take 100 percent tax-free distributions at any time, with no income restrictions, and no penalties for early withdrawals. It's kind of like a Roth IRA on steroids.

While the entity type will determine whether a traditional or nontraditional plan is used, the balance of the features left to be decided provide a great deal of creativity and flexibility as to their design capabilities and the many custom-made provisions that can be arranged between the employer and employee. However, none of these options comes with an automatic management feature. If people are using an investment product such as a mutual fund or ETF, they would certainly review the portfolio's performance at least annually or quarterly, if not more often. A similar view should be taken with a life insurance portfolio funding a DCP or a SERP, the reason being its performance must be evaluated to make certain the performance assumptions that were originally made were reasonable and are still on track to accomplish their initially intended objectives today.

Many in the corporate world have already taken advantage of the significant benefits of a strategically designed DCP or SERP. Statistics and practical observations as an experienced practitioner indicate that these popular corporate benefits are increasingly finding their way into the ranks of many smaller closely held businesses, primarily because of the ease of administration in setting up a plan and the ability of the owner to determine who can participate.

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