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The Power of Deferred Compensation Plans

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A deferred compensation plan, or DCP, is a contractual agreement between a corporation or other employer and one or more of its key executives under which the corporation promises to pay benefits in the event of death, disability or retirement, provided that the executive is employed by the corporation at the time the benefit becomes payable.

The typical DCP is drawn up in a written agreement between the two parties and should contain the benefits to be provided by the employer and what the executive must achieve before he can receive these benefits. While there are two types of plans, qualified and non-qualified, I'll be focusing on non-qualified plans. Unlike qualified retirement plans, non-qualified DCPs can discriminate and only choose highly paid executives. Also, there are no governmental reporting requirements.

Non-qualified plans are mere unsecured promises by the employer to the employee and aren't protected against a financial failure of the company. When the policy is owned by the employer, the employee is a mere creditor of the corporation.

If your client is an employer, she may want to use a DCP in a few different situations:

To reward an employee for his loyal service after a certain number of years.
To provide a financial incentive for an employee to stay with her company for a number of years. In this situation, the DCP acts as a "Golden Handcuff" because it's only available if the employee meets certain pre-set conditions related to the completion of certain employment requirements.
To reward an employee by supplementing his current retirement plan at some point in the future.
Designing Objectives

Just as the objective in a closely held business is to always attempt to use corporate assets to gain personal benefit, a similar objective in designing a DCP should always be to use the lowest available tax bracket, corporate or personal. A strategically designed DCP often creates such alternate beneficial options when it comes to choosing between the employer's corporate lower tax bracket and the employee's higher personal tax bracket.

Using Life Insurance to Fund the Plan

There are two funding methods for DCP investments in stocks and bonds or a life Insurance policy. For purposes of this article we'll be discussing a life insurance policy. One that builds up a significant amount of cash value on a tax-deferred basis is a good way to fund the deferred compensation plan. The policies of choice to fund a plan are whole life or indexed universal life, which are intended to take advantage of a policy's maximum ability to accumulate its cash value on a tax-deferred basis for a prolonged period of time.

Distribution of Accumulated Deferred Assets

Let's look at a typical situation in which an employee, aged 40, might consider a DCP to provide a supplemental retirement income for when he retires in 25 years. For example, the employee could choose to defer $25,000 of his income in a DCP, funded with a life insurance policy with a $ 1 million death benefit that will continue to grow on a tax-deferred basis until he reaches aged 65. At that point, the employee, assuming he was a non-smoker and in good health, will have paid in $500,000 after 20 years. Then on the 25th year, at aged 70, the employee begins to draw out an annual income of approximately $139,000 income tax free. One of the main reasons life insurance funding is used is the fact that a policy can be strategically designed to not only have the monies accumulate tax deferred, but also, to allow the income that's ultimately distributed to supplement the employee's retirement plan to be arranged through a series of loans and withdrawal of basis for the next 15 years on a 100 percent income tax-free basis. Further, the loans never have to be paid back as long as the death benefit survives the insured/employee.

Another example might be an executive who's unable to make any additional deposits to his 401(k) plan but would still like to supplement his retirement years by making some additional deposits while still working. Although that executive may no longer be able to make any further tax deductible deposits to his 401(k) plan, he would still be able to make non-deductible deposits while still taking advantage of the tax-deferred accumulation aspects of a 401(k) plan. And once those distributions are ready to be made, they too can be made on a 100 percent income tax-free basis, assuming some basic design rules previously mentioned are followed.

Tax Benefits

There are particular tax benefits to a DCP depending on whether the entity offering the DCP is a C corporation, a subchapter S or a limited liability company. The entity type will determine whether the employer selects a traditional plan, which the employee pays for and owns the policy himself. Or whether a non-traditional plan is used, in which the employer will make a loan to the employee and, by using a split-dollar arrangement, will still allow the employee to take a 100 percent income tax-free distribution at retirement.

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