

Strategic Insights



Nonqualified Deferred Compensation Arrangements

Why Retirement Planning is More Difficult for Business Owners

Business owners have two unique problems in funding their own retirement. First, tax-favored qualified plans restrict highly compensated individuals with limits on the amounts that can be deferred or contributed into these plans. Plus, nondiscrimination rules for these plans require you to contribute funds into these plans for all your qualified employees. These factors can restrict your ability to accumulate money for retirement on a tax-favored basis.

Many business owners are not taking significant salaries from their business earnings. Reasons for this include avoidance of high personal income tax rates and the need and/or desire to reinvest earnings back into the growth of the business. This makes funding outside investments for retirement difficult.

Chances are you are counting on your business to provide the needed dollars for retirement. Cashing in on your business for retirement involves more than just having enough financial resources inside the business. So, how can you cash in on your business when it comes time to retire?

Nonqualified Deferred Compensation Arrangements

A nonqualified deferred compensation arrangement may be the solution to these restrictions. If properly structured,¹ the business owner can avoid income taxation until the deferred amounts are actually or constructively received. (Note that these amounts are not tax deductible by the business until paid out.)

There are three types of deferred compensation plans.

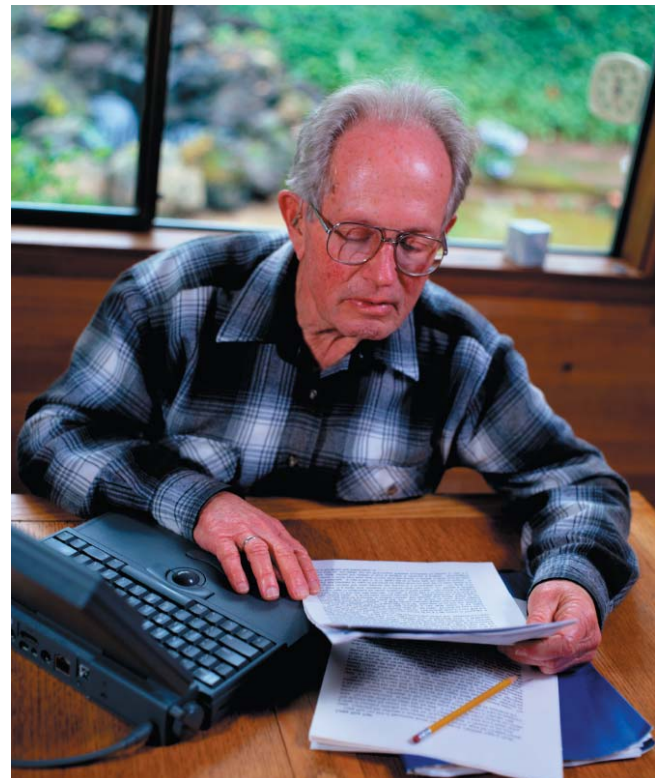
- Salary reduction plans allow the business owner to elect to defer some of his or her regular compensation
- Salary continuation plans provide a retirement income for the business owner without reducing current compensation.

¹The American Jobs Creation Act of 2004 added Code 409A which changed the law on requirements for nonqualified deferred compensation plans.

- Death-only plans provide retirement income for the business owner's family in the event of premature death.

In order for any of these plans to work, the continuation of the business through your retirement years is crucial. A business succession plan can be combined with a salary continuation plan.

Benefits to be paid to you in retirement are set out in the deferred compensation written agreement. The benefits must be subject to a "substantial risk of forfeiture," i.e., leaving earned compensation with the business in a salary deferral plan or staying with the company for a period of time in a salary continuation plan.



How a Salary Reduction Plan Works

- Business owner or key employee elects to defer some percentage of his or her salary or bonus. Income tax is not due on that money until it is received.
- Business enters into a written agreement setting the terms for when the deferral is to be paid (usually retirement).
- Business establishes a sinking fund or purchases a life insurance policy on the individual to cover the liability of the future payments.
- At retirement, the business pays the deferred salary as specified in the agreement. The business deducts the payment as salary paid, and the individual pays income tax on the salary paid including FICA and FUTA.

How a Salary Continuation Plan Works

- Business promises to pay individual a set retirement income contingent on the condition of continued employment for a period of years. The business does not get a deduction, and individual does not pay income tax on that money until it is received.
- The business and the individual enter into a written agreement setting the terms of the unsecured promise with a substantial risk of forfeiture.
- The business establishes a sinking fund or purchases a life insurance policy on the individual to cover the liability of the future payments.
- At retirement, the business pays the continued salary as specified in the agreement. The business deducts the payment as salary paid, and the individual pays income tax on the salary paid including FICA and FUTA.

How a Death Benefit Only Plan Works

- The business promises to pay individual's family a set retirement income or lump sum payment in the event of the individual's death prior to retirement.
- The business and the individual enter into a written agreement setting the terms for payment of the death benefit.
- The business purchases a life insurance policy on the individual to cover the liability of the death benefit payments.
- If the individual dies prior to retirement, the business pays the death benefit as promised.

A deferred compensation arrangement can also be used as a “golden handcuffs” plan for a select group of your key employees. You decide which of your key employees will participate.

Funding the Arrangement

Life insurance may be used to informally fund all these plans. The benefit of using life insurance is that it can provide significant pre- and post-retirement death benefits while accumulating funds to provide retirement income.

The life insurance is owned by the business, and the business is the named beneficiary. Cash values are an asset of the corporation, and the death benefits are received by the business income tax free. You have no personal ownership interest in the life insurance as the salary benefits must be an “unsecured promise” to you by the business.

Summary

Running a business in today's competitive environment can be challenging. Much of the success and growth of your business is attributable to your own talents and efforts. It is important that you plan your retirement as diligently as you have planned the growth of your business.

You can also enhance your overall executive benefit program by adding any one of these types of Deferred Compensation Plans. And when life insurance is used as a funding vehicle, the cost of the plan may be fully recovered by your business. Your Columbus Life Financial Professional is prepared to work with you and your advisors to create the programs that are best for your company, you, your family, and your key employees. Call today to find out more.

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