Deferring Compensation

In addition to providing qualified plans to employees, many business owners implement nonqualified alternatives in order to supplement retirement benefits. These selective benefit plans are generally offered to key employees and owners. One popular nonqualified benefit is deferred compensation.

Basically, nonqualified deferred compensation refers to an arrangement between an employer and an employee in which compensation for current services is postponed until some future date or the occurrence of a future event. The effect is to postpone taxation for the employee until compensation is received - usually at retirement or disability.

Types of Deferred Compensation

Deferred compensation plans can be categorized several different ways. Plans can be:

Funded or unfunded.

Forfeitable or nonforfeitable.

Defined benefit or money purchase.

They can also provide one or a combination of death benefits, disability benefits and retirement benefits.

Funded plans generally involve a trust fund or escrow account where the employer transfers money at a later date for its "promise to pay" deferred compensation. These are not very popular as the participant may be deemed to have "constructive receipt" of such funds and therefore inherits a current tax liability when funded.

IRS Revenue Ruling 60-31, 1960-2 CB 174, states that an employee's right to receive deferred compensation, backed during the deferral period solely by an employer's "naked promise" to pay, produces no currently taxable income for the employee. A deferred compensation plan is not regarded as funded merely because the corporation purchased and owns a life insurance policy or annuity contract to make certain that funds will be available when needed.

Rabbi Trusts

One of the problems with a typical unfunded deferred compensation plan is that the employee has no guarantee that future payments will be made. If the employer defaults in making promised payments, becomes insolvent, or files bankruptcy, the employee simply becomes a general creditor waiting in line with all the other creditors hoping to recoup some of their receivables.

The rabbi trust protects an executive from an employer's future unwillingness or inability to pay promised benefits while retaining the benefits of deferred income taxation. The IRS has stated in a series of private letter rulings that an irrevocable trust or an escrow account can be established to fund a deferred compensation agreement as long as the assets placed into the rabbi trust remain subject to the claims of general creditors. If this condition is met, the employee will not be deemed to have "constructive receipt" of the assets, and, therefore, will not have received a current economic benefit. Hence, the employee will not be required to pay taxes until the payments are made at a future date.

The rabbi trust gives the employee security in knowing that the employer is, in fact, setting aside money to fulfill its obligation under a deferred compensation agreement.