Deferred Compensation

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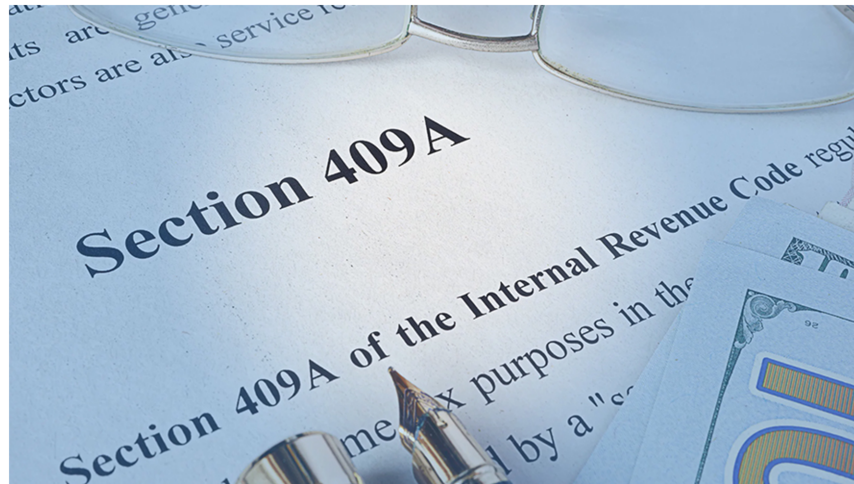
Deferred Compensation



The use of non-qualified deferred compensation arrangements has grown substantially in recent years.

This growth is attributable to many factors, including restrictive limits on contributions or accruals for the benefit of the highly compensated covered under qualified retirement plans, the increasingly burdensome and complex compliance requirements of qualified plans, and the need for more flexible, selective, and cost-effective mechanisms for compensating key employees.

Plan Characteristics

There are many different types of deferred compensation plans, but they all generally have several features in common. They are not subject to the nondiscrimination rules of qualified plans; therefore, they may be used to reward only a select group of employees.

The deferred compensation is generally credited with interest to compensate the employees for the time value of money while the compensation is deferred.

If properly arranged, the deferred compensation will not be taxable to the employees until they actually receive it.

Though tax deferral is generally beneficial, it can be counter-productive if an employee’s tax rate increases by the time the compensation is actually received.

Tax Considerations

In the current environment of constantly changing tax policy, growing federal and state deficits, and economic uncertainty, predicting future tax rates can be difficult if not impossible. Everything does, however, point to the strong possibility of increased personal tax rates.

Therefore, the critical issue for many employees and employers who are contemplating the use of non-qualified deferred compensation arrangements is whether deferral is worth it. That is, will employees be better off with the deferred compensation arrangement than they would be without it?

Clearly, if tax rates do not rise, a highly compensated employee will almost always be better off deferring some of his or her compensation until a later date. However, if tax rates do rise, an employee will be better off deferring the compensation to a later date only if the compensation is deferred for a sufficient period to time – the break-even period.

Specifically, if compensation is deferred, the employee will be taxed in a future tax year at a possibly higher future tax rate on the entire amount, including the interest credited on the account. If compensation is not deferred, he or she will pay tax at the current tax rate immediately and therefore have less available for investment.

The trade-off is between the current lower tax rate, that must be paid immediately and that reduces the amount available for investment, and the possibly higher future tax rate, that must be paid later and that allows the entire before-tax amount to earn interest.

If the income deferral period of time is sufficiently long, the benefit of earning interest on the before-tax amount of deferred compensation may exceed the cost of the higher tax rate that is applied to the whole amount when it is ultimately received.

Source: *Financial Planning Consultants, Inc.*

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- To conduct our business according to high standards of equity, honesty and fairness.
- To provide competent, prompt, client focused service which, in the same circumstances, we would expect for ourselves.
- To treat all clients with fairness and equity, to assure the best value possible.
- To remain your life-long financial partner to take care of your ever-changing needs.
- To help you reach your life's financial goals by understanding what is important to you.

Jose Feliciano, CFP, CLU, CHFC
Founder and President

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