Executive Deferred Compensation

Companies are constantly looking for ways to provide golden handcuffs to key employees to avoid losing the earnings power these individuals bring to the company. Whether a key employee leaves for a more lucrative offer or sustains an unplanned loss due to death or disability, the company can be financially impacted. For the executive, they are looking to provide protection for their family in the event of their death or disability and also want to be fairly compensated for the benefits they bring the company.

Three Benefits That Protect the Executive, the Family, and the Company

The company will incur a loss if the executive suddenly leaves for another job, becomes disabled or dies. By taking out a Key-Man policy on the executive, the company will be reimbursed the loss they will sustain in the event of the executive's premature death. The compensation the company receives will reimburse the company for lost business and the cost of training a new person to do the job the deceased employee performed. If the employee leaves for a new job, the cash value can be tapped to train a new employee and help the company through the transition period.

Secondly, the company can use a portion of the proceeds to provide a survivor income benefit to the family in the event of the executive's premature death. The executive can rest assured that if something happens to them, their family will receive a benefit from the company in the form of monthly payments or a lump sum.

Thirdly, the company can provide a financial benefit to the executive after a certain specified period of time (XX number of years) or in the event of disability in the form of a lump sum or annual payments. The life insurance policy can eventually be transferred to the participating executive typically as a deferred bonus thereby creating a supplemental retirement asset. After the policy transfer, any payment of the life insurance death benefit is made directly to the executive's beneficiaries.

How it Works

Under this arrangement, the written agreement with the executive sets forth the benefits the participating executive will derive from the plan either at death, disability or at the conclusion of the term of the agreement. The employer applies for and owns the life insurance policy on the valuable key executive's life. Premiums are paid by the employer, and a portion of the coverage is designated to indemnify the employer against the key executive's premature death. For the executive's promised benefits, the life insurance policy can act as an informal funding vehicle that is not specifically earmarked or vested in the executive. In addition, the employer can use the policy as a vehicle to provide the executive a benefit after the term of years and can bonus out the policy to the executive. This effectively reduces the executive's cost of acquiring the policy from purchasing it at

its fair market value to paying the income tax on the transferred cash value. Depending on the policy and the term, there may be sufficient cash value for the executive to borrow from the policy to pay the taxes on the cash value.

Taxation of Deferred Compensation

The executive has no interest in the insurance unless and until the policy is distributed to the executive. The executive receives no taxable income until the benefits are vested or paid. The employer does not get to take a deduction for the policy premiums until benefits are vested or paid to the executive. In other words, premium payments are not deductible to the company or taxable to the executive. Only when the benefits are vested or paid to the executive does the company get to deduct its payments to the executive and the executive then takes the payments into income. Upon vesting, social security tax is then due and payable.

409(a) Applies

Section 409(a) Deferred Compensation applies to this transaction, and the recent changes to 409(a) have in essence made deferred compensation more restrictive and less flexible. Section 409(a) considers compensation deferred for purposes of Code Section 409(a) if an employee has a legally binding right to future compensation and such compensation is not constructively received. There must be a substantial risk of forfeiture in order to avoid constructive receipt; i.e. the right to receive the compensation is conditioned on future performance and subject to a substantial risk of forfeiture (assets subject to company creditors).

Product Matching

The Executive Life UL product, which is a cash rich product, would be a great match for the deferred compensation market where the payment may be in the form of a death benefit or even a living benefit where withdrawals and loans from the policy are used to fund the benefit.