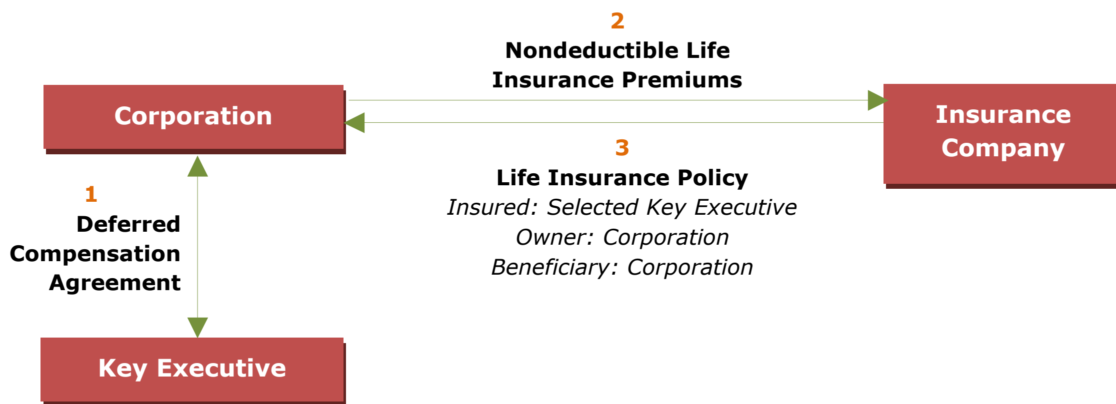
Deferred Compensation Plan in Action

Presented by: **Jim Lorenzen, CFP, AIF**
The Independent Financial Group

Prepared for:

Here's how a deferred compensation plan could work for your corporation and selected key executives today...



1. The corporation enters into a deferred compensation agreement with each selected key executive. The agreement spells out the benefits to be provided if the executive fulfills certain conditions, such as remaining with the corporation until retirement.

2. After satisfying the notice and consent requirements for employer-owned life insurance contracts, the corporation purchases sufficient insurance on the key executive's life to fund the after-tax cost of promised benefits and, if desired, to recover its nondeductible premium costs.

3. The life insurance policy is owned by the corporation, which pays the premiums and is named beneficiary.

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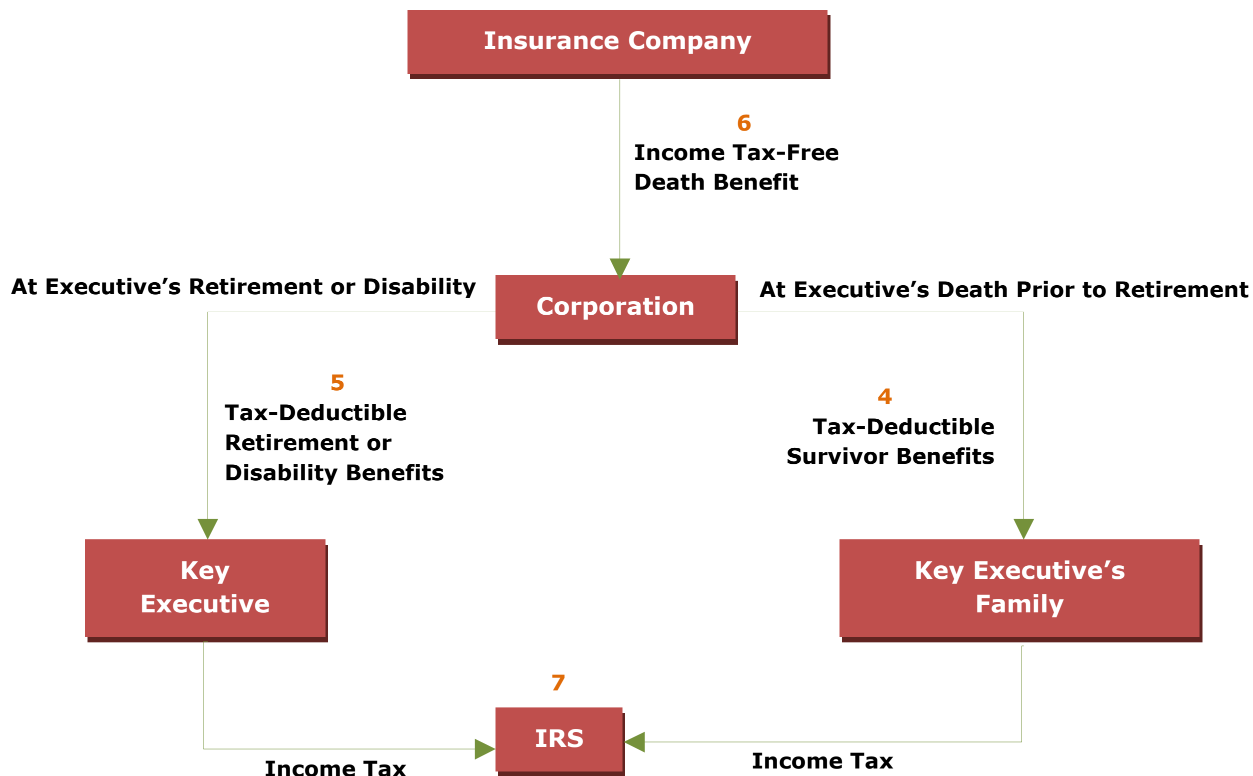
Here's how promised benefits could be paid from a deferred compensation plan informally funded with life insurance...



4. If the key executive dies prior to retirement, the death benefit is received free of regular income tax by the corporation (assuming the requirements for employer-owned life insurance contracts are satisfied). The corporation can then use the income tax-free death benefit to pay the promised tax-deductible survivor benefits to the key executive's family.
5. If the key executive becomes disabled prior to retirement or remains actively employed until retirement, the corporation pays the promised tax-deductible disability or retirement benefit from current cash flow, from loans or withdrawals from the policy's cash value, or from a combination of the two (withdrawals and loans will reduce the policy's death benefit and cash value available for use).
6. By maintaining the policy until the key executive's death, the corporation ultimately receives the income tax-free death benefit to recover its costs.
7. Benefits received by the executive or the executive's family are taxable as received.

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“Rabbi Trusts” and Deferred Compensation Plans

Presented by: **Jim Lorenzen, CFP, AIF**
The Independent Financial Group

Prepared for:

For the employee who wants further assurance that promised deferred compensation benefits will be paid, a "rabbi trust" may be the solution.

In order to avoid current income taxation, funds set aside by an employer to informally fund future deferred compensation benefits must be subject to the claims of the general creditors of the employer. These funds, however, could also be used by the employer for other business purposes. This can be a cause for concern to employees who are participating in a deferred compensation arrangement, particularly when they are electing to defer an actual portion of their current compensation in return for future benefits.

A useful tool for overcoming this concern is the **"rabbi trust"**, so-named because the first rulings involving this form of trust dealt with a deferred compensation arrangement established by a congregation for its rabbi.

A "rabbi trust" is an irrevocable trust into which an employer contributes money to fund the promised deferred compensation benefits. Since the assets of the "rabbi trust" remain available to the general creditors of the employer through court judgments, the employee's rights to future benefits remain forfeitable, thus deferring taxation until benefits are actually received. Under the terms of the trust, however, access to the funds is denied to both current and future company management. This gives the employee some assurance that a change in company management will not result in plan funding being used for other business purposes.

The IRS has issued guidelines for "rabbi trusts" which, if followed, will provide assurance that contributions to the trust will not be currently taxable to the participating employees.

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“Secular Trusts” and Deferred Compensation Plans

Presented by: **Jim Lorenzen, CFP, AIF**
The Independent Financial Group

Prepared for:

Do you believe that income tax rates will be higher or lower in the future?

The purpose of a "secular trust" is to give an employee complete assurance that money set aside by an employer to fund future deferred compensation benefits will be available for that purpose, even if the business goes bankrupt. To achieve this result, however, produces distinctly different income tax results from the traditional deferred compensation arrangement.

With a "rabbi trust," the money set aside by an employer to fund future benefits is not available to management to use for other business purposes, but is available to the company's general creditors. In contrast, a "secular trust" denies access to the funds by **either company management or the company's creditors**.

Since the employee's rights to the funds in a "secular trust" are nonforfeitable, however, the employee is currently taxed on employer contributions to the trust and the employer, in turn, receives an immediate income tax deduction. If it wishes, the employer can pay the employee a tax-deductible bonus sufficient to cover the employee's increased income tax. Finally, future benefits are received income tax free by the employee, since taxes have already been paid.

Use of a "secular trust" may be appropriate if the long-term solvency of the company is questionable, or if the employee believes that income tax rates will be higher in the future. Since taxes have already been paid, future benefits will not be subject to these potentially higher income tax rates.

In order to avoid unintended tax consequences, your legal and tax advisors should be consulted when considering use of a "secular trust."

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