National Tooling & Machining Association

NTMA

PRECISION

Business Management Advisory

For Precision Custom Manufacturers

AC18 **File: ACCOUNTING AND FINANCE**

LOWERING INCOME TAX THROUGH DEFERRED COMPENSATION

SUMMARY

Deferred compensation arrangements can be just what the doctor ordered for a business wishing to attract key employees or to lock in those key employees already a part of the organization. Deferred compensation is a contractual arrangement between an employer and an employee under which the employer agrees to pay at some future date — usually at retirement — compensation for services the employee renders currently. Usually, the contract will provide for benefits on death or disability as well as retirement. When the employee receives the deferred compensation, he or she presumably will be in a lower tax bracket because of lowered income, and by deferring current taxation of part of current pay to this more attractive tax situation, this individual should enjoy more after-tax dollars. Additionally, the Social Security Administration has ruled that the deferred amounts will not affect Social Security payments since the deferred income is for services previously performed.

SOME HISTORY OF DEFERRED COMPENSATION

The concept of deferred compensation has been around for some time. Since 1960, the rules have been fairly well established that a taxpayer need not include in income any part of pay that has not actually or constructively been received. By entering into an agreement with the employer prior to rendering a service, the taxpayer can defer taking payment for that service until a more advantageous tax period is reached.

However, early in 1978, the Internal Revenue Service temporarily threw the situation into confusion by proposing new Treasury Regulation 1.61-16 which provided that if an employee elected to have a portion of the current income deferred, the amount deferred would be included in current income. The fact that the employee's rights were forfeitable was immaterial. Needless to say, few employees would be willing to risk losing pay they could receive currently, even if they did have to pay the tax on it.

The proposed regulations seemed to curtail only those deferred compensation arrangements which involved the election on the part of the employee to defer income.

Those contracts initiated by an employer to attract or retain a key employee apparently were not affected, although it seemed clear that the Treasury Secretary was in favor of eliminating tax deferral on all but "broad-based" plans covering large segments of employees.

Resounding public criticism and Congressional action effectively eliminated the proposed regulations (except for plans of private, tax-exempt employers) through the Revenue Act of 1978. Only organizations under Section 501 of the Internal Revenue Code remain affected by the proposed regulations.

Thus, at the present time, the capital accumulation opportunity afforded by deferred compensation is still available to employees entering into such arrangements with their employers.

TWO IMPORTANT CONCEPTS

The IRS-defined concepts of constructive receipt and economic benefit are the heart of deferred compensation.

Under the doctrine of constructive receipt, income, although not actually reduced to a taxpayer's possession, is constructively received in the taxable year during which it is credited to his or her account, or set apart for this individual so that it may be drawn upon at any time.

However, income is not constructively received if the taxpayer's control of its receipt is subject to substantial limitations or restrictions. The IRS has ruled that there will be no constructive receipt of income even though the employee's rights are non-forfeitable if both:

1. The agreement is entered into before the compensation is earned;
2. The employer's promise to pay is not secured in any way.

Economic benefit refers to acts or transactions performed by an employer that result in something of value being bestowed upon an employee. An example would be the establishment of an irrevocable trust for the benefit of an employee under which the employee enjoys non-forfeitable benefits from contributions by the employer. This economic benefit would be deemed to be income and subject to immediate taxation in the year the contributions were made. To accomplish its purpose, any deferred compensation arrangement must eliminate the application of constructive receipt of the deferred income and avoid any current economic benefit to the employee covered by the contract. Otherwise the effort will be to no avail.

TO FUND OR NOT TO FUND

Deferred compensation contracts can be funded or non-funded. Under a funded arrangement, the employer sets aside assets to meet the future obligations of the contract and the employee is currently taxed on any contributions to the extent he or she is substantially vested. Substantial vesting occurs if the benefit is transferable or not subject to a substantial risk of forfeiture (for example, when the employer purchases an annuity contract with the employee named as owner, or the employer establishes an irrevocable trust for the benefit of the employee). As amounts vest, the employee must include the vested portion in the gross income and the employer is allowed a deduction for the same amount.

An unfunded contract must not be formally funded and the employee's rights must be subject to substantial restrictions, or if benefits become non-forfeitable, there must not be any present economic benefit from or constructive receipt of the benefit. Therefore, the employee has only an unsecured, contractual right to future payments. When payments begin, they are taxable to the employee and tax deductible to the employer.

EXAMPLE OF TAX SAVINGS THROUGH DEFERRED COMPENSATION

To illustrate how a deferred compensation arrangement might work to the advantage of an executive, assume that an employer is willing to pay Mr./Ms. Executive a $12,000 bonus for 10 years, that this person is in a 50% tax bracket and that the deferred bonus can be invested so as to earn 8% interest. The result is as follows:

Amount of Bonus	$ 12,000	$ 12,000
After-tax Dollars for Investment	6,000	12,000
Assumed Rate of Return	8%	8%
Pre-Tax Value at End of 10 Years	-	173,839
After Tax Value at End of 10 Years	72,037	86,920
Gain from Deferred Income	-	21%

DEFERRED COMPENSATION NOT A SUBSTITUTE FOR A QUALIFIED PLAN

Deferred compensation should never be considered as a substitute for a qualified pension or profit sharing plan. Instead, it is best used as a supplement to or in conjunction with a qualified plan to solve individual problems that cannot be handled through a qualified plan because of the participation and funding requirements of such plans.

PROFESSIONAL GUIDANCE CALLED FOR

Deferred compensation arrangements have important advantages to the employers and employees. However, each situation must be considered as though it were different from any other since a small oversight in drafting the contract can completely negate the tax saving potential. Therefore, professional guidance is essential to setting up a plan of this type.

This BMA was prepared by Carlin-Black-Mercer, Columbus, Ohio, an employee benefit consultant firm.