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Time For A Deferred Compensation Plan?

Back in October 2004 Congress passed a new law in response to the perception that businesses were abusing deferred compensation programs. The law was written very broadly and seems to have had the effect of having companies shy away from a very valid compensation platform.

The state of the economy should have many companies looking at deferred compensation as a key strategy to help retain their key employees. In a time where many companies do not have current resources to provide raises or maintain the current standard of living, the promise of a future payment for helping the company through the tough times may provide great incentive and pride for the employee.

A Deferred Compensation Plan allows the employee to earn money now or over a period of years and not pay tax on that money until it is actually paid out. Correspondingly the company does not receive a tax deduction until the money is paid either.

Starting a deferred compensation program does require a lot of forethought. To comply with the law the plan is required that the plan be in writing, have strict set payout dates, state what the payouts will be or how they are calculated and not be funded with an offshore Rabbi Trust.

The payout dates have received the most attention; this requires the payout to be on specified dates, at death, change of ownership, separation of service, disability, or unforeseen emergency. Failure to meet these requirements will result in a stiff penalty to the employee.

The employee would recognize taxable income when they earned the compensation regardless of when it is paid. This results in paying the regular income tax with a twenty percent excise tax on top of that. Another non-tax consideration is to design the plan to meet the goals of the company. Whether the plan pays a set amount of compensation or a amount determined by formula tied to the value of the company in order to be successful the goal must be in line with owners goals.

Deferred compensation plans can be extremely flexible. They can be as simple as a cash payment to an employee if they remain with the company for a period of years, or as complex as a phantom stock plan with a special formula to determine the value of the company subject to a vesting schedule. The key is that as long as it is put in writing and meets the legal requirements talked about above the company and the employee can agree to virtually anything.

The risk of the penalties does make this a Deferred Compensation Plan an item that should be discussed with the company's lawyer and CPA. Even with those risks this is potentially a very creative way to not only retain a key employee but to also tie their compensation to the interests of the company.



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