Deferred Compensation - One Size Does Not Fit All

When I sat in "Advanced Market Training" at the very beginning of my career I was informed about a variety of great tax strategies for businesses to use. Everyone of them involved some type of Non-Qualified Deferred Compensation (NQDC) arrangement, and each involved an amazing Tax Deferred Growth for an Employee and Tax Deductions for the Employer. After the training, I got into the Real World and learned about Subchapter S Corporations and LLCs, and I realized that these amazing strategies did not apply to all businesses.

Since that training I have found that quite often an Insurance Agents attempt to apply many NQDC strategies universally. The facts are that all of these strategies do not apply universally, and often in a pass through entity NQDC strategies do not work as explained in the carrier training material which was focused on C-Corps.

> Jack Doe owns JD Development, LLC, a software development firm that specializes in creating database applications for government. Jack is 50 and is setting a plan in motion to sell JD Development in the next 10 years. His plan is to sell to an outside entity because he believes that will net him the most value; however, if he were to lose his Larry his Lead Developer or Candy his Contracts Officer his plans would be gravely affected. Larry and Candy not only perform key management and business functions internally, they also are well connected to Federal and State Government clients and prospects.
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> Rather than offer LLC Shares to either Larry or Candy, Jack has decided he would like to increase their salary and defer that increase contingent on Larry and Candy staying at JD Development, LLC for at least 10 years. Because of his plans for the overall business Jack wants the plan to be simple and to not create any issues with his financials.
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> Jack meets an insurance agent at a networking event and after a few meetings is sold on the idea of buying Whole Life policies on Larry and Candy which will be owned by JD Development, LLC. Jack plans to pay the premium with the deferred income as the agent told him he could and receive a Tax Deduction for the premiums he pays while Larry and Candy build up Tax Deferred Growth on the income.
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> Jack mentions the idea to his CPA during a prep meeting for his annual audit, the CPA fills in some of the blanks Jack is missing from his talk with the agent. Owning the policies in the company name creates another asset on the balance sheet. Also his "Deferred Compensation Agreement" if done properly is a 409(A) plan which will be an "unfunded liability". JD Development can't take an immediate tax deduction on that deferred income, Jack will need to wait till Larry and Candy take the income to receive any deduction. Jack will also have to add an entirely new set of reporting to the IRS annually for the 409(A) plan. The CPA also explains that this only the financial side of the issue, there is a whole other set of issues to wrestle with around the legal aspects of properly setting up a Deferred Compensation agreement.
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> Jack stops the conversation with the Insurance Agent and reaches out to his lawyer and CPA. Together they reach the conclusion that Jack needs: immediate tax deductions for the business, a written legal agreement with Larry and Candy surrounding the deferred compensation & a formal vesting plan for how and when Larry and Candy receive the funds. Jack's Lawyer recommends a Restricted Employee Bonus Arrangement (REBA). Larry and Candy each receive a life insurance policy with cash value owned in their name, funded by a bonus from JD Development, LLC. Part of receiving the bonus is an employment agreement to stay at JD for 5 years or they surrender the policy and all cash value inside it. Jack gets an immediate tax deduction on the bonus, and he also "handcuffs" Larry and Candy without greatly affecting his financials. Jack uses an agent recommended by his lawyer to handle the underwriting and putting the policy in place.

Not all Deferred Compensation works the same, business owners need informed partners to discern the best choices for their goals and their businesses.