

## BENEFITS AND CAVEATS OF DCAs

### Benefits

*Supplement to a qualified plan:* A DCA can provide benefits in excess of those limited under IRC sections 401(a)(17) and 415. They are frequently referred to as SERPs (supplemental executive retirement plans).

*Tax savings:* The participant may be in a lower tax bracket when she retires and the DCA payments are available. Additionally, the employee reaps the time-value benefit of deferring the payment of taxes, with the employer receiving a reciprocal time-value detriment to the employer whose deduction is deferred.

*Recruiting and keeping executives:* A DCA can be utilized to recruit a new executive who would lose unvested benefits from his former employer (a golden parachute—a bona fide DCA—is generally exempt from IRC section 280G), to allow executives to share in the profits based on performance, or to lock in an executive (velvet handcuff) by making it disadvantageous for him to change employers.

*Early-retirement inducement:* A DCA can be useful in implementing a selective early-retirement program, which is usually impossible under its qualified plan.

*Protection of management:* A DCA can help a company with temporary cash-flow problems maintain or recruit executives.

### Caveats

*Can a qualified pension or profit-sharing plan do a better job?* The two major problems with a DCA—lack of security for the employee, and deferral of the tax deduction for the employer—are avoided with a qualified plan. Qualified plans, however, must meet the burdensome ERISA compliance requirements: reporting, disclosure, minimum participation, and vesting. In the case of a family business, key employees tend to be family members and friends. Broad participation and vesting of benefits become less of an employer burden and more of a legitimate tax shelter. Such a plan should be thoroughly explored before implementing a DCA.

*Will a professional corporation finance its DCA obligation through company-owned life insurance?* A problematic situation may arise in which a controlling shareholder-employee of a professional corporation is inclined

to enter into a DCA with her company and to have the company finance its obligation through a cash-value company-owned life insurance (COLI) policy. Although life insurance does have myriad business uses, its use in a professional corporation as described above is inappropriate. A personal service corporation is taxed at a flat 35% corporate rate on any of its retained income used to informally fund the DCA in a rabbi trust or otherwise, including income retained to pay premiums on the COLI (the premium payments are not tax deductible). This corporate tax rate may be higher or approximate the tax rate that would have been paid by the employee if the income were paid out currently. Moreover, the employee continues to be subject to the future risk that the corporation will be unable to fulfill its contractual obligations under the DCA. If there is a need for life insurance protection, the corporation should pay additional compensation to the employee to cover the premium cost. This will result in taxation at only one level: the employee's. In addition, the employee will be the outright owner of the life insurance contract, as opposed to the possessor of a contractual right to receive payments under the DCA.

*Will the DCA benefit be offset by a loss of other qualified retirement income?* If an employer is also maintaining a qualified retirement plan, an employee should not electively defer compensation in a DCA if this would result in a reduction in employer contributions to the qualified plan. Because qualified plan contributions are typically based on a percentage of currently taxable compensation, reduction of that taxable compensation through an elective DCA may reduce contributions to the qualified plan.

*Is the employer a good security risk?* Tax deferral can be obtained only if the DCA is unfunded. The employee has no security for the payment of DCA benefits beyond the financial ability of the employer to meet its contractual promise. Even in the case of a "quasi-funded" arrangement, such as a rabbi trust, receipt of DCA benefits remains a function of the ongoing solvency of the employer. □