

Concept Profile

SALARY DEFERRAL

Earn Now, Pay Later

It is the beginning of the twenty-first century and we have historically low unemployment, a very tight and competitive job market, as well as the creation of new industries that were unheard of just a decade ago. But one issue remains the same, how do companies recruit and retain talented, highly compensated employees? One way is by establishing non-qualified deferred compensation plans, such as a Salary Deferral Plan.

WHAT IS A SALARY DEFERRAL PLAN?

A Salary Deferral Plan is a plan in which an executive can elect to defer part of his or her salary, bonus, and commission. Salary Deferral Plans may be structured to supplement or “mirror” a 401(k) plan. Unlike a standard qualified 401(k) plan, 401(k) mirror plans do not have a maximum deferral limit and may be offered only to selected employees.

WHY ESTABLISH A SALARY DEFERRAL PLAN?

A Salary Deferral Plan is an excellent benefit to offer highly compensated executives who are faced with reverse discrimination due to qualified plan restrictions and limitations. Corporations usually target to provide retirement compensation to employees for at least 60% of the three-year final average of salary and incentive compensation. However, a cap has been placed on the amount of compensation that may

be used in calculating qualified retirement benefits provided by an employer. For 2002, these per year limits are: \$160,000 for annual benefits from a defined benefit plan and \$200,000 for setting the maximum amount of compensation for determining benefits in a defined contribution plan. Therefore, businesses may not be able to provide their top executives with 60% of their final three-year average of salary and incentive compensation at retirement. For example, an executive whose total salary and incentive compensation is \$425,000 will receive \$120,000 (60% of \$200,000) a year, which is only 28% of his or her final pay. One way a business can help the executive reach 60% is to establish a Salary Deferral Plan.

HOW DOES IT WORK?

The executive and employer enter into an arrangement to defer a certain amount of compensation for the year. This amount is credited to a “phantom” interest bearing account and is ordinarily distributed over a period of time, beginning at retirement or termination of employment. This account is also ordinarily payable in a lump sum at the death of the participant.

EXAMPLE

The Signature Corporation has 12 top executives and at the beginning of the year they each elect to defer \$55,000 of their income. This amount goes into a “phantom” interest bearing account and the \$55,000 plus any credited interest will be paid to each executive for 15 years starting at retirement. Let’s assume that the phantom interest rate is 10% a year. One executive is age

47 and he will retire at age 62. The \$55,000 annual contribution plus 10% interest is projected to grow tax-deferred to \$1,922,235. The executive will be able to receive \$229,749 (\$137,849 after-tax) a year for 15 years after retirement. This can be compared to investing the \$55,000 (\$33,000 after-tax) annually at 6% (growing to \$814,193 after-tax, assuming a 40% tax bracket), and only receiving \$79,085 a year for 15 years after retirement.



ADVANTAGES OF SALARY DEFERRAL PLANS

Employer	Employee
<ul style="list-style-type: none"> • Able to select participants • May co-exist with qualified plans • Increases competitiveness with “Total Compensation Packages” • Minimal set-up cost 	<ul style="list-style-type: none"> • Solves “reverse discrimination” problem • Tax-deferred growth of assets • Provides additional source of retirement income • Potential unlimited contributions

SUMMARY

Salary Deferral Plans can be an excellent addition to incentive packages, and a way to reward key employees. These plans will ordinarily have a minimal cost to the employer. The ideal candidates for a Salary Deferral Plan are highly compensated employees looking for a way to minimize taxes and maximize retirement income.

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