Deferred compensation plans and pass-through tax entities

In closely held for-profit companies, the use of pass-through tax entities is common. The most popular entities are S corporations, partnerships, limited liability partnerships (LLPs), and limited liability companies (LLCs). LLCs usually elect to be taxed either as S corporations or partnerships.

There are two main reasons for closely held company owners to consider using pass-through tax entities. Double taxation occurs in C corporation structures when earnings are taxed at the corporate level and then again when a dividend is paid to the owners. Pass-through tax entities are subject to only one level of taxation and may also allow owners to take direct advantage of tax losses that would be "locked" in a C corporation.

Ordinarily, there is no income-tax advantage for pass-through entity owner-employees utilizing nonqualified deferred compensation benefits. Since deferred compensation benefits are tax deductible only when paid, any increase in taxable income due to owner-employee deferrals at the entity level flows directly through to the owners. Any decrease in W-2 income due to the deferral is completely offset by the increase in K-1 (passthrough) income. In multi-owner scenarios, the use of deferred compensation can cause a disproportionate taxable income effect if owner-employees defer amounts that are disproportionate to their ownership interest. For these reasons, deferred compensation is not normally beneficial for owner-employees of pass-through tax entities.

On the other hand, deferred compensation is a valuable benefit for key non-owner executives of a company. Pass-through tax entities have the same issues in recruiting, retaining, and rewarding key employees as other entities. Although it is not advantageous to use deferred compensation benefits for themselves, pass-through entity owners may want to offer these benefits to non-owners within their organization. The use of company contributions with vesting schedules based on service or performance can be particularly helpful in rewarding key employees and making sure they remain with the organization.

Pass-through entity owners should consider these tax and cash-flow issues

- Deferred compensation benefits are not tax deductible until the benefits are paid. Employee deferrals that normally would have been currently deductible as compensation will flow through to the owner's K-1, increasing taxable income. When a distribution is paid, the taxable income will decrease.
- The owner's basis in the pass-through entity will increase by the additional amount of taxable income flowing through due to employee deferrals and will decrease by tax-deductible distributions from the plan. This will affect capital gains calculations if the owner sells his or her stake in the business.

- The current value of the owner's interest in the entity will increase because of the value of the future tax deduction that will be available when the deferred compensation benefit is paid. If an owner sells an interest in the entity before distributions occur, the value of this future tax benefit should be included in selling price negotiations.
- Owners should carefully consider the type of assets purchased to informally finance deferred compensation benefits. The tax issues are like those of C corporations, but again, all taxable income flows through to the owner's personal return. Taxable mutual funds will generate ordinary and capital gain income to the owner; corporate-owned life insurance will grow tax-deferred, and with proper planning, offer tax-free benefits to the entity and its owners.