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Qualified and Nonqualified Deferred Compensation Plans in Small Businesses: Creative Uses and Problem Solving

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I. Overview

a. *Using Benefit Plans to Solve Compensation Challenges*. At some point in their life cycle, privately held businesses of all sizes and types will almost certainly run into the same issue—how to adequately compensate a mission-critical employee or a handful of top managers whose skills and pay structure demand additional upside or more complex tax planning. While paying an employee in a privately held company may seem limited to a small handful of straightforward options, there is almost always a deferred compensation or executive compensation planning technique that will provide the right incentives to employees while maintaining tax advantages over a simple pay raise or cash bonus.

Like anything else in the employee benefits field, though, the advantages, pitfalls, and tradeoffs can be complex, counterintuitive, and potentially costly if not well thought out in advance. This outline will delve briefly into some of the qualified and nonqualified deferred compensation plans and other executive compensation arrangements that can be tailored to almost any situation requiring a creative compensation solution. As may be obvious from the context, every possible type of plan or compensation arrangement cannot be covered in this brief outline. Books could be filled—and many have—with compensation planning techniques aimed at solving these thorny issues. This outline serves only to introduce the reader to some creative solutions to recurring key employee compensation solutions.

The examples in this outline are based on, or are similar to, actual situations encountered in practice. Many of the conclusions discussed below may have been reached due to the particular circumstances and individual preferences—certainly there are other viable ways of addressing some of the scenarios. Other legal factors outside those mentioned also play a role. In short, there is never a magic bullet.

b. *Qualified Retirement Plans.* For those unfamiliar with the distinction, "qualified" retirement plans refer to those plans that are "tax-qualified" under Section 401(a) of the Code. These include 401(k) plans, profit-sharing plans, defined benefit pension plans, employee stock ownership plans ("ESOPs"), cash balance plans, and a few others. (Closely related, but not discussed in depth here, are "eligible" plans such as 403(b) plans and most 457(b) plans; they are tax-advantaged much like "qualified" plans but use different terminology based on their respective Sections of the Code.)

Qualified plans come with a laundry list of highly technical requirements—covering a minimum number of employees; not discriminating in favor of highly compensated employees; fully funding a trust with contributions; complying with stringent fiduciary obligations; performing compliance testing; completing annual filings and participant disclosures; abiding by distribution timing requirements; and many others. The full scope of this set of rules again falls outside the scope of this outline.

c. *Nonqualified Deferred Compensation Plans and Equity Compensation*. In contrast to qualified plans, "nonqualified plans" are free from many of the restrictive and onerous coverage, compliance, fiduciary, and disclosure requirements that make qualified plan sponsorship so complex. They also refer to a broader set of arrangements. While not always strictly "deferred" compensation, this outline will refer to some equity and executive compensation planning mechanisms under the broader label of nonqualified plans. These can range immensely—from salary deferral plans to stock grants; from insurance-based retirement plans to retention bonus tools.

Nonqualified plans allow much more latitude in favoring executives, but generally don't carry all the same tax advantages of a qualified plan. Where qualified plans almost always involve immediate deductions for contributions into the plan and tax-free or tax-deferred growth, nonqualified plan payments generally are not deductible by the company until included in the executive's taxable income. In many cases, nonqualified plan payments must come solely from the employer's general assets, meaning executives may be subject to the company's credit risk for decades, even into their retirement.

A relatively recent concern—and massively important consideration—for all nonqualified deferred compensation plans is the much-maligned Code Section 409A. With final regulations running the length of a short novel, Section 409A overlays the entire field of nonqualified deferred compensation. While, again, the full scope of that Code Section alone runs well beyond the space allotted here, no deferred compensation arrangement is complete without a thorough analysis of the 409A implications.

d. *When Things Go Awry.* With anything this complex, something is bound to break. This outline finishes with a brief discussion of how to correct errors in qualified (and some nonqualified) deferred compensation plans.

II. Qualified Plans

a. *Employee Ownership - ESOPs as Succession Strategy*

i. Scenario: The two owners of a profitable mid-sized S corporation want to retire and sell the business, but would like to find a way for its long-term employees to own and control the company. The owners can't find any buyers in the market who they are convinced would run the business as well as its current workers.

ii. Solution: Adopt an employee stock ownership plan, or ESOP, which will purchase the owner's shares and transition ownership of the company to the current and future employees.

iii. How it Works: An ESOP is a qualified retirement plan that covers a broad-based employee population—much like a profit-sharing plan or 401(k) plan—whose primary investment is the employer's stock. Particularly powerful are 100% ESOP-owned S corporations, which pass through all tax liability to their shareholders, which in this case is a tax-exempt trust, thereby creating a tax-exempt, "for-profit" company.

As part of succession planning, an ESOP can be formed and initially purchase only a part of the company's shares, or it can purchase all the company's shares. Once the ESOP owns all or a part of the company's shares, the company makes deductible contributions to the ESOP (like profit-sharing contributions), which in turn result in shares being allocated to each participant's account. As the company's share value hopefully increases, the participants' account balances grow along with it. When employees leave the company or retire, generally their shares are redeemed or paid out in cash, restricting ownership of company shares to current employees only.

Creating, maintaining, and operating an ESOP is a complex and significant undertaking involving retirement plan compliance, corporate finance and governance issues, and significant administrative responsibilities, but can provide an extraordinarily powerful incentive for employees who are now also shareholders in the company.

b. *Maximizing Owners' Profit Sharing Contributions – Each Participant in a Separate Allocation Group (New Comparability Discrimination Testing)*

i. Scenario: A small S corporation has three owners who are significantly older than their employees and would like to maximize their deductible retirement plan contributions every year. They are already deferring the maximum amount under 401(k), but the plan requires that any profit-sharing contribution must be a flat percentage of each employee's compensation, meaning a profit-sharing contribution of 15% of pay to the three owners also requires a profit-sharing contribution of 15% of pay for the company's dozen or so other employees, who are primarily younger, lower paid, and in higher turnover positions.

ii. Solution: Amend the plan to allow profit-sharing contributions to be separately determined for each participant and tested under the "new comparability" formula.

iii. How it Works: The "new comparability" approach is simply a method for passing required compliance testing when making profit-sharing contributions; however, when used under the right employee demographics, it can result in significantly higher contributions to older participants, who in many cases are the most highly compensated employees or business owners. The testing method and details are complex, but the basic principle is that each employee's profit-sharing contribution is projected out to that employee's retirement age—generally 65—in determining whether the employees' contributions discriminate in favor of the business owners and highly compensated employees.

With the right demographics—for example, two owners aged 62 and 59 and ten other lower-paid employees in their twenties and thirties—this approach can result in dramatically higher contribution amounts for the business owners compared to the younger, lower-paid employees. Often the formula is arrived at by assuming the maximum profit-sharing contribution for the owners, then working backwards to calculate the minimum required contribution for each other employee. While it's a more complicated plan design, it can result in tens of thousands of additional dollars that are immediately deductible by the company and tax-deferred to the owners.

c. *Taking Advantage of the Payroll Tax Loophole - Profit Sharing Bonuses*

i. Scenario: A successful construction company intends to award $1,000,000 of year-end cash bonuses to its non-highly compensated employees (non-owners who made less than $120,000 in the prior year). Doing so will result in immediate income taxation to the employees and incur approximately $153,000 of Social Security and Medicare taxes (split between the employees and employer).

ii. Solution: If the profit sharing allocation formula is (or is amended to be) each participant in a separate allocation group the bonuses can be contributed to each employees profit sharing account rather than paid in cash thereby saving the $153,000 of combined FICA payroll taxes (and likely saving other costs that relate to gross payroll such as workmen's compensation premiums).

iii. How it Works: Since all of the employees receiving profit sharing bonuses are non-highly compensated employees, they can all receive different amounts based on their individual performance and there will be no non-discrimination testing required so long as no highly compensated employee receives a contribution. Unlike the income tax benefit, which is only a deferral, the payroll tax savings are forever—there are no payroll taxes on employer contributions either at the time of contribution or at distribution.

d. *The Prosperous Consultant – Owner-Only Defined Benefit Plans*

i. Scenario: A 50-year old consultant with a single-member LLC has had for the last several years steady and predictable earned income of over $450,000 each year. He has started planning late, and has no retirement plans, so is now attempting to maximize his deductions while setting aside as much as possible for his anticipated retirement in 12 to 15 years.

ii. Solution: Establish and fund a defined benefit pension plan.

iii. How it Works: Defined benefit plans—usually what are referred to as pension plans—can offer significant retirement benefits and much larger current deductions than 401(k) plans. Defined benefit plans pay retirement benefits based on the participant's years of service and compensation up to a maximum amount set by law—currently $215,000 per year in retirement. Alternatively, the present value of all the benefits may be distributed in one lump sum.

In this case, since the sole participant consistently earns significant income, he will be eligible to fund the maximum annual benefit amount permitted by law. But defined benefit plans are not subject to the same annual contribution limitations as "defined contribution" plans like 401(k) plans. To meet the defined benefit plan's minimum funding requirements—i.e., to ensure the plan has money to pay the promised benefits—the company will likely have to contribute well over $150,000 per year. (Caution: Although funding, and potentially overfunding, the plan will generate large deductions, excess funding and excess investment returns can leave defined benefit plans overfunded; if the plan's assets exceed the amount needed to pay the maximum benefits allowed by law, the excess assets can be subject to punitive "reversion" taxes if returned to the employer.)

A "DB/DC combo" plan provides even more flexibility and deductible contributions. This approach keeps the same pension plan setup, but adds a 401(k) profit-sharing plan, allowing elective salary deferrals, up to 6% in a profit-sharing contribution, and the full defined benefit plan contribution, all of which are deductible.

This money will be held in trust, invested, and distributed to the participant as tax-deferred retirement income.

e. *Free Pass on 401(k) Compliance Testing – SERP as 401(k) Replacement*

i. Scenario: A company has three main classes of employees—upper management, consisting of a small handful of highly compensated employees; office/administrative employees, consisting of a few dozen administrative staff overseeing the company's human resources, finance, and related departments; and laborers, a large contingent of lower-paid and transitory workers. The company wants to provide a generous 401(k) matching contribution to the upper management and administrative staff, but would like to avoid significant matching contributions for the laborers because of the frequent turnover and large number of employees. The company's 401(k) plan will fail the portion of its annual compliance testing requiring coverage of a minimum number of non-highly compensated employees.

ii. Solution: Exclude the upper management group from the 401(k) plan altogether—creating a nonqualified deferred compensation plan for them with an equivalent company match and mirrored investment options—and exclude the entire laborer workforce, leaving only the administrative employee population receiving the generous 401(k) matching contributions.

iii. How it Works: If a 401(k) covers no "highly compensated employees" it can exclude entire categories of employees from participation and contributions without running afoul of any of the required annual compliance tests. Highly compensated employees are those employees earning over a threshold amount in the prior year—currently, an employee whose compensation exceeded $120,000 during 2016 is a highly compensated employee during 2017. Passing or failing discrimination (or nondiscrimination) testing of various types is determined by comparing the benefits provided to non-highly compensated employees to those provided to highly compensated employees. Broadly speaking, if the benefits afforded to highly compensated employees materially exceed the benefits afforded to non-highly compensated employees, the 401(k) plan runs the risk of failing various types of nondiscrimination testing. Whenever the plan covers zero highly compensated employees, these compliance tests are always satisfied, regardless of any "discrimination" among different classes of non-highly compensated employees.

By excluding all highly compensated employees from the 401(k) plan, the company can exclude as many non-highly compensated employees—for example, all laborers—as it would like, even if the excluded group represents the vast majority of the company's employees. This allows the company to direct its matching contributions only to the administrative group. By creating a nonqualified deferred compensation plan that mirrors the company's 401(k) plan, the same (or greater) level of deferrals, matching contributions, and investment options can be provided to the highly compensated management group (albeit with some limitations discussed below regarding nonqualified plans generally).

III. <u>Nonqualified Deferred Compensation and Executive Compensation Plans</u>

a. *The Private Equity Executive Meets the Family Business – Incentive Stock Options*

i. Scenario: Family-owned business acquires a small S corporation with a recently installed CEO. The CEO comes from a private equity background and is used to receiving a block of equity with a liquidity event within five to seven years. The family is willing to give the CEO 5% of the equity in the company, but wants to encourage her to remain with the company for at least five years, so prefers to transfer 1% each year for five years. They have no intention of re-selling the company and rarely make shareholder distributions. The company has also agreed to gross up the CEO for any taxes incurred on stock grants, but wants to limit its potential expense if the company's value increases dramatically over the next five years. The company's cash flow is expected to increase over the short-term, but it is unwilling to cover the tax bill of the entire 5% grant immediately.

ii. Solution: The company grants the CEO an "incentive stock option" pursuant Section 422 of the Code, coupled with a gross up bonus equal to the exercise price. In addition, the company provides the executive annual incentive bonuses based on the company's financial performance.

iii. How it Works: An "incentive stock option" (or "statutory stock option") allows the CEO to buy shares of the company without incurring any taxable event until the CEO eventually disposes of the stock.

If the company granted the CEO the stock incrementally, the CEO would report (and the company would cover) compensation income of the fair market value of the shares transferred. If the company increased in value over five years, this approach could get expensive. Alternatively, if the company issued restricted stock vesting over five years, and the executive made a Section 83(b) election, the company would have to pay a significant tax gross up immediately.

Under a "nonqualified stock option" (or "nonstatutory stock option"), which is often generically referred to as a "stock option," the employee is taxed on the spread between the exercise price and the fair market value—for example, if the employee exercises an option to buy 100 shares of stock for $100,000, but the fair market value of those 100 shares upon exercise is $120,000, the employee has $20,000 of compensation income taxed as ordinary income and subject to payroll taxes immediately upon exercise. Incentive stock options may only be issued by corporations—either C or S—or partnerships and LLCs electing to be taxed as corporations; they are impermissible with entities taxed as partnerships.

But upon exercising an incentive stock option, the employee has no taxable event, and any gains when the shares are sold are taxed as (often long-term) capital gains, deferring the taxable event and reducing the amount of tax. This would defer the CEO's tax and provide a ready source of funds to pay capital gains taxes upon sale. (Caution: The spread upon the exercise of an incentive stock option is not taxable income, but is considered income for AMT purposes.)

There are however, conditions to the favorable treatment of incentive stock options: The options first exercisable during any given year cannot exceed $100,000; the options must expire after ten years; the recipient must be an employee; the exercise price must be at least 100% of the fair market value on the option's grant date (or 110% if the recipient owns 10% or more of the company); and the recipient must hold the shares bought for at least two years after the grant date and at least one year after the exercise date.

The incentive stock option allows the company to grant the CEO an option to buy 1% of the company's shares every year provided the CEO remains employed at the end of the year. The company pays the CEO a bonus equal to the exercise price—which does not change over time—and a tax gross up each year. The company is able to control its cost of providing stock to the CEO and reduce its overall outlay, while the CEO is able to minimize and defer income taxes on the receipt of stock. The ongoing annual bonuses provide the missing "liquidity" to which the CEO was accustomed.

b. *The Next Google – Restricted Stock and 83(b) Elections*

i. Scenario: An early stage startup corporation needs to expand beyond its few founders and has identified a key hire. The company is still in the formative stages, and does not have significant assets beyond the founders' initial capital contributions of $1,000,000. The founders are convinced that the company's value will increase exponentially over the coming years, but only if their targeted hire will stay on through the entire development cycle. The company can't afford to pay a competitive salary, but the founders are willing to part with some of their equity.

ii. Solution: The company issues restricted stock to the key hire of 10% of the company's shares. The key hire makes a Section 83(b) election.

iii. How it Works: As noted above, if the company simply granted the key hire 1% of the company's shares per year over ten years, the employee would be taxed on the full fair market value of 1% of the company each year. As the company's value (hopefully) increases, the employee would be taxed on the increasing value every year. If the company's value increased as expected, and is worth $10,000,000 in the tenth year, the employee would owe taxes on $100,000 of income in the tenth year alone. All these amounts would be taxable as ordinary income compensation.

If the company granted the key hire "restricted stock," i.e., the stock is granted immediately but subject to forfeiture if the employee leaves, of 10% of the company's shares that vested at 1% per year over ten years, the same tax result would occur.

However, if the employee makes a Section 83(b) election on the restricted stock grant within 30 days of receiving the restricted stock, the employee would pay income taxes on the full 10% of the company's shares immediately upfront, even though he isn't fully vested. If the company's value is $1,000,000 when the stock is granted, the key hire would owe income taxes on $100,000, for a total of around $40,000. After a Section 83(b) election, the increased value would not result in any additional taxes as the shares vest over the next ten years. Any later sale of the stock will result in capital gains. While this frontloads taxable income, it often makes sense if the value of the stock is anticipated to rise dramatically.

Unfortunately, if the key hire decides to move on after five years and forfeits the last 5% of his original stock grant, he would have paid income taxes on the forfeited 5% upfront ($20,000, or half of the original $40,000 in taxes paid) and cannot take a deduction for the $20,000 of taxes previously paid with respect to the forfeited shares.

c. The Public Servant – Governmental 415(m) Plans for Excess Benefits

i. Scenario: An executive leaves his position in the private sector for a prominent governmental position with a state agency, taking a substantial pay reduction in the process. To make up for the lower base pay, the organization promises to make contributions to the agency's retirement plans of 20% of the executive's base pay. Before long, the executive has reached the maximum annual contribution limits in the retirement plans, but has not received the full 20% of his base pay in employer contributions.

ii. Solution: Adopt a Section 415(m) plan that allows the agency to set aside additional funds over the qualified plan limits without the vested amount being immediately subject to income tax under Section 457(f) (described in *i.* below).

iii. How it Works: Section 415(m) plans are unique to governmental employers. They allow accrual of additional vested retirement benefits for government employees, but only to the extent the retirement plan contributions to which the employee is entitled exceed the Section 415 limits on the total amount of contributions to retirement plans in a year (currently $54,000). Generally this would be a nonqualified deferred compensation plan subject to Section 457(f), which imposes income tax as soon as the employee's account is vested. However, Section 415(m) of the Code provides that Section 415(m) plans will be taxed like nonqualified deferred compensation plans of taxable employers, i.e., the retirement benefits will only be taxed when paid. Like nonqualified plans, a 415(m) plan must remain "unfunded" with the payments coming from the employer's general assets.

Here, once the agency employee's 20% contribution requirement exceeds $54,000 in a year, the agency can place the excess amount—and only the excess amount—in a Section 415(m) plan to be paid upon the employee's retirement. This allows the employee to receive his full annual entitlement under the more favorable tax-deferral rules that generally do not apply to governmental employers.

d. The Tech Company's Buyout – Change in Control Incentive Plans

i. Scenario: A mid-sized technology company wants to reward several programmers with stock options, but only wants the programmers to be able to exercise them as part of a sale of the company. The company doesn't want to worry about employees exercising or trying to cash out options immediately ahead of, or during, a transaction.

ii. Solution: Create a change in control incentive unit plan entitling select programmers to a cash bonus payable at closing, provided they remain employed until closing, in an amount equal to the number of "incentive units" they own, multiplied by the price per share in the sale transaction, minus the "exercise price" they would otherwise pay if they were issued options.

iii. How it Works: The premise is fairly simple—certain employees receive a cash bonus upon the sale of the company. Using "incentive units," which are nothing more than contractual rights to cash payments based on the transaction price, allows the company to mimic the same economics as granting the employees options exercisable only in connection with a change in control.

The company enters an agreement with each programmer "granting" them "incentive units" equal to a number of company shares. The "exercise price" of the incentive unit is the fair market value of one share on the grant date. Then, once the company is sold, the employee receives a cash bonus equal to the appreciation on the number of incentive units ("shares") the employee owns. For example, one share of the company's stock is worth $12 and the company grants the employee 1,000 incentive units. Two years later, the company is sold for $20 per share. At closing, the employee would receive $8,000—the total value of his incentive units ($20 x 1,000 = $20,000) minus the exercise price ($12 x 1,000 = $12,000). The bonus is paid in cash at closing, and neither party to the transaction has to worry about the employees exercising options to join the transaction or cashing out and cancelling the options.

Although many of the tax consequences would be the same as issuing options in the above example, the incentive unit concept avoids any issuance of equity. One major advantage to this incentive unit approach more generally is that it avoids issuing equity but still allows employees to share in any upside in a transaction. But with that simplicity comes a cost—the entire amount is taxed as compensation income to the employee, and is subject to ordinary income tax rates, payroll taxes, and withholding.

e. *Keeping it Simple – Incentive Plans for Portfolio Company Employees*

i. Scenario: A small private equity company wants to provide the executives of its portfolio companies with equity compensation, but the companies generally are smaller LLCs taxed as partnerships. The executives are accustomed to being treated as W-2 employees instead of K-1 partners. Both parties want equity-like features and vesting based on financial performance, but also want to allow the executives to remain employees without an overly complex organizational structure.

ii. Solution: Create an incentive unit plan as explained immediately above, and build in vesting conditions and "distributions" equal to those the executives would receive had they been granted LLC membership interests.

iii. How it Works: In essence the incentive unit plan is a nonqualified deferred compensation plan, but instead of simply accruing an account balance, the payouts reflect the same economic terms that would have existed had the executive received a partnership interest. The employees are granted a maximum of about 5% of the company's total equity, which must be earned incrementally based on financial performance (paying off transaction debt, achieving EBITDA targets, reaching pre-determined company value). Once vested, the incentive units distribute cash to the executives at the same time, and on the same terms, as the members of the LLC receive distributions as long as the executives remain employed. Upon the executive's retirement (or occasionally pre-retirement voluntary resignation), death, or disability, or a sale of the portfolio company, the executive's incentive units are "redeemed" by the company by paying the executive (or his estate) a cash payment equal to the price at which the company would have re-purchased his units in those scenarios under the operating agreement. This approach allows the executive to receive similar economic treatment to the company's owners without the complexity of becoming a partner.

Although not strictly adhered to by some practitioners, the IRS's position is that one person cannot simultaneously be a partner and an employee of a partnership (or LLC taxed as a partnership). Treatment as a partner can cause several administrative difficulties, including the partner's receipt of a K-1 instead of W-2, payment of self-employment taxes, inability to participate in the company's cafeteria plan and certain other fringe benefits, and potentially multiple state tax returns where the company conducts business.

f. *The Forgotten Policy – Whole Life Insurance Rollout with Deferred Compensation*

i. Scenario: A small company purchased a whole life insurance policy for a key employee many years ago, with the intention of eventually transferring the policy to the employee. The company was and is the owner and sole beneficiary of the policy. As other things came and went, the company never got around to planning how to roll out the insurance policy. By the time the company got around to planning the rollout, the policy had a cash surrender value of over $400,000. The company wanted to encourage the employee to remain employed through retirement, and the employee wanted to avoid paying taxes on the entire cash surrender value in one year, preferring to spread out receipt while he is in a lower tax bracket in retirement.

ii. Solution: Create a nonqualified deferred compensation plan vesting the employee in an amount of cash equal to the policy's cash surrender value as of the date of the employee's retirement, payable over ten years, and have the company use the policy's cash surrender value to fund the benefit payments.

iii. How it Works: If the company were to simply transfer the entire policy to the employee at his retirement, the employee would have taxable compensation income equal to the cash surrender value—say, $500,000 at the employee's retirement. Even if the policy with its $500,000 cash value was received and taxed early in the year following the employee's retirement, the employee would nonetheless reach the top 39.6% tax bracket based on that transfer alone. Assuming the employee is married filing jointly and has no other income, and ignoring deductions, the total tax owed would be roughly $143,000 for an effective tax rate of about 28.5%.

Instead of transferring the policy and its cash value outright, the company instead sets up a deferred compensation plan that would pay the employee $500,000 in ten annual installments of $50,000 each upon his retirement. With the same assumptions above, the employee would fall in the 15% bracket, and the total income tax over ten years would amount to a little over $65,000 for an effective tax rate of about 13%. Spreading the taxation over ten years reduces the total amount of tax by more than half, saving the employee almost $70,000.

With the benefit amount directly linked to the amount of cash value in the policy, the company has a readily available source of funds in the exact amount needed to pay the deferred compensation benefits, and can keep the life insurance policy in force as the owner and beneficiary.

g. *The Underpaid Charity Head – 457(b) Plans for Non-Profit Executive Planning*

i. Scenario: A 501(c)(3) organization's executive director is planning on retiring within the next few years. Upon announcing his plans, the organization's board of directors realizes that, while the executive director is well-compensated, they have been paying him under the prevailing market rate. The board wants to make him whole. Because the director is nearing retirement, both parties would prefer for the additional funds to be contributed to a tax-deferred retirement plan that can earn a stable and conservative investment return for the next several years.

ii. Solution: The organization adopts and funds a 457(b) plan; the sole participant in the plan is the executive director.

iii. How it Works: While 457(b) plans are commonly maintained by governmental entities, private tax-exempt entities can also sponsor 457(b) plans. The rules for the two types of entities differ fairly significantly.

While governmental 457(b) plans operate very much like 401(k) plans, private, tax-exempt 457(b) plans occupy a middle ground of several plan types. Similar to a 401(k) plan, private tax-exempt 457(b) plans can accept employee deferrals, employer contributions, or both of up to a maximum of $18,000 per year. In this case, the employer funds the entire $18,000 each year so the employee does not have to make his own deferrals. The director's account balance is invested in conservative investments held on the organization's books. Because of the 457(b) plan rules, the director's account payments must come from the organization's general assets and cannot be funded in a separate trust—much like a nonqualified deferred compensation plan. The account generally cannot be distributed before the director's severance from employment, which works well here. Also like 401(k) plans, distributions from the 457(b) plan may be spread over installment payments after retirement to minimize the income tax impact of each payment. But the distributions are wages reportable on Form W-2 and are subject to income tax withholding on wages, not the typical pension withholding requirements, like nonqualified plans. Also like nonqualified plans, FICA taxes are owed immediately upon each contribution to the plan because the director is fully vested. If the mixture weren't already complicated enough, private 457(b) plans have their own unique rules on deferring benefit payments after retirement, rollovers, and other commonly encountered plan design features.

h. *Golden Handcuffs – Deferred Bonus Plans*

i. Scenario: A company wants to encourage retention among its senior managers, who tend to leave after receiving a large annual bonus for a successful year.

ii. Solution: The company adopts a deferred bonus plan under which 50% of each senior manager's annual incentive bonus is paid immediately, and the other 50% is deferred.

iii. How it Works: The company's deferred bonus plan requires that 50% of every senior manager's bonus is deferred until the earliest of the manager's retirement after age 65, death, or disability; the sale of the company; or seven years after the year to which the bonus relates. If the manager leaves before one of those events—say, before seven years—she will forfeit the deferred 50% of her last seven years of bonuses. However, if the managers reach retirement age or something happens beyond their control—death, disability, sale of the company—they will receive all their deferred bonuses without forfeiture.

In the meantime, the deferred amounts can be invested in funds elected by the managers. The bonus amounts and earnings will accrue tax-deferred to the managers, although the company may not take any deductions until the bonuses are paid, and the company will owe taxes on any realized gains on investments held under the deferred bonus plan. This can pose obstacles for small C corporations, which will owe entity-level tax on those deferred bonuses as they accrue and remain invested; of course, the company will eventually get a deduction for the total amount paid out.

i. Seeing the Project Through – 457(f) Plans as Tax-Exempt Retention Tools

i. Scenario: A 501(c)(3) organization is in the midst of a five-year project being overseen by two key managers. The organization wants to incentivize the two managers to see the project through to completion, and is willing to set aside $20,000 per year for each employee. They will each receive all $100,000 if, and only if, they remain employed until the completion of the project.

ii. Solution: The organization enters 457(f) deferred compensation agreements with each employee promising to pay them each $100,000 if they continue working until the project is completed.

iii. How it Works: Any deferred compensation provided by a private tax-exempt organization to its employees that does not meet the more stringent requirements of Section 457(b) is subject to restrictive tax requirements. The total of all deferred amounts is taxed for income and FICA purposes as soon as the money becomes vested under Section 457(f) of the Code. Although Section 457(f) governs many types of compensation arrangements of private tax-exempt and governmental employers, the primary thrust of Section 457(f) requires immediate and full taxation of all vested deferred compensation, even if the money is not paid to the employee. Unless carefully structured, the employee could have to pay taxes on the entire amount deferred long before the amount is paid. Generally Section 457(f) plans are set up so payment is made shortly after vesting for that reason.

The theory behind the mismatch of taxation and payment under Section 457(f) is the supposed tension between "for-profit" taxable employers, who have an incentive to accelerate nonqualified deferred compensation distributions in order to take the deduction for those payments, and the employees, who prefer to defer distributions and taxation for as long as possible. The IRS reasons that no such tension exists with tax-exempt entities, which have no financial incentive to distribute deferred compensation because the deduction does not matter to them.

Here, the two key managers will not vest until the completion of the five-year project, at which point they will be taxed on the full $100,000, even if they are not paid right away. In this case, they will be paid immediately upon completion so will have funds to pay their taxes.

j. The Policy Purchase – Restricted Endorsement Bonus Arrangements

i. Scenario: A key employee of a small business wants to own a whole life insurance policy, and the company is willing to provide additional funds for the employee by paying the premiums for a certain number of years. In return, the company wants to find a way to motivate the employee to continue working for the company.

ii. Solution: The company and employee enter a restricted endorsement bonus arrangement, or "REBA," under which the company pays the premiums on the policy, which includes an endorsement prohibiting the employee from withdrawing from, surrendering, or taking a loan from the policy for a fixed number of years.

iii. How it Works: The employee buys and owns the whole life insurance policy under a REBA. The employee and employer enter a separate agreement under which the employer promises to pay the employee a bonus each year, provided the employee is still employed, of the full amount of the annual premium (often the payments are made straight to the insurer). Frequently the employer will include a gross-up to cover the income taxes on the bonus/premium payment itself so the employee doesn't have to pay income taxes out-of-pocket. As long as the company cannot benefit from the policy—for example, by requiring the employee to name the company as beneficiary until the restrictions lapse—the premium payments are deductible to the employer as employee compensation.

The parties agree to place an endorsement (which is recorded with the insurer) on the policy prohibiting the employee from accessing any cash value or surrendering the policy for at least ten years. The employee can still name and change the beneficiary in the meantime. If all goes to plan, after ten years the employer has made ten premium payments, the employee has not incurred any additional taxes (except those covered by the employer), and the employee owns the policy and its tax-deferred cash value from which the employee can take tax-favored loans.

The status of these arrangements under ERISA is not entirely clear. Depending on the facts involved, they could be construed as welfare benefit plans (due to the purchase of life insurance) or funded retirement plans (due to the primarily retirement-based lapse of restrictions). If the REBA is classified as a funded retirement plan, it would cause significant compliance concerns. Employers and advisors should be comfortable with the classification before establishing these types of plans.

k. The Reluctant Merger – Using Rabbi Trusts to Secure Deferred Compensation

i. Scenario: A company's key executives participate in a nonqualified deferred compensation plan allowing salary deferrals and company contributions. Several executives have balances exceeding $1,000,000. The company is considering selling itself, but the negotiations have turned acrimonious and the company's executives want as much certainty as possible that the acquiring company will set aside enough money to pay the executives' deferred compensation accounts when due.

ii. Solution: The company creates and fully funds an irrevocable "rabbi trust" that can only be accessed if the company becomes insolvent.

iii. How it Works: Nonqualified deferred compensation must remain "unfunded" to (among other things) defer taxation until benefits are paid. While this concept restricts funded trusts or other vehicles placing the executives' money beyond the reach of the company's creditors, the IRS has permitted "rabbi trusts"—so named because the first one approved was for use by a rabbi and his congregation—established to hold deferred compensation balances without being considered funded and taxed. The assets set aside in a rabbi trust must be accessible to the company's creditors in the event of the company's insolvency, but otherwise assets in an irrevocable rabbi trust can be shielded from any other use by the company sponsoring the deferred compensation plan.

l. The Almost-Magic Bullet – Profits Interests in LLCs and Partnerships

i. Scenario: The four equal members of an established and profitable LLC taxed as a partnership would like to provide a 10% equity interest in the company to its new CFO. All parties would like to provide the CFO with ongoing distributions from profits on the same terms as the four existing members, and would like the CFO to participate in any appreciation of the company's value as they contemplate selling the company within the next ten years. The CFO would like to minimize the taxes he has to pay upfront.

ii. Solution: The company grants the CFO a "profits interest" in the company.

iii. How it Works: Also called "carried interest," a profits interest is a powerful tax planning tool for service providers of partnerships. It is an actual ownership interest in the LLC, but only entitles the holder to appreciation and profits earned after the grant of the profits interest. Key to this approach is that, if structured properly, a grant of a profits interest does not create a taxable event, i.e., the service provider receives an ownership interest without any immediate tax consequences. The non-taxable nature of a profits interest grant is premised on the theory that the future appreciation and profits are speculative and therefore cannot be assigned an accurate value.

Profits interests are different from "capital interests," which are the regular membership interests held by the original four members. Many of the distinctions between capital interests and profits interests operate via the operating agreement's distribution provisions.

The major limitation in a profits interest is that the holder cannot receive any portion of the company's value on a liquidation basis as of the grant date—for example, if the company was valued at $8 million on the date the CFO received his 10% profits interest, the CFO can never receive a distribution upon liquidation out of the first $8 million. So if the company is sold in five years for $13 million, the four original partners would each receive 25% of the first $8 million, or $2 million apiece. On the next $5 million, the original four partners would receive 22.5% (or $1,125,000) each and the CFO would receive 10% (or $500,000).

However, the CFO can receive his 10% share of annual distributions from profits or excess cash immediately and in full. So if the CFO receives his profits interest on January 1, 2018, and the company has net distributable profits of $400,000 from its operations during 2018, the CFO can receive his 10% share of the $400,000 distribution without regard to the pre-existing value of the company on a liquidation basis.

Profits interests can also be subject to a vesting schedule, which introduces a few complicating factors, but is useful for retention purposes. Additionally, receiving a profits interests makes the holder a partner for tax purposes, which can come with some unintended consequences. Careful (and more complex) structuring involving tiered partnerships or other entities can sometimes avoid the holder being treated as a partner of the operating company.

IV. When Things Go Awry

a. *Qualified Plans*. Even the most well-intentioned and high-performing companies will inevitably come across an error or mistake made in their qualified plan. Fortunately both the IRS and Department of Labor have provided broad self-correction or voluntary amnesty programs allowing sponsors to fully correct the mistake (and sometimes pay a relatively minor fee) to bring the plan back into compliance.

i. *The IRS's Employee Plans Compliance Resolution System – EPCRS.* Governed by a lengthy Revenue Procedure—currently Rev. Proc. 2016-51—the IRS's EPCRS program has been enormously successful and universally well-received in the retirement plan community. The Code itself provides solutions for some errors occurring in qualified retirement plans, but the vast majority of simple (or complex) mistakes don't allow for any type of relief, meaning the plan technically could be disqualified and lose its favorable tax treatment. After going through several iterations of correction programs, the IRS most recently settled on the current form.

The current EPCRS structure allows plan sponsors to "self-correct" many operational errors, which are those arising from the employer's failure to properly follow the plan document's terms. Self-correction of operational errors does not require any reporting or filing with the IRS. For example, an employee elected to defer 4% of her pay into her employer's 401(k) plan, but her election form was misplaced and never entered in the company's payroll system, meaning her elective deferrals were never deducted from her pay and contributed to the plan. Under the EPCRS program, the employer would make contributions to the affected employee's 401(k) account and adjust the account for missed earnings. As long as the employer fully corrects the error and retains documentation, the error is considered fully corrected and will not be subject to penalty or disqualification if the plan is later audited.

The next step up in EPCRS is the "Voluntary Correction Program," commonly known as VCP, which allows broad correction of plan document errors, certain significant operational errors not eligible for self-correction, and other mistakes—for example, a plan sponsor that failed to amend its 401(k) plan within the time allowed for a required change in the law. The VCP program does require submitting the correction to the IRS for approval and paying a user fee generally based on the number of participants in the plan. Note that if IRS acceptance of the proposed correction is questionable, the VCP filing can be done anonymously with the client's identity not disclosed unless or until the correction is acceptable to both parties. Also note that despite the IRS assertion that they don't recognize scrivener's errors they routinely approve retroactive amendments to plan documents to conform to how the plan was operated in practice.

Finally, the EPCRS program contains "Audit Closing Agreement Program", or "Audit CAP," rules for correcting errors the IRS discovers on a plan audit. The correction mechanisms generally the same, but the payment required to correct the error is higher than if the employer self-corrected or used the VCP program.

ii. *The DOL's Voluntary Fiduciary Correction Program – VFCP*. While the IRS correction procedures can remedy qualified plan mistakes arising under the Internal Revenue Code, the Department of Labor has jurisdiction over qualified plans' fiduciary responsibility provisions under ERISA. Broadly, ERISA's fiduciary duties require individuals with control over retirement plans to act in participants' best interests, act prudently, follow the plan's terms and the law, and avoid certain actions called "prohibited transactions" set forth in the law that generally involve using a plan's assets for improper purposes.

The DOL's VFCP program provides a correction method for certain commonly encountered fiduciary violations—for example, a company that withholds an employee's 401(k) deferral from her paycheck but does not contribute the deferral into the 401(k) plan for two or three weeks has misused "plan assets" in the form of the employee's deferrals. These errors often occur as a simple payroll mistake, and not as the result of any ill intent, and may be corrected by depositing the deferrals and providing the employee the missed earnings those deferrals would have generated. The VFCP program is, however, more limited than the IRS's EPCRS program—whereas the EPCRS program could cover any number of potential errors, the VFCP program has a defined list of about 20 fiduciary mistakes that may be corrected, mostly involving participant contributions, loans, or the plan's purchase or sale of assets from parties closely related to the plan or for more than their fair market value. The VFCP program cannot correct many of the more significant fiduciary violations.

Any errors corrected under VFCP must be submitted to the DOL, but there is no user fee for the program.

As noted above, probably the most frequent use of VFCP is correction of the fiduciary violation and prohibited transaction that occurs when employee 401(k) elective deferrals and loan repayments are not remitted to the plan in a timely manner. In fact, the DOL frequently "invites" plans that report late deposits on their Form 5500 to make a VFCP filing or potentially face a full investigation and imposition of penalties.

VFCP also provides a helpful avenue for removing "nasty" or illiquid assets from a plan. The typical scenario involves a plan holding a parcel of real estate, closely held stock, or a limited partnership interest that is causing valuation and administrative headaches. Both the original purchase and the continued holding of the illiquid asset may be breaches of fiduciary duty that can be corrected by the fiduciary (usually the sponsoring employer) purchasing the asset from the plan for the greater of fair market value or the restoration of the original purchase price plus "lost earnings" as calculated using the DOL online calculator. Following VFCP also provides an exemption from the IRS prohibited transaction penalty.

b. *Fixing Nonqualified Plans*. Nonqualified deferred compensation plans suffer from a much less forgiving enforcement environment. The only formal correction guidance that exists to date involves a series of IRS Notices allowing correction of certain violations of Section 409A of the Code. The correction guidance is fairly narrow in scope as far as the errors that may be corrected, and often requires income inclusion, tax penalties, repayment of erroneous distributions, or a combination of the foregoing. The correction guidance may not be of much use to small employers with discrete potential errors. Additionally, the guidance can only correct errors of plan terms or operations that violate Section 409A—there is no correction guidance for many other nonqualified plan operational mistakes.