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

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

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Overview

- Qualified retirement plans
  - What they are
  - How they can be used
- Nonqualified deferred compensation plans and executive compensation arrangements
  - What they are
  - How they can be used
- When things go awry
- IRS and DOL correction procedures
Qualified Plans

- Tax-qualified retirement plans such as 401(k), profit-sharing plan, pension plan, ESOP
- Strict and complex regulatory and technical requirements
- General inability to discriminate in favor of highly compensated employees
- Best tax outcome – immediate deduction by employer and tax deferral by employee
Nonqualified Plans & Executive Compensation

- More loosely regulated
- Ability to discriminate in favor of highly compensated/key employees
- Fewer tax advantages – employer’s deduction is generally tied to employee’s inclusion in income
- Much more flexibility in design
When Things Go Awry

- Two major voluntary correction programs for qualified plans
  - EPCRS (IRS)
  - VFCP (DOL)
- Limited correction programs for nonqualified and executive compensation plans
  - IRS 409A correction guidance
Qualified Plans
Employee Ownership: ESOP as Succession Strategy

- Retiring small business owners want to sell company, but want current employees to own
- Sale to ESOP allows sale of stock and allocation to current employees on tax-favored basis in retirement plan
- 100% S corp ESOPs create tax-free entity
- Complex administration and operation
Maxed Out Owners: New Comparability Testing

- Older S corporation owners want to maximize deductible retirement plan contributions
- Fixed percentage profit sharing contributions allow max contribution, but expensive
- Create separate allocation groups and test under “new comparability” discrimination rules allowing larger contributions for older, higher-paid employees and owners

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Payroll Tax Loophole: Profit Sharing Bonuses

- Company plans on paying cash bonuses at year-end based on individual performance.
- If limited to non-highly compensated employees, contribute bonuses to 401(k) as profit-sharing contribution.
- Never subject to 15.3% FICA taxes.
The Prosperous Consultant: Owner-Only Pension Plan

- Owner of consulting business 12-15 years from retirement with significant and consistent earned income wants savings and deduction
- Pension plan allows significant annual funding to meet payout obligations—can exceed $150,000 per year, fully deductible
- Distributions made at retirement in pension installments or lump sum
- “DB/DC combo” allows above plus 401(k) elective deferrals and 6% profit-sharing contribution
Free Pass 401(k):
SERP as 401(k) Replacement

- Company with large transitory and lower-paid employee population wants generous 401(k) plan for “administrative” employees
- By excluding highly compensated employees, plan can “discriminate” in favor of desired administrative non-highly compensated employees without risking testing failure
- SERP for HCEs replaces 401(k) participation
Executive Compensation
Nonqualified Plans and
Private Equity Meets Family Business: Incentive Stock Options

- Family-owned business buys S corp with recently installed CEO with PE background
- Company wants to grant 5% of stock over 5 years and gross up CEO for taxes, but wants to control cost and limit gross ups
- Grants ISO to CEO to buy 1% of stock a year for 5 years at grant date value, with annual bonus equal to exercise price
- Significant limitations on ISOs
The Next Google: Restricted Stock and 83(b) Elections

- Low-valued startup wants to make key hire, retain for 10 years, and grant equity; company is certain value will increase
- Company grants restricted stock vesting over 10 years; would be taxed every year as shares vest (and increase in value) over 10 years, causing higher taxes in later years
- 83(b) election results in immediate income tax, but only on lower value on grant date
The Public Servant: Governmental 415(m) Plans

• Private-sector executive takes government role with pay cut; agency promises 20% of base pay in deferred comp plans
• Qualified plan limits exceeded before 20%
• Agency creates 415(m) plan that can hold excess promised benefits in better tax position than typical governmental plan rules
Tech Company Buyout: Change in Control Incentives

- Tech company wants programmers to share in company sale via options, but without having to deal with exercise/issuance
- Company grants share-equivalent “incentive units” to programmers calculating cash bonus upon sale based on transaction price minus exercise price, mimicking option economics without exercise and issuance of equity
Keeping it Simple: 
Cash Incentives in the Portfolio

- PE company with small portfolio companies wants to grant executives equity; executives used to being W-2 employees, not partners

- Portfolio companies create unit-equivalent incentive plans providing cash "distributions" and "redemptions" with same economic terms as equity ownership without complexity
The Forgotten Policy: Rolling Out Whole Life Insurance

- Company owned whole life insurance policy for years intending to transfer to employee, but significant cash value build up.
- Company wants to transfer value to employee upon retirement without big tax hit.
- Instead of transferring policy in lump sum (39.6% bracket), company creates deferred comp plan paying cash equal to cash surrender value over 10 years (15% bracket).
Underpaid Charity Head: Private 457(b) Plans

- Non-profit director close to retirement, but has been underpaid; org allows extra funds
- 457(b) plan covers director with employer contributions up to $18,000 annually
- Tax-deferred until payment in retirement
- Lump sum or installments; payment options
- Funds must remain on employer’s books
Golden Handcuffs: Deferred Bonus Plans

- Company wants to encourage retention after bonus season in beginning of each year
- Company creates deferred bonus plan paying 50% of each bonus upfront and 50% deferred for seven years, or until retirement, sale of company, death, disability
- Deferred funds can be invested and tax-deferred until payment
Seeing the Project Through: 457(f) Plans as Retention Tool

- Non-profit wants two executives to oversee completion of five-year project
- Organization sets aside $20,000 per year for $100,000 total for each employee
- Employees receive $100,000 on completion
- Section 457(f) requires immediate tax upon vesting for plans of tax-exempt entities; payment shortly after vesting is critical
Policy Purchase: Restricted Endorsement Bonus Plan

- Key employee wants to buy own whole life insurance policy; company willing to pay but wants assurances employee will stay
- Company pays premiums on policy as taxable bonuses (plus gross up) each year
- Parties have restrictive endorsement limiting employee withdrawal/surrender for ten years
The Reluctant Merger: Rabbi Trusts as Security Tool

- Company is selling itself, and executives concerned about securing deferred comp
- Company creates “rabbì” trust holding assets
- Rabbi trust terms require full funding and irrevocability upon change in control
- Trust assets must be available to company’s creditors in insolvency; no other reversion
Almost-Magic Bullet: Profits Interests

- Partnership wants to grant 10% of appreciation and future profits to CFO
- Company issues “profits interest” that allows tax-free grant and participation in profits
- Holder cannot receive any existing value as of grant date on liquidation basis, but can receive future distributions from operations immediately
Qualified Plan Corrections:
IRS EPCRS

- Broad IRS program allowing voluntary correction of IRC-based errors at three levels:
  - Self-correction (SCP)
  - Voluntary Correction Program (VCP)
  - Audit Closing Agreement Program (Audit CAP)

- Plan mistakes must be fully corrected
- VCP and Audit CAP require IRS submission, approval, and user fee
Qualified Plan Corrections: DOL VFCP

- DOL’s program to correct ERISA fiduciary violations involving “plan assets”
- Limited to about 20 specific violations
- All require DOL submission, but no user fee
- Particularly useful for correcting failures to timely contribute elective deferrals/loan repayments and removing illiquid plan assets
Nonqualified Plan Corrections: IRS 409A Guidance

- No significant guidance or correction methods for many executive compensation plans
- Recent correction programs for 409A violations, but limited in scope and timeframe and often involve taxes or other payments
Questions?

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