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Deferred Compensation Planning for Management Retention and Business Transition

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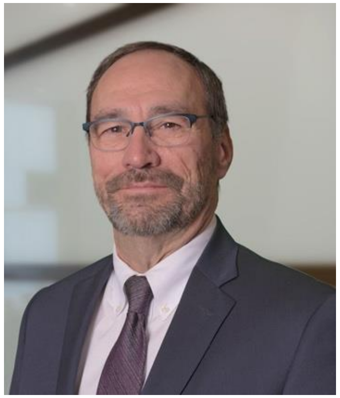

Dan Welytok

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Dan is a Shareholder and Chair of von Briesen’s Tax Section. His practice focuses on helping management achieve practical results in all aspects of business. He assists clients nationally and internationally with business development, tax issues, acquisitions and divestments, capital structuring, financing, corporate governance, information technology, licensing and distribution, regulatory and compliance issues, labor and employee benefits matters, and dispute resolution. Dan represents clients before the Internal Revenue Service, the Department of Labor, Federal and state courts and regulatory agencies on audits, controversies, compliance issues, white collar tax defense, and business disputes.

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Agenda

- Types and Uses of Deferred Compensation Plans
- Funding of Deferred Compensation Plans
- Legal Requirements Unique to Deferred Compensation Plans
- Using Deferred Compensation for Business Transition
- FICA Tax Considerations
- Deferred Compensation in Non-Profit and Public Sectors
- Retirement Plan Adjustments
- Planning Considerations

Types and Uses of Deferred Compensation Plans

- Comparison to “qualified” plans
- Participation
- Benefit Formula
- Vesting
- Elective Deferral (simplest, least common)

Examples of Deferred Comp Plans

- Excess Benefit/SERPs (coordinated with qualified plan)
- Defined contribution excess plan
- Defined benefit offset plan
- Short or Long-Term Incentive/Bonus/ Performance Based Plans
- Phantom Stock Plans
- Stock Appreciation Rights (SARs)
- Equity compensation/stock & stock option plans
- Severance Arrangements

Types and Uses of Deferred Compensation Plans

Primary Uses:

Attract/retain top talent	Reward/ incentivize exceptional performance	Participate in company growth/ success	Finance purchase of company equity	Provide additional income for retirement

Funding of Deferred Compensation Plans

- Plans are considered unfunded – even if assets are set aside, they must be available to general creditors in event of insolvency of employer
- Rabbi Trusts – eases fear of non-funding
- Use of life insurance
- Investment returns in deferred comp plans

Deferred Comp Plan Requirements – Tax

- **Internal Revenue Code (“Code”) § 409A**
  - For each amount deferred, agreement must specify the payment trigger(s) and the time and form of payment
    - Permissible payment triggers: death, disability, termination of employment, unforeseen emergency, change in control, fixed payment date or schedule
  - Generally cannot accelerate or defer payments

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Deferred Comp Plan Requirements – Tax

- If the plan violates § 409A in either form or operation, amounts deferred are includible in income when they vest and an 20% additional tax applies
- IRS has limited forgiveness programs

Deferred Comp Plan Requirements – Tax

- Amounts deferred and vested before January 1, 2005 are grandfathered, unless agreement is materially amended
- Agreements <u>not</u> subject to § 409A include:
  - Short-term deferrals
  - Involuntary separation pay plans
  - Stock options/stock appreciation rights with exercise price at least equal to FMV

Deferred Comp Plan Requirements – Tax

– Common § 409A "traps" include

✓ What constitutes a "termination of employment"

✓ Payments conditioned on employee signing a release

✓ Stock options/stock appreciation rights without FMV analysis

Deferred Comp Plan Requirements – Tax

- **Code § 83 – Transfers of Property** (e.g., Restricted Stock)
  - Generally taxed when property is no longer subject to a substantial risk of forfeiture
  - Recipient may make an 83(b) election
- **Code § 162(m)**
  - $1,000,000 deduction limit on pay to certain executives of publicly traded companies

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Deferred Comp Plan Requirements – Tax

- **Excess Parachute Payments**
  - If payments to a “disqualified person” are conditioned on a change in control and exceed three times the person’s “base amount” (generally, annualized income):
    - No deduction allowed for payments that exceed the base amount
    - 20% excise tax applies on payments that exceed base amount
  - Exceptions for S-corps, and if shareholders approve arrangement

Deferred Comp Plan Requirements – ERISA

- Generally applies to agreement that provides for payments at or after termination of employment (exception for severance pay plans)
- If agreement (1) is unfunded and (2) covers a select group of management or highly compensated employees, it avoids minimum participation, vesting, and fiduciary rules of ERISA
- Can avoid Form 5500 reporting if employer files a “top-hat” notice with the Department of Labor
- Claims and appeal provisions of ERISA apply

Using Deferred Compensation for Business Transition

- In the professional service field, provides incentive for primary owner(s) to transition book of business to younger partners
  - Individually designed, or select group coverage
  - In a management buyout or business succession, one or more shareholders can redeem the equity of the retiring owner(s) and use a deferred comp plan to provide them with additional consideration.

FICA Tax Considerations

General Rule

include deferred compensation payments in FICA wages when paid

Special Timing Rule

include deferred compensation amounts in FICA wages the later of when work is performed or amounts vest

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FICA Tax Considerations

1

Can provide significant FICA tax savings for employees over FICA wage base

2

Mandatory for account-based plans or when amounts are reasonably ascertainable

3

Permissible for non-account plans before amounts are reasonably ascertainable (with later true-up)

4

Cannot use special timing rule if deferred compensation right was created in anticipation of termination of employment

Non-Profit/Public Sector Deferred Compensation

- **Code § 457(f)**
  - Deferred compensation is taxable when amount is no longer subject to a substantial risk of forfeiture
- **Code § 457(b)**
  - Provides for "eligible" deferred compensation plans with specific annual contribution limits and distribution requirements
  - Different rules for government vs. tax-exempt employers (e.g., exclusive benefit trusts for government plans)

Non-Profit/Public Sector Deferred Comp

- **Code § 4960**
  - 21% excise tax on annual compensation over $1,000,000/ year for covered employees of tax-exempt employers
  - Includes pay from related organizations or governmental entities
  - Amounts are treated as "paid" when no longer to a substantial risk of forfeiture
    - As a result, deferred compensation will often be treated as "paid" before actual payments are made

Non-Profit/Public Sector Deferred Comp

- **Reasonable Compensation**
  - Deferred compensation is taken into account in determining if compensation paid to employees of tax-exempt employers is reasonable

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Retirement Plan Adjustments

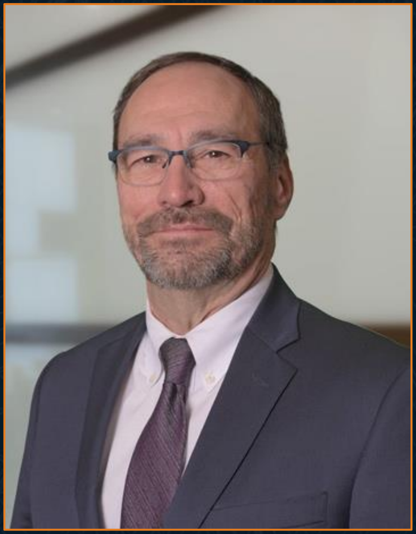
Qualified retirement plans usually base contributions and accruals on a participant's "compensation"

When setting up a deferred compensation agreement, review whether qualified plan's definition of "compensation" includes accruals or payments of deferred compensation

Planning Considerations

- Assess goals of a plan and how it may impact a sale or merger
- Explore plan types and design options to match goals
- Project funding needs/identify source of funds
- Implement the plan and comply with the rules

Questions?



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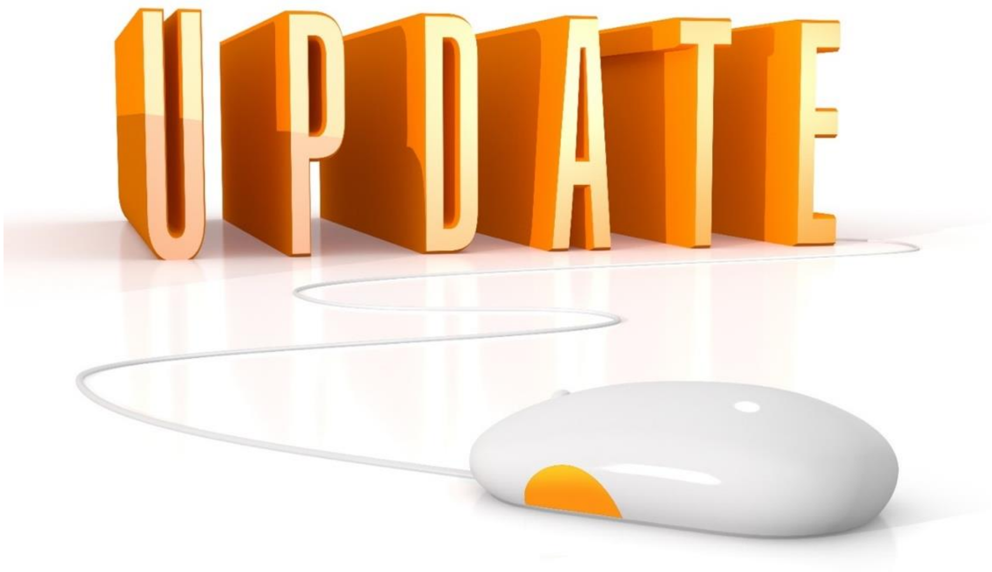

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