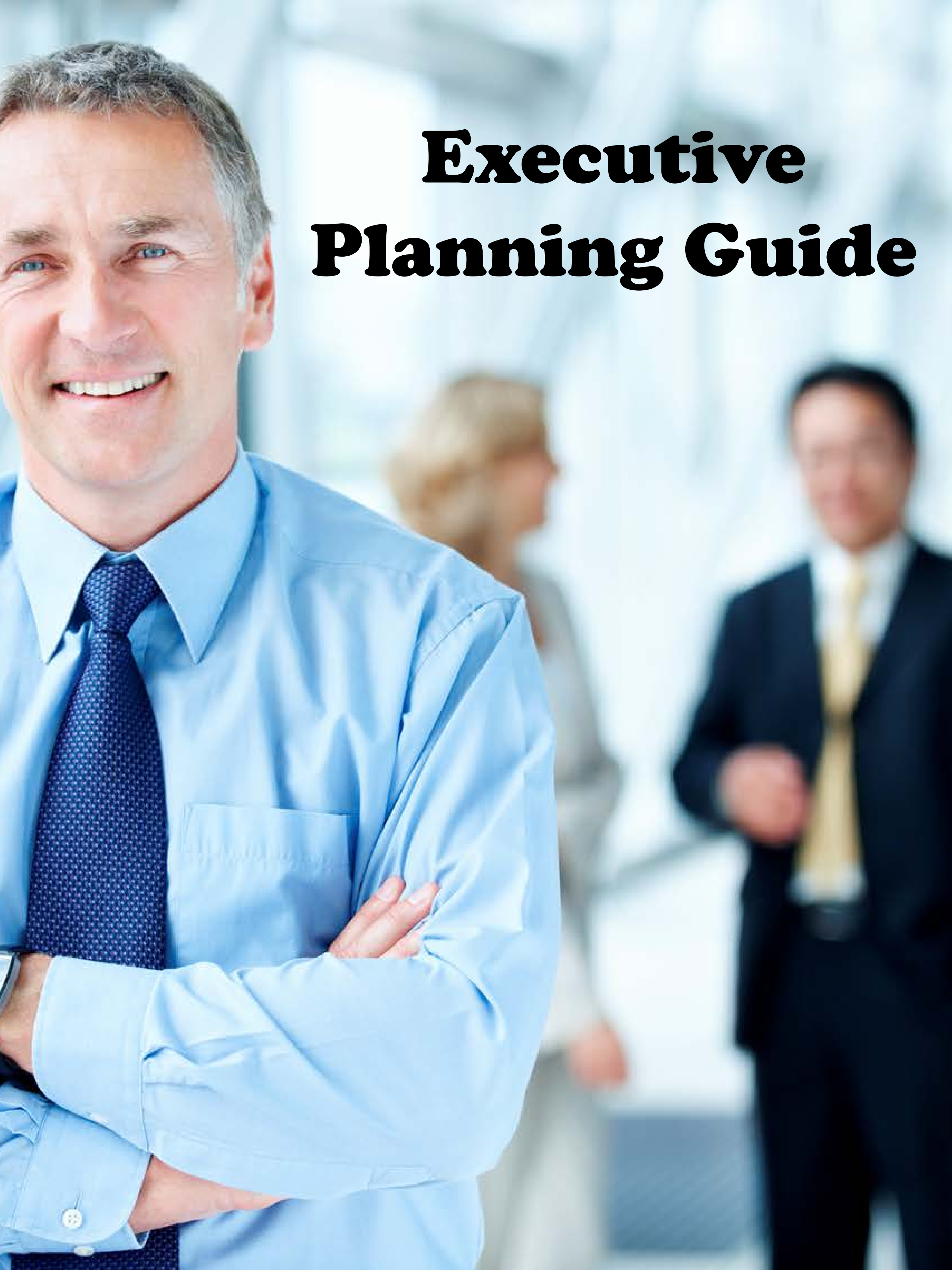
Executive Planning Guide



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Executive Planning Guide

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Special Planning Considerations for Executives

What planning considerations should executives bear in mind?

Historically, many corporate executives (rather than their employers) have been in a position to propose or demand attractive compensation packages. In addition to competitive salaries, many high-level employees are asking for (and receiving) bonuses, stock options, extra vacation time, flexible hours, and other perks. In order for you to negotiate a creative compensation package, however, you need to be aware of the typical incentives available.

How do you negotiate a compensation package?

To negotiate effectively, you need to take the following steps.

Find out what similar professionals are earning

The first step in negotiating a compensation package is to be aware of the salary level that other professionals in a similar position are commanding. You can obtain this information by word of mouth, through perusal of classified advertisements and newspaper articles, and by accessing certain Internet sites that contain salary surveys. Regarding the Internet, you might wish to consult *The Wall Street Journal's*Executive Career Site for a survey of median salaries in different job categories.

Be able to articulate your own value

If you're looking for a raise or seeking to add perks to your present compensation arrangement, be sure that you can quantify or at least articulate how you have helped your company meet its goals. If you're looking for a new job, demonstrate how you've succeeded in prior positions.

Become familiar with different kinds of compensation arrangements

Employers generally wish to attract, motivate, and retain qualified executives and other key employees. For top executives, straight salary is rapidly becoming a thing of the past. If you want perks in addition to a top salary, you must become familiar with the various compensation arrangements available.

Don't jump at the first offer

If you're an executive, bear in mind that an employer's first offer is often not his or her final offer; everything is negotiable. Go into your negotiations having already practiced how to say no (in a polite way).

What are some typical examples of executive perks?

There exist a myriad of different incentive arrangements. Keep in mind, though, that several employers will use golden handcuffs to ensure that they (as well as you) derive maximum benefit from incentive packages. Briefly, golden handcuffs refer to the combination of rewards and penalties given to key employees that compensates them so generously for staying with the company (and punishes them so severely for leaving) that it would be undesirable for the employees to leave the company.

The following are examples of typical incentive packages.

Golden parachutes

Golden parachutes are severance agreements that protect key employees from the effects of a corporate takeover or change in control. They provide key employees who are terminated (or who have resigned) as a result of a takeover or change in control with either continued compensation for a specified period following their departure or a lump-sum payment.

Incentive stock options

An incentive stock option is a right or option granted by the sponsoring corporation to its employees to purchase shares of the corporation's stock at a certain price for a specified period of time, notwithstanding an increase in the value of the stock after the option is granted. Incentive stock options received must satisfy certain requirements imposed by the Internal Revenue Code. However, if they meet these requirements, they offer advantageous tax treatment to the employee.

Nonqualified stock options

Nonqualified stock options are similar to incentive stock options, but they offer more flexibility and fewer tax advantages.

Phantom stock

Phantom stock arrangements are based on hypothetical investments in company stock. More specifically, phantom stock is the right to receive a cash or a property bonus at a specified date in the future based upon the performance of phantom (rather than real) shares of a corporation's common stock over a specified period of time.

Fringe benefits

Fringe benefits may be defined as noncash compensation benefits provided by employers. They may take a variety of forms, including employee discounts, free parking, meals and lodging, and athletic facilities.

Nonqualified deferred compensation

A nonqualified deferred compensation plan is a contractual commitment by an employer to an employee to pay currently earned compensation in a future year. It is often possible for an executive to increase retirement benefits with these plans.

Split dollar life insurance

Split dollar life insurance is an arrangement between an employer and an employee in which there is a sharing of the costs and benefits of the life insurance policy. It can provide current life insurance protection to an employee in an amount he or she might not otherwise be able to afford.

Below-market executive loans

Below-market executive loans are loans a nonpublicly held company makes available to its executives as a supplement to their regular compensation. Typically, such loans are interest free or made at favorable interest rates.

> **Caution:** Loans made by publicly held companies to executive officers and directors are prohibited under the Sarbanes-Oxley Act of 2002.

Executive business expense reimbursements

Executives often incur business-related expenses when furthering the company's interests off-premises. For instance, an executive might be required to take a client out for lunch. Companies will often reimburse executives subsequently for these business expenses.

Executive bonus plans

An executive bonus plan (also known as a Section 162 plan) involves an addition to regular salary or compensation that is provided, usually near the end of the year, to enable employees to share in profits resulting from a successful year.

Golden Handcuffs

What are golden handcuffs?

The term "golden handcuffs" does not refer to one specific method of retaining key employees. Rather, it refers to a combination of any of a number of different rewards and penalties given to key employees to encourage them to remain with a particular firm. Essentially, an employer interested in golden handcuffs would provide a very generous compensation package--with strings attached--to his or her key employees. There are two ways to convince valuable executives to remain with a company. One is to reward them if they stay. The other is to penalize them if they leave. Many employers combine both approaches by mixing generous economic incentives (like bonuses and stock grants) with vesting schedules and holding periods.

What are some examples of golden handcuffs?

There are several creative ways to compensate executives. Indeed, employers go a long way toward pleasing key employees if cash bonuses, fringe benefits, below-market rate loans, or nonqualified deferred compensation retirement plans are provided to them in addition to salary and traditional retirement plans. Nevertheless, to truly create golden handcuffs (that is, to truly encourage executives to stay long-term), various forms of equity compensation should be considered. With equity, the employer promises to pay executives generously in the future (with financial value they help to create), and makes it very expensive for them to leave the firm. The combination of performance-based pay, a stake in the future of the business, and a forfeit of benefits for leaving the firm creates a powerful incentive for an executive to stay.

Phantom stock

Phantom stock may be viewed as one example of a golden handcuffs arrangement. Unlike real stock, phantom stock does not convey any actual ownership in the business. Rather, executives are rewarded for superior performance with a "phantom" share or credit in an employee account for an amount equal to the value of the company's real shares of stock. As time goes on, this account is credited with changes in share value and with the value of dividends. Note that there is generally no taxable income for the holders of phantom shares until the employee redeems the phantom shares at a later date.

The advantage of this arrangement to the employer is that ownership and control of the corporation will not be diluted. Also, phantom stock works well if the employer is an S corporation and can't exceed the maximum allowable number of shareholders. To employ golden handcuffs, a vesting period is established for the phantom shares. In other words, the phantom shares are granted--but require a minimum holding period. If the executive leaves the company before the holding period has expired, he or she will forfeit the value of the shares.

Nonqualified stock options

Nonqualified stock options are another effective tool for retaining executives. As an option-holder, the employee has the right to purchase shares in the company at the grant price (which is typically the current share value). As the business grows in value, the value of the stock option rises. Options are generally subject to a vesting period before they can be exercised to purchase shares. This requires employees to remain with the company.

To truly encourage executives to stay, the employer might wish to consider using a "stair-step" approach to vesting.

> **Example(s):** An executive, Jim, has options to purchase 100 shares of his company's stock at $10 per share. The company can mandate that up to 50 percent of the options may be exercised at the end of Jim's second year of employment and that the remaining 50 percent can be exercised only upon completion of the fourth year.

Incentive stock options

An incentive stock option is a right or option granted by a corporation to key employees to purchase shares of company stock at a certain price that may be no less than fair market value at date of grant, for a specified period of time, and notwithstanding an increase in the value of the stock after the option is granted. These options are sometimes referred to as qualified or statutory stock options (as opposed to the nonqualified stock options mentioned previously) because they must comply with numerous requirements imposed by Internal Revenue Code Section 422.

This statute requires, among other requirements, that the grant price of the incentive stock option equal or exceed the fair market value of the stock at the time of the grant and that the employee meets certain holding period requirements. Specifically, the stock acquired under the option must be held for at least two years from the time it is granted and one year from the time it is exercised, unless the employee who receives the ISO owns more than 10 percent of the employer, in which case the option price must be at least 110 percent of the fair market value of the stock and the option is not exercisable after five years from the date of grant. However, an employer can create more strict requirements with respective incentive stock options or the nonqualified stock options mentioned previously. If an option qualifies as an incentive stock option instead of a nonstatutory stock option, the employee exercising such an option will not be taxed upon exercise of the option, but will instead be taxed at capital gains rates when the stock is ultimately sold.

> **Caution:** IRC Section 409A contains complex rules that govern NQDC plan deferral elections, distributions, funding, and reporting. If a NQDC plan fails to satisfy Section 409A's requirements participants may be subject to current income tax, as well as an interest charge and 20 percent penalty tax. In some cases phantom stock plans and nonqualified stock options may be subject to Section 409A's requirements. Incentive stock option plans are exempt from Section 409A.

Golden Parachutes

What is a golden parachute?

Golden parachutes are severance and other compensation agreements that protect key employees from the effects of a corporate takeover or change in control. Payments under golden parachutes are triggered by a change in ownership or control of the corporation. They provide key employees, whose employment is often terminated as a result of a takeover or change in control, with either continued compensation for a specified period following their departure, or a lump-sum payment, or some other negotiated benefit.

Although golden parachute payments are deductible by corporations if the payments are reasonable, Internal Revenue Code Section 280G provides that no deduction will be allowed to an employer for any "excess parachute payment." In addition, IRC Section 4999 imposes a 20 percent excise tax on the recipient of any excess parachute payment.

Internal Revenue Code definition--Section 280G

Under IRC Section 280G, "parachute payments" are any payments:

- in the nature of compensation,
- made to a "disqualified individual,"
- that are contingent on a change in control in the ownership of a corporation, in the effective control of a corporation, or in the ownership of a substantial portion of the assets of a corporation, and
- that have an aggregate present value of at least three times the individual's base amount of compensation. (The "base amount" is the employee's average annual compensation includable in the employee's gross income for the most recent five tax years ending before the date of the change in ownership.)

Example(s): Lee is an officer of XYZ Corporation and his base amount is $100,000. A payment of $400,000 that was contingent on a change in the ownership of XYZ Corporation is made to Lee on the date of the change of ownership. The payment is considered a parachute payment because it is at least three times Lee's base amount. (3 x $100,000 = $300,000). If the payment amounted to only $299,999, however, the payment would not be viewed by the Internal Revenue Service as a parachute payment (because the payment didn't equal or exceed three times Lee's base).

Caution: The term "parachute payment" also includes any payment in the nature of compensation to (or for the benefit of) a disqualified individual that's made pursuant to an agreement that violates a generally enforced securities law or regulation. These payments are not included in the three-times-base amount test--they are parachute payments regardless of whether that test is met, and regardless of any change in control or ownership of a corporation.

In the nature of compensation

Generally, all payments that arise out of an employment relationship or are associated with the performance of services are considered to be payments in the nature of compensation. These payments include wages and salary, bonuses, severance pay, fringe benefits, transfers of property, pension benefits, and other forms of deferred compensation.

Disqualified individual

For purposes of the parachute payment rules, a disqualified individual is any employee or independent contractor who, at any time during the "disqualified individual determination period," is a shareholder who owns more than 1 percent of the corporation, an officer, or a highly compensated individual.

Tip: The "disqualified individual determination period" is the 12 months prior to, and ending on, the date of a change in ownership or control of the corporation.

A highly compensated individual is a member of the group consisting of the lesser of the highest-paid 1 percent of the employees of the corporation or the highest-paid 250 employees of the corporation. However, an individual is not considered highly compensated unless he or she has compensation in the year the change in control occurs of at least the amount described in IRC Section 414(q) ($115,000 for 2012 and 2013).

Whether an individual is an officer is determined on the basis of all the facts and circumstances. However, no more than 50 (or if less, the greater of 3 employees, or 10 percent of employees) are treated as officers for this purpose.

Change in ownership or control

A payment is considered to be contingent on a change in ownership or control if the payment would not have been made had no change in ownership or control occurred. If it's substantially certain that a payment would have been made whether or not the change occurred, then the payment is not considered to be contingent on a change in ownership or control.

In general, a payment is also treated as contingent on a change in ownership or control if the following conditions exist:

- The payment is contingent on an event that is closely associated with a change in ownership or control
- A change in ownership or control actually does occur
- The event is materially related to the change in ownership or control (i.e., the event occurs within the period that begins one year before and ends one year after the date of change in ownership or control)

Examples of events that are closely associated with a change in ownership or control include:

1. the onset of a tender offer
2. a substantial increase in the market price of the stock that occurs within a short period prior to a change in ownership or control
3. the cessation of the listing of the stock on an established securities market
4. the acquisition of more than five percent of the corporation's stock by a person or persons acting as a group not in control of the corporation

Tip: If an employee has a vested right to receive a payment in the future, and the payment is accelerated as a result of a change in ownership or control, only the excess (if any) of the amount actually received over the present value of the future payment is treated as contingent on the change. In certain instances, even if a future payment is not accelerated, a portion of the payment may be treated as contingent on a change in ownership or control if the right to the payment becomes vested as a result of the change.

Caution: IRS regulations provide that a payment is presumed to be contingent on a change in ownership or control if the payment is made pursuant to an agreement entered into (or significantly modified) within one year before the date of the change in ownership or control. This presumption can be rebutted only by clear and convincing evidence that the payment was not contingent on a change in ownership or control of the corporation.

Exceptions

Because the parachute provisions are aimed primarily at publicly traded companies, these provisions do not apply to payments made by small business corporations and certain others. Specifically, the term "parachute payment" does not include any payment to a disqualified individual from:

- A corporation eligible to elect S status, as defined in Internal Revenue Code Section 1361

- A corporation whose stock is not readily tradable prior to the change in ownership--but only if more than 75 percent of the shareholders approve the payment
- A qualified plan, SEP, or SIMPLE IRA
- A tax exempt organization under sections 501(c), 501(d), and 529, if certain requirements are satisfied

Payments that the individual establishes (by clear and convincing evidence) are reasonable compensation for personal services to be rendered on or after the date of the change in ownership or control are also excluded from the definition of parachute payment (and are not included in the three-times-base amount test).

> **Caution:** Severance pay, and payments that are parachute payments as a result of agreements that violate securities laws or regulations, are never treated as reasonable compensation.

What are the tax consequences?

Recipient

Generally, parachute payments are includable in the taxable income of the recipient when received. In addition, IRC Section 4999 imposes a 20 percent excise tax on the recipient of any "excess parachute payment."

Employer

Generally, parachute payments are deductible as reasonable compensation for personal services actually rendered. However, IRC Section 280G disallows a deduction for any "excess parachute payment" paid or accrued.

Excess parachute payments

An excess parachute payment means an amount equal to the excess of any parachute payment over the individual's "base amount." The base amount is the individual's average annual taxable compensation for the most recent five years before the takeover.

> **Example(s):** John was a director of the ABC Corporation, which was taken over by another business. John had been averaging a $120,000 salary for the past five years. Under an agreement, ABC Corporation paid John $500,000 on the date of the takeover. Assume John's base amount is $120,000. The $500,000 payment to John was an excess parachute payment because it exceeded the $360,000 base amount ($120,000 x 3). The excess payment of $380,000 ($500,000 - $120,000) is not deductible by the corporation, and John must pay an excise tax of $76,000 (20 percent of $380,000).

> **Caution:** Payments are not parachute payments unless the aggregate amount received is at least three times the employee's base amount of compensation. However, once this threshold is met, the amount that is an excess parachute payment is the portion of the parachute payment that exceeds the employee's base amount of compensation.

If a disqualified individual receives more than one parachute payment, the base amount must be allocated among the payments in order to calculate the excess parachute payment amount. The portion of the base amount allocated to any parachute payment is determined by multiplying the base amount by a fraction, the numerator of which is the present value of the parachute payment and the denominator of which is the aggregate present value of all the parachute payments.

> **Example(s):** Jane, whose base amount is $100,000, is entitled to receive two parachute payments, one of $200,000 and the other of $400,000. The $200,000 payment is made at the time of the change in ownership or control, and the $400,000 payment is to be made at a future date. The present value of the $400,000 payment is $300,000 on the date of the change in ownership or control. The portions of the base amount allocated to these payments are $40,000 (($200,000/ $500,000) × $100,000) and $60,000 (($300,000/$500,000) × $100,000), respectively. Thus, the amount of the first excess parachute payment is $160,000 ($200,000 minus $40,000) and that of the second is $340,000 ($400,000 minus $60,000).

An excess parachute payment can be reduced by any portion of the payment that the individual establishes (by clear and convincing evidence) is reasonable compensation for personal services actually rendered by the individual before the date of the change in ownership or control. Reasonable compensation is based on the facts and circumstances of each case. Factors relevant to the determination include the following:

- The nature of the services rendered
- The individual's past compensation for performing similar services
- The compensation of individuals performing comparable services in situations where the compensation is not contingent on a change in ownership or control

Caution: Severance payments, and payments that are parachute payments as a result of agreements that violate securities laws or regulations, are never treated as reasonable compensation.

The following example illustrates how an excess parachute payment is calculated where a disqualified individual establishes that a portion of the payment constitutes reasonable compensation.

Example(s): Assume that a parachute payment of $600,000 is made to a disqualified individual, and the portion of the individual's base amount that is allocated to the parachute payment is $100,000. Also assume that $300,000 of the $600,000 parachute payment is established as reasonable compensation for personal services actually rendered by the disqualified individual before the date of the change in ownership or control. Before the reasonable compensation is taken into account, the amount of the excess parachute payment is $500,000 ($600,000-$100,000). The $300,000 of reasonable compensation is first allocated to the disqualified individual's base amount ($100,000). The excess ($200,000) then reduces the excess parachute payment. Thus, in this case, the excess parachute payment of $500,000 is reduced by $200,000 of reasonable compensation, resulting in an adjusted excess parachute payment of $300,000.

Why would an employer want to use golden parachutes?

Employers provide golden parachutes to key employees for several reasons, including:

- To provide incentives to sought-after employees to join an employer (or to remain with an employer) despite significant risk of a takeover or change in control that could result in employees losing their jobs

Example(s): Toy Shop, Inc. employed Bob Smith as a top executive. Because the company was very profitable, several international corporations expressed a desire to buy Toy Shop, Inc. Smith feared that he'd be left without a job if the company accepted one of the foreign offers, so he asked the officers of Toy Shop, Inc. to pay him a large bonus if the corporation got sold. This bonus would amount to three times his average annual salary.

- To reduce key employees' incentive to oppose takeovers that are beneficial to the organization but may endanger the employees' jobs

Incentive Stock Options

What is it?

An incentive stock option is a right or option granted by the sponsoring corporation to its employees to purchase shares of the corporation's stock at a certain price for a specified period of time, notwithstanding an increase in the value of the stock after the option is granted. It is sometimes referred to as a qualified or statutory stock option.

> **Example(s):** Assume that as a result of her outstanding sales performance during the year, Marissa was given a bonus: an option to purchase 1,000 shares of stock at $10 per share within the next 10 years. Within 15 months, the value of the stock had risen to $15 per share. If Marissa chose to exercise her option at that point, she would pay only $10,000 for stock that was actually worth $15,000.

How do you exercise an incentive stock option?

Typically, an employee exercises the option by paying cash equal to the exercise price or by tendering shares of employer stock that he or she already owns. With respect to the stock method, the employee can engage in a nontaxable stock-for-stock exchange (under Internal Revenue Code Section 1036). Basis in the shares transferred becomes the basis in an equal number of the new shares.

What are the requirements of Internal Revenue Code Section 422?

Incentive stock options provide favorable tax treatment to the employee, but for an option to be considered an incentive stock option for tax purposes, it must satisfy certain requirements set forth in Internal Revenue Code Section 422. These requirements are as follows:

- The incentive stock option may be granted only to an employee of the issuing corporation (or its parent or subsidiary). Employee status generally must be maintained from the grant of the option until its exercise, although an employee may exercise the option within three months following a termination of employment (within one year if disabled).
- The written stock plan must specify the total number of shares that may be purchased. It must also specify the employees or class of employees who are eligible to receive the stock options. Additionally, the plan must be approved by the corporation's stockholders within 12 months before or after the plan is adopted by the employer's board of directors.
- The option cannot provide that it will not be treated as an incentive stock option.
- The option must be exercised within 10 years after it is granted.
- The option must be granted within 10 years after the earlier of (1) the date the plan was adopted or (2) the date the plan was approved by the stockholders.
- The incentive stock option (by its terms) can be transferred by the employee only at death (through a will or by the laws of descent and distribution). While the employee is alive, only he or she can exercise the option to purchase stock.
- The option exercise price must not be less than the fair market value (FMV) of the stock on the date of grant.
- If the option is granted to a 10-percent-or-more shareholder, the exercise price must be at least 110 percent of the fair market value (FMV) of the stock (rather than 100 percent). Furthermore, the option may not be exercisable after the expiration of 5 years (rather than 10 years from the date the option is granted).

- The maximum total value of the stock (determined as of the grant date) that is first exercisable during any one calendar year may not exceed $100,000 for any one employee. Thus, for example, an incentive stock option award could permit acquisition of up to $500,000 worth of stock if it provided that the options were exercisable in five installments, each of which becomes exercisable in a different year and does not exceed $100,000.
- If the optionee (employee) sells the stock within two years of the date the option is granted, or within one year of the date the option is exercised, the sale is considered a "disqualifying disposition." Certain transfers of the stock during this time period may also result in a "disqualifying disposition." A disqualifying disposition results in the loss of favorable tax treatment. In other words, the employee must meet the holding period requirements. The stock acquired under the option must be held for at least two years from the time it is granted and one year from the time it is exercised.

Tip: It is important to note that an incentive stock option may contain additional terms and conditions that are not inconsistent with Internal Revenue Code Section 422. These terms may be more restrictive. For instance, the option exercise price may increase each year. In addition, an option can expire immediately upon termination of employment, rather than allowing an employee to exercise the option during the three-month period following termination.

When can it be used?

- Corporation needs incentive to retain key employees
- Cash bonuses are not available or appropriate
- Executive (or employee) requires stock ownership as incentive
- Stock has long-term growth potential
- Current owners are willing to dilute their ownership

Note that incentive stock options can only be used by corporations; they are not available to the employees of a partnership or limited liability corporation (LLC).

Strengths

Tax deferral

The optionee (employee) does not recognize income or capital gain until a disposition occurs (generally, that means until the stock is sold). Therefore, taxation is deferred. The amount recognized is the difference between the amount paid for the stock and the sale price.

Favorable capital gain rate

Assuming the holding period requirements are met, taxes are measured (in the year the stock is sold) at capital gain rates, which are usually more favorable than ordinary income rates. If the shares are held for at least two years from the date the option was granted and at least one year from exercise, the tax on sale is payable at a long-term capital gain rate. If the holding period requirements are not met, the gain is taxed as a combination of ordinary income and capital gain.

No withholding obligation on corporation

Assuming the holding period requirements are met, there is no withholding tax obligation on the corporation at the time of exercise of the option (because there is no income tax obligation) nor at the time of disposition of the stock. Therefore, compensating an employee with incentive stock options provides cash flow benefits to the corporation not present in other stock compensation arrangements.

Helps business to attract, motivate, and retain key employees

A principal challenge to employers is to attract, motivate, and retain key employees (and executives in particular). These goals can be promoted by giving employees an equity interest in the business. Incentive stock options accomplish this task.

Avoids cumbersome Employee Retirement Income Security Act (ERISA) requirements

Many employers offer qualified retirement plans to employees; generally, such plans are subject to cumbersome ERISA rules pertaining to funding, vesting, disclosure, and other areas. Nonqualified plans are generally not subject to most of ERISA. By selecting a nonqualified plan such as an incentive stock option, you can sidestep the cumbersome aspects of ERISA.

Therefore, from the employer's standpoint, it is wise to structure stock plans in a way that reserves to the employer the greatest degree of discretion with respect to the selection of participants, the size of awards, and the ability to terminate and reduce plan benefits. For practical purposes, this means that employers often offer incentive stock options only to executives--not to rank-and-file employees.

Avoids IRC Section 409A requirements

IRC Section 409A contains complex rules that govern nonqualified deferred compensation (NQDC) plan deferral elections, distributions, funding, and reporting. If a NQDC plan fails to satisfy Section 409A's requirements, participants may be subject to current income tax, as well as an interest charge and 20 percent penalty tax. The IRS has stated that Section 409A does not apply to incentive stock option plans.

Provides incentive for the employee by providing an ownership interest in the business

Executives and other employees are much more likely to put forth their best efforts when they have an ownership interest in the business. If the business is successful, the value of the stock will rise (and so will the employee's investment).

Minimizes the use of corporate funds for payment of compensation

Cash flow is increased because the business does not need to pay out cash to provide employees with deferred compensation.

Tradeoffs

Corporation does not get a tax deduction

The corporation is not entitled to any deduction from gross income with respect to the grant or exercise of the incentive stock option or the disposition by the employee of the stock if the relevant holding periods are met by the optionee. If the optionee makes a disqualifying disposition, however, the corporation is entitled to a deduction for a compensation expense equal to the amount of ordinary income recognized by the optionee.

Corporation has less flexibility, due to Internal Revenue Code Section 422

Code Section 422 is fairly restrictive and cumbersome. A corporation might enjoy greater flexibility by offering a nonqualified stock option, which is not subject to Section 422.

Employee may be subject to alternative minimum tax (AMT)

The employee may be subject to AMT in the year of exercise of the stock option because the exercise gives rise to an adjustment of AMT income. More specifically, the excess of the stock's fair market value at the time of exercise over the option exercise price is a tax preference item that may trigger an AMT obligation.

How to do it

Consult an attorney regarding your state's laws

Federal tax law regarding incentive stock options is uniform. It is possible that state law may differ, however, so it is important to consult an attorney to ensure that you understand your state's approach to incentive stock options as well.

Seek the guidance of an attorney and/or certified public accountant to set up your incentive stock option plan

Your plan must comply with the requirements of Internal Revenue Code Section 422. Therefore, it is essential that you consult an employee benefits/Employee Retirement Income Security Act (ERISA) attorney to set up your plan properly. It may be necessary to consult with a certified public accountant as well.

Tax considerations

Income Tax

To the employee

An employee will not recognize any taxable income on the grant of an incentive stock option. Tax is deferred until there is a disposition of the stock. (Disposition means any sale, exchange, gift, or transfer of legal title.) The price at which the option was exercised becomes the taxpayer's basis in the stock.

The tax treatment on the disposition of the stock depends on whether the stock was sold by the employee within the proper holding period. The holding period is the later of two years from the date of grant or one year from the date of exercise by the employee. A disposition of the stock prior to the expiration of the holding period will cause the recognition of "compensation income," which is ordinary income tax treatment on the difference between the fair market value (FMV) of the stock and the option price on the date of exercise. This compensation income recognized is added to the basis of the stock. Any later increase in the value of the stock from the date of exercise to the date of disposition will be treated as capital gain (short- or long-term).

> **Example(s):** Jack was granted an incentive stock option in Year 1 to acquire 1,000 shares of ABC stock at $10 per share. Six months later, he exercised his option when the FMV of the stock was $15 per share. Eleven months after buying the stock, Jack sold his 1,000 shares at $20 per share. Since he did not hold the stock for the required period of time, he has a disqualifying disposition on the date of the sale.

> **Example(s):** In the year of the sale of his stock (the disqualifying disposition), Jack recognizes compensation income of $5 per share ($15-$10). He then adds the $5 per share income to the basis of his stock to arrive at a new basis of $15 per share. When he sells the stock at $20 per share, he has a short-term capital gain of $5 per share ($20-$15).

If the employee complies with the holding period requirements, by comparison, he or she will enjoy the more favorable long-term capital gain treatment when the stock is sold. To receive this tax treatment, the employee must not dispose of the acquired stock for: at least two years from the date the option was granted; and, at least one year after the employee exercised the option.

> **Caution:** The employee may be subject to alternative minimum tax in the year of exercise of the stock option.

To the employer

The corporation is not entitled to any deduction from gross income with respect to the grant or exercise of the incentive stock option or the disposition by the employee of the stock if the relevant holding periods are met by the employee. If the employee makes a disqualifying disposition, however, the corporation is entitled to a deduction for a compensation expense equal to the amount of ordinary income recognized by the employee.

There is no withholding tax obligation on the corporation at the time of exercise of the option or at the time of disposition of the stock.

Gift and Estate Tax

Gifts of incentive stock options

A gift entails a transfer of the donor's basis in the stock to the donee. A gift of incentive stock option stock should not be made until the statutory holding period has been met. Otherwise, the donor will recognize compensation income equal to the difference between the FMV of the stock and the option price on the date of exercise. Gifts of incentive stock options may be subject to gift tax.

Death of the incentive stock option holder

Incentive stock options are includable in the option holder's gross estate for estate tax purposes. In general, the assets of a decedent are afforded a step-up in basis at death, and this rule applies to incentive stock options. A step-up in basis means that the FMV of the stock on the date of the employee's death becomes the new basis for the stock. The basis of unexercised stock options is stepped-up to FMV at death as well.

> **Example(s):** If John had an option to purchase $10,000 shares of stock at $10 per share and the value of the stock had risen to $15 per share at his date of death, John's executor or administrator would use $15 per share (the FMV at date of death) for the stock basis.
>
> **Caution:** If the estate of a person who died in 2010 elects out of the estate tax, assets transferred at death will not receive a step-up in basis but will receive a carryover or modified carryover basis instead.

Nonqualified Stock Options

What is it?

A stock option is a written offer from an employer to sell stock to an employee at a specified price within a specific time period. A stock option can be a valuable form of additional compensation to your employees, because it provides your employees with the benefits of company ownership along with potential tax benefits. When you offer your employees stock options, you provide them with the opportunity to purchase shares of your company's stock at a price that may be below the stock's fair market value (FMV). If your employee exercises the stock options, he or she purchases the shares at the lower option price, resulting in a windfall to your employee if the stock's value increases. Since stock options usually last for a long period of time (e.g., 10 years), your employee does not have to sell or purchase the stock when it would be economically unwise. As a result, your employee can avoid economic loss. As for taxation of the stock option, the employee is usually not taxed when you offer him or her the stock option. Instead, taxation is deferred until the time the employee exercises the option. There are two types of stock options that you can offer to your employee: incentive stock options and nonqualified stock options, also known as nonstatutory stock options. This discussion will focus on nonqualified stock options.

Nonqualified stock options (NQSOs)

In general

Unlike an incentive stock option (ISO), which must meet certain requirements under Internal Revenue Code Section 422 to achieve its tax-favored status, a nonqualified stock option (NQSO) is a stock option that either does not meet statutory requirements or specifically states that it is an NQSO. Although an employee who participates in an NQSO is not entitled to the same tax benefits as an ISO, it can still be an attractive alternative to an ISO, because it does not have to follow the requirements of Internal Revenue Code Section 422. As a result, an NQSO plan is an extremely flexible form of employee compensation, allowing you to configure the plan to meet both your and your employees' needs.

Taxation of nonqualified stock options

Generally, if an option does not have a readily ascertainable FMV at the time it is granted to the employee, it is not treated as taxable income to the employee at the date of the grant. Instead, the option is treated as taxable income when your employee purchases the option shares. The amount of taxable income is the difference between the FMV of the shares at the date of purchase and the option price (the amount your employee pays for the shares). As for employer tax benefits, you do not receive a deduction when the option is granted. Instead, you receive a deduction in the same year the employee has taxable income as a result of exercising the option. The amount of the deduction is the same as the amount of the employee's taxable income.

> **Example(s):** Jeff was given an option in Year 1 to purchase 500 shares of Acme, Inc. at the current market price of $50 per share. Jeff could exercise the option at any time during the next three years. In Year 2, he purchased 250 shares for $12,500 (250 x $50). The FMV of the shares at the time of purchase was $18,750 (250 x $75), so Jeff has $6,250 ($18,750 - $12,500) in taxable income. In addition, Acme, Inc. can deduct $6,250 for Year 2. If the option does have a readily ascertainable FMV at the time of the grant, it is taxed at that time, while the employer receives a corresponding tax deduction.
>
> **Tip:** Generally, an option has a readily ascertainable FMV if the option can be traded on an established market.

IRC Section 409A

IRC Section 409A contains complex rules that govern nonqualified deferred compensation (NQDC) plan deferral elections, distributions, funding, and reporting. If a NQDC plan fails to satisfy Section 409A's requirements participants may be subject to current income tax, as well as an interest charge and 20 percent penalty tax. Nonqualified stock options plans may be subject to IRC Section 409A.

Phantom Stock

What is it?

Phantom stock arrangements are based on hypothetical investments in company stock. More specifically, phantom stock is the right to receive a cash or property bonus at a specified date in the future based upon the performance of phantom (rather than real) shares of a corporation's common stock over a specified period of time. Typically, an employee is awarded a number of units of phantom stock each year (at the end of the year), based on his or her contribution to the company's success.

> **Example(s):** Anna is a long-time employee of XYZ Incorporated. She is an essential employee who knows the business and its customers. Anna is getting older and wants some lasting form of compensation in addition to her paycheck. XYZ Incorporated, however, has been a family-owned business for 35 years and its shareholders do not wish to issue stock to employees who are not family members.

> **Example(s):** So, XYZ Incorporated decides to adopt a phantom stock plan. This plan gives Anna the right to receive cash at age 56, provided that she is still employed by the company. She'll receive her bonus based on phantom stock plan units equal in value to one share of XYZ Incorporated stock. Units will be awarded at the end of each year according to Anna's contribution to the company's success. Both parties are happy with this arrangement.

How is the amount of the bonus calculated?

The amount of the bonus is often computed as the difference between the fair market value (FMV) of the stock at the date of grant and the FMV of the stock at the later specified date. Along with this appreciation in the value of the stock, the employee is also usually given an amount equal to the dividends paid over the same period of time.

> **Example(s):** Michael, a key executive, enters into a phantom stock plan under which his employer awards him 10,000 phantom shares when the market value of each share is $50. The shares are credited with dividend equivalents. At the end of five years, Michael is paid an amount equal to the increase in the value of the shares over the $50 base amount, plus the dividend equivalents.

When can it be used?

Corporation needs incentive to retain key employees

A principal challenge to employers is to attract, motivate, and retain key employees (and executives in particular). These goals can be promoted by giving phantom stock to particular employees.

Current owners are unwilling to dilute their ownership

Because the owners do not wish to dilute their ownership in the business, incentive stock options and other such methods should not be considered here. Instead, phantom stock can provide an incentive to the employee without the need for a stock issuance.

Parties want compensation to be linked to company's growth

Phantom stock should be used when both the employee and the employer want compensation to be linked to the company's growth.

Strengths

Provides tax deferral for the employee

The employee generally does not recognize federal income tax upon the grant of the phantom stock rights. Rather, he or she is generally taxed at ordinary income tax rates only upon the receipt of cash or stock at the settlement date.

Provides tax deduction for the employer

The corporation is allowed a deduction for compensation expense when the employee recognizes the income. Thus, the corporation deducts the amount of cash or market value of stock paid to the employee on the settlement date.

Helps business to attract, motivate, and retain key employees

A principal challenge to employers is to attract, motivate, and retain key employees (and executives in particular). These goals can be promoted by giving phantom stock to particular employees.

Phantom stock is one example of golden handcuffs. In general, golden handcuffs refers to the combination of rewards and penalties given to key employees that compensates them so generously for staying with the company (and penalizes them so severely for leaving) that it would be unwise for them to leave the company. Phantom stock can serve as golden handcuffs if you establish a vesting period or holding period for the shares of stock--if the employee leaves the company before the requisite number of years has expired, he or she must forfeit the value of the shares.

Avoids cumbersome Employee Retirement Income Security Act (ERISA) requirements

Many employers offer qualified retirement plans to employees. Generally, such plans are subject to cumbersome ERISA rules pertaining to funding, vesting, disclosure, and other areas. Nonqualified plans are generally not subject to most ERISA provisions. By selecting a nonqualified plan, such as phantom stock, you can sidestep the cumbersome aspects of ERISA.

Therefore, from the employer's standpoint, it is wise to structure stock plans in a way that reserves to the employer the greatest degree of discretion with respect to the selection of participants, the size of awards, and the ability to terminate and reduce plan benefits. For practical purposes, this means that employers frequently offer phantom stock plans only to executives or other key employees--not to rank-and-file employees.

Keeps ownership of business from being diluted

The owners of small or family-owned corporations often fear giving stock ownership to outsiders. With phantom stock plans, the corporation's actual stock does not have to be given away. Thus, control of the business is not diluted.

Minimizes the use of corporate funds for payment of compensation

Cash flow is better than it would be with a typical deferred compensation plan, since the business does not need to pay out cash periodically to provide employees with deferred compensation.

Tradeoffs

Corporation's deduction is deferred

With qualified plans, corporations are generally entitled to immediate tax deductions for money contributed to employee plans. Phantom stock plans are nonqualified. As a result, the corporation's deduction is deferred--it gets a deduction on the settlement date.

Phantom stock does not provide all of the rights associated with stock ownership

From the employee's perspective, phantom stock does not provide all of the rights associated with stock ownership. In particular, voting rights are not provided. Thus, phantom stock may be less attractive to those employees who want more of an equity-based incentive.

How to do it

Consult an attorney to set up the plan

It will be necessary for you to consult an employee benefits/Employee Retirement Income Security Act (ERISA) attorney to set up your phantom stock plan. An attorney will consider the goals of your business and your financial situation and advise you of the most advantageous compensation plan to adopt. Additionally, it may be necessary to consult a certified public accountant to discuss funding arrangements for the plan and to ensure that proper accounting methods are followed.

Fund the plan

There are a number of options for funding a phantom stock plan, including the purchase of corporate-owned life insurance.

Tax considerations

To the employee

The employee generally does not recognize federal income tax upon the grant of the phantom stock rights. Rather, he or she is generally taxed at ordinary income tax rates at the settlement date (some time in the future).

To the employer

The corporation is entitled to an income tax deduction at the settlement date; that is, at the time when the employee includes the money in gross income.

> **Caution:** IRC Section 409A contains complex rules that govern nonqualified deferred compensation (NQDC) plan deferral elections, distributions, funding, and reporting. If a NQDC plan fails to satisfy Section 409A's requirements participants may be subject to current income tax, as well as an interest charge and 20 percent penalty tax. Depending on its design, a phantom stock plan may be subject to section 409A's requirements.

Fringe Benefits

What is a fringe benefit?

Fringe benefits may be defined as noncash compensation benefits provided by employers to their employees. Fringe benefits may take a variety of forms, including employee discounts, company cafeteria or meal plans, free parking, and free gym/club memberships. Although executives normally participate in a company's broad-based fringe benefit programs, such as group medical plans, many executives also receive fringe benefits that are available only to the executive group. Fringe benefits must be included in the employee's income unless they are specifically excluded by another provision of the Internal Revenue Code.

> **Caution:** Partners and shareholders owning more than two percent of an S corporation's stock cannot exclude certain fringe benefits from income. The following must be included in income:
>
> - Contributions to accident and health plans, including employer payments or reimbursement of medical expenses
> - The cost of providing up to $50,000 of group-term life insurance
> - The cost of meals or lodging furnished for the company's convenience
> - Qualified transportation fringes
> - Achievement awards
> - Adoption assistance

Nondiscrimination rules

Some employee benefits may be subject to income tax to the employee if they discriminate in favor of executives or other highly compensated employees (HCEs). Basically, this means that if an employer wants to provide these benefits to certain executives, it needs to cover the rank-and-file employees as well.

For purposes of the fringe benefit rules that include nondiscrimination provisions, the definition of an HCE for 2013 is an individual who:

- Is a five percent owner at any time during either the plan year or the look-back (prior) year, or
- Had compensation in 2013 in excess of $115,000. However, the employer can ignore the income test if the employee was not also in the top 20 percent of employees in terms of compensation for the preceding year

Employers often offer certain fringe benefits that are not subject to nondiscrimination requirements. In this way, employers may pick and choose which employees to cover.

What are some common examples of tax-favored fringe benefits that may be provided on a discriminatory basis?

A number of tax-favored fringe benefits are available on a selective or discriminatory basis. They are tax-favored in the sense that these benefits can be provided to executives (and/or to rank-and-file employees) without causing the employee to recognize income for the value of the benefit. These benefits include the following:

- Business-related working condition fringe benefits
- Convenience-related lodging and de minimis meals

- De minimis fringe benefits
- Insured health plan coverage (except self-insured medical reimbursement plans)
- Athletic facilities
- Qualified moving expense reimbursements
- Qualified transportation
- Qualified bicycle commuting
- Achievement awards
- Retirement planning services
- Tuition reimbursement

Business-related working condition fringe benefits

A working condition fringe benefit is property or services provided to an employee so that the employee can perform his or her job. It applies to the extent the employee could deduct the cost of the property or services as a business expense or depreciation expense if he or she had paid for it. Examples of working condition fringe benefits include the use of a company car for business and certain job-related education.

Convenience-related meals and lodging

The fair value of convenience-related meals or lodging furnished to an employee, his or her spouse, and his or her dependents is excluded from the employee's income. The meals must be furnished on the employer's business premises and be for the convenience of the employer. Convenience of the employer means the meal is furnished for a substantial business reason other than to provide the employee with additional pay. Cash provided for meals is not excludable unless it falls under the de minimis fringe benefit exception, or unless it's related to qualifying travel expenses. Lodging may be excluded from income if it is furnished on the employer's business premises for the convenience of the employer, and the employee is required to accept these lodgings as a condition of employment.

> **Tip:** An employer-operated eating facility which the employer owns or leases on or near its premises cannot discriminate in favor of highly compensated employees.

De minimis fringe benefits

A de minimis fringe benefit is one that normally would be a taxable fringe benefit, but because the goods or services have only a nominal value, accounting for the items is unreasonable or administratively impractical. The employee can exclude from income the value of these benefits. Examples include occasional theater or sporting event tickets, occasional cocktail parties or group meals, and occasional typing of personal letters by a company secretary. Cash and cash equivalent fringe benefits (gift card, charge card, or credit card) no matter the size, are never excludable as a de minimis benefit.

Insured health plan coverage

Plans issued by licensed insurance companies are not subject to the nondiscrimination requirements. Employees may consider additional medical coverage in the form of lower deductibles, or lower coinsurance payments, for example. This treatment stands in contrast to that afforded to self-insured medical reimbursement plans, which cannot discriminate.

On-premises athletic facility

A company can set up an athletic facility such as a gym or swimming pool for employees and deduct the costs to the same extent allowed for other business expenses. The use of such a facility is tax free to the employees who take advantage of it. The value of employer-paid memberships to a commercial athletic club will not qualify for this income exclusion, however.

Qualified moving expense reimbursements

These are excluded from an employee's income. A qualified moving expense reimbursement includes any amount received by an executive from an employer as a payment for, or a reimbursement of, expenses that would have been deductible as moving expenses on the executive's tax return if directly paid or incurred by the executive.

Qualified transportation

Qualified transportation fringe benefits provided for certain employee expenses of commuting or parking are excluded from an employee's income.

Qualified parking is parking provided to an employee on or near the business premises of the employer, or on or near a location from which the employee commutes to work. Up to $245 per month (for 2013, $240 for 2012) of qualified parking can be provided tax free to the employee. In addition, employees may be offered a choice of the qualified parking option or cash compensation for such parking. If an employee chooses cash compensation rather than the parking, however, that amount is included in gross income.

In addition, the amount of transit pass and van pooling benefits that can be excluded from an employee's income is $245 per month for 2013 ($240 for 2012).

> **Tip:** Partners and certain S corporation owners (over two percent of stock owned) cannot exclude qualified transportation benefits from income.

Qualified bicycle commuting

Effective for taxable years beginning after December 31, 2008, the Emergency Economic Stabilization Act of 2008 adds a qualified bicycle commuting reimbursement fringe benefit as a qualified transportation fringe benefit.

A qualified bicycle commuting reimbursement fringe benefit means, with respect to a calendar year, any employer reimbursement during the 15-month period beginning with the first day of such calendar year of an employee for reasonable expenses incurred by the employee during the calendar year for the purchase and repair of a bicycle, bicycle improvements, and bicycle storage, provided that the bicycle is regularly used for travel between the employee's residence and place of employment.

The maximum amount that can be excluded from an employee's gross income for a calendar year on account of a bicycle commuting reimbursement fringe benefit is an amount equal to the product of $20 multiplied by the number of the employee's qualified bicycle commuting months for the year. The $20 amount is not indexed for inflation. A qualified bicycle commuting month means with respect to an employee any month for which the employee does not receive any other qualified transportation fringe benefit and during which the employee regularly uses a bicycle for a substantial portion of travel between the employee's residence and place of employment. Thus, no amount is credited towards an employee's applicable annual limitation for any month in which an employee's usage of a bicycle is infrequent or constitutes an insubstantial portion of the employee's commute.

A bicycle commuting reimbursement fringe benefit cannot be funded by an elective salary contribution on the part of an employee.

What about club dues and spousal travel costs?

As a result of 1993 federal legislation, most expenses involving an executive's club dues (e.g., country clubs, luncheon clubs) or for a spouse's travel are nondeductible by the employer. When a company pays for these nondeductible expenses, taxable income may result for the executive. The proper tax treatment depends on whether the employer pays the expenses directly or, instead, reimburses the executive for the cost.

Expenses paid directly by employer

Executives can substantiate certain club dues and travel expenses to their employers. Such amounts can be treated as business expenses even though the employer gets no deduction for the amount. The denial of a deduction to the employer does not preclude those noncash items from qualifying as working condition fringe benefits. This means that the employer's deduction for providing these benefits may be limited, but the executive is not required to recognize income.

> **Example(s):** ABC Company directly pays an executive's $8,000 country club membership. If the executive uses the country club 60 percent of the time for business use and 40 percent of the time for personal use, then $4,800 (60 percent x $8,000) will be treated as a working condition fringe benefit and will be nontaxable to the executive. The remaining $3,200, however, will be taxable as compensation income to the executive, and this amount will be deductible by ABC Company.

Expenses reimbursed by employer

At present, it appears that the IRS will treat club dues and spousal costs as taxable compensation income to the executives if a company reimburses them for these costs.

What about a company car?

Company cars are often provided by employers to employees. To the extent that a company car is used for business purposes, the employee can exclude this fringe benefit from income as a working condition fringe benefit. Unreimbursed personal use of a company car (which includes commuting) is treated as a taxable fringe benefit to the employee. The fringe benefit income is reported as compensation on the employee's Form W-2.

Employees who use a company car must choose between (1) reimbursing the company for personal use to avoid income and (2) recognizing fringe benefit income for unreimbursed personal use. Recognizing the fringe benefit income results in a more favorable economic benefit and less out-of-pocket expenses for the employee.

Reimbursement versus fringe benefit income

> **Example(s):** John uses a company car for both business and personal use--he uses it for business 40 percent of the time and for personal purposes 60 percent of the time. The fair market value of the car is $10,000. Therefore, the value of John's personal use is $6,000 (60 percent x $10,000). If John chooses to reimburse his company, he'll be out-of-pocket $6,000 cash.

> **Example(s):** If, however, John chooses to incur fringe benefit income, he'll pay a total of only $2,700. John will report $6,000 worth of additional compensation income on his personal tax return. Assuming a combined 45 percent federal and state tax rate, the income will cost John $2,700 (45 percent x $6,000) in total.

Of course, employees often incur expenses while using company cars. Typical examples include gasoline and tolls.

Other executive perks

Certain executive fringe benefits, such as executive-owned life insurance, can be funded with employer-provided bonuses and can escape the nondiscrimination rules.

Low- or no-interest loans can also be given by employers to selected executives. In addition, business expenses can be reimbursed.

Nonqualified Deferred Compensation Plans: The Employee Perspective

What is it?

A nonqualified deferred compensation (NQDC) plan is an arrangement between an employer and employee that defers the receipt of currently earned compensation. A NQDC plan doesn't need to comply with the discrimination and administrative rules that govern qualified plans, such as Section 401 of the Internal Revenue Code. And if the NQDC plan is "unfunded" (most are) the plan avoids the burdensome requirements of the Employee Retirement Income Security Act of 1974 (ERISA). Since an NQDC plan doesn't have to comply with these regulatory requirements, it's a flexible form of employee compensation that allows your employer to tailor the benefit amounts, payment terms, and conditions of the plan to your needs. In addition to its flexibility, an unfunded NQDC plan can provide you with significant tax benefits: Unlike cash compensation, which the IRS taxes currently, deferred compensation generally isn't subject to federal income taxes until you begin receiving distributions from the NQDC plan.

Funded versus unfunded plans

In general

It is important for you to understand whether your employer's NQDC plan is "funded" or "unfunded" in order to understand how the federal tax laws and ERISA apply to the plan. Most NQDC plans are unfunded. The reason is that employers usually adopt NQDC plans in order to provide their employees with the benefit of tax deferral while at the same time avoiding the often burdensome requirements of ERISA.

> **Tip:** ERISA does not apply if your employer is a church or a state or local government. If you're employed by a state or local government your NQDC plan is subject to a special set of rules under IRC Section 457, and this article does not generally apply.

Unfunded plans

An unfunded plan avoids most ERISA requirements, and your benefits are usually not subject to federal income tax until you receive them. A NQDC plan is unfunded if either assets have not been set aside by your employer to pay plan benefits (that is, your employer pays benefits from its general assets on a "pay as you go" basis), or assets have been set aside but those assets remain subject to the claims of your employer's creditors (often referred to as an "informally funded" plan). In general, when a plan is unfunded you must rely solely on your employer's unsecured promise to pay benefits at a later date. As a result, you may be fearful that when it comes time for you to receive the deferred compensation, your employer may be unwilling or unable to pay the deferred compensation or that a creditor may seize the funds through foreclosure, bankruptcy, or litigation. Unfunded plans must generally be limited to a select group of management or highly compensated employees, and are often called "top-hat" plans.

> **Tip:** Although there is no formal legal definition of "select group of management or highly compensated employees," it generally means a small percentage of the employee population who are key management employees or earning a salary substantially higher than the average salary for all management employees. Generally, courts will look at the number of employees in the firm versus the number of employees covered under the top-hat plan, the average salaries of the select group versus the average salaries of other employees, and the extent to which the select group can negotiate salary and compensation packages.

Funded plans

If you fear losing your deferred compensation benefits (for example, if your employer becomes insolvent or declares bankruptcy) your employer may want to consider offering a funded NQDC plan. These are unusual, because funded NQDC plans generally must comply with all of ERISA's requirements, and your plan benefits are subject to federal income tax as soon as they are vested. In general, a plan is considered "funded" if assets have been irrevocably set aside with a third party (for example, in a trust) by your employer for the payment of your NQDC plan benefits, and those assets are beyond the reach of your employer and your employer's creditors. In other words, if you are guaranteed to receive your benefits under the NQDC plan, the plan is considered funded. This is also sometimes referred to as "formal funding." One of the most common methods of formally funding a NQDC plan is the secular trust. But again, unfunded plans are far more common than funded plans.

Informally funded plans

While most employers want to avoid formally funding their NQDC plans in order to avoid ERISA while providing the benefit of tax deferral, employers often want to accumulate assets in order to ensure they can meet their benefit obligations when they come due. This is called 'informally funding" a NQDC plan. Even though your employer sets aside funds, the NQDC plan is not considered formally funded because the assets remain part of your employer's general assets, and can be reached by your employer's creditors. Informal funding allows your employer to match assets to future benefit liabilities, and provides you with psychological assurance (at least) that your benefits will be paid when due. The most common method of informally funding a NQDC plan is the rabbi trust, discussed more fully below. An irrevocable rabbi trust, adequately funded, can provide you with the assurance that your benefits will be paid in all events other than the insolvency or bankruptcy of your employer.

Tax treatment--unfunded plan

In general

Any amount your employer promises to pay you from an unfunded NQDC plan is generally not subject to federal income tax until you actually receive payment of your benefits from the plan. This is true whether or not your employer chooses to informally fund the NQDC plan (for example, through contributions to a rabbi trust). However, there are instances in which your NQDC plan benefits may be taxed prior to your actual receipt of the funds.

Constructive receipt

Under the doctrine of constructive receipt, the IRS can tax you prior to your "hands-on" receipt of funds if the funds are credited to your account, set aside, or otherwise made available to you without substantial restriction. In other words, once the funds have been earned and are payable to you on demand, you must report the income even if you choose not to actually accept current payment of the funds. The constructive receipt doctrine has been codified in part by Internal Revenue Code (IRC) Section 409A.

Section 409A of the Internal Revenue Code

IRC Section 409A provides specific rules relating to deferral elections, distributions, and funding that apply to most NQDC plans. If your employer's NQDC plan fails to follow these rules, your NQDC plan benefits for that year and all prior years may become immediately taxable, and subject to penalties and interest charges. It is very important that your employer be aware of, and follow the rules in, IRC Section 409A, when establishing a NQDC plan.

Tax treatment-- funded plan

Your employer's contributions to a funded NQDC plan are generally taxable to you once you become vested in the contributions--that is, when the benefits are no longer subject to a substantial risk of forfeiture. This is true even if you don't yet have a right to receive payment from the plan. If the plan is funded with a secular trust you may be entitled to a distribution from the trust to pay the taxes. Or your employer may decide to pay you a cash bonus that covers your tax liability. The tax treatment of benefits paid from a NQDC plan funded with a secular trust can be quite complex.

NQDC plan issues that concern key employees

Dollar limitations on contributions to and benefits payable from qualified plans

Sometimes, highly compensated employees are adversely affected by the dollar limitations on contributions to and benefits payable from qualified plans. As a result, they don't receive as high a percentage of their compensation as do lower-paid employees under a qualified plan. A NQDC plan can help solve this problem.

Tip: The compensation limit (which is indexed for inflation) is $255,000 for 2013 ($250,000 for 2012).

Example(s): Hal and Jane work at BCD Corporation. Hal earns $300,000 in 2013, while Jane earns $100,000. They both participate in a defined benefit plan that provides a general benefit of 50 percent of salary. Although the plan formula dictates that Hal should get a benefit of $150,000 (50 percent of $300,000), he actually is only allowed to receive $127,500 (50 percent of $255,000) because $255,000 is the maximum compensation amount that may be used in calculating the benefit in 2013. Conversely, Jane is entitled to $50,000 (50 percent of $100,000) because her entire annual salary can be taken into account, since it is below $255,000. As a result, Hal may only receive approximately 42.5 percent of his pay, while Jane may receive the 50 percent as dictated by the plan formula. Hal is adversely impacted by the $255,000 maximum, while Jane isn't.

Tax benefits

Generally, a key employee is subject to a higher income tax rate. As a result, a key employee can benefit from deferring compensation, since he or she is likely to be in a lower tax bracket during retirement, when the deferred compensation is finally received.

Example(s): Hal works at XYZ Company. Hal is given the option of receiving as earned or deferring until retirement a $100,000 bonus. His current marginal tax rate is 35 percent, and his estimated marginal tax rate at retirement will be 25 percent. Assuming no other variables, if Hal decides to receive the $100,000 bonus this year, he will be taxed $35,000 (35 percent of $100,000), but if he defers the income until retirement, he will only be taxed $25,000 (25 percent of $100,000).

Rabbi trusts

In general

A rabbi trust is a trust that your employer establishes in order to satisfy its obligation to provide you with benefits under an NQDC plan. It's called a rabbi trust because a rabbi was the beneficiary of the first such trust to receive a favorable IRS ruling. The primary reasons for establishing a rabbi trust are for your employer to provide you with assurance that assets will be available, and that payment of your deferred compensation will be made when due under the terms of the NQDC plan (except in the event of your employer's insolvency or bankruptcy).

Tip: Although the rabbi trust assets are held apart from your employer's other assets, the funds are still subject to the claims of your employer's general creditors. For this reason the NQDC plan is considered unfunded (or informally funded) for tax and ERISA purposes.

Tip: A rabbi trust can be in the form of either a revocable or irrevocable trust. If a rabbi trust is irrevocable, your employer gives up the use of the NQDC plan assets and can't get them back until all plan benefits have been paid. The assets are there to cover you, except in the case of your employer's bankruptcy or insolvency. If bankruptcy or insolvency occurs, the assets become accessible to your employer's general creditors (including you), and your NQDC plan benefits may be lost.

Why would you want your employer to establish a rabbi trust?

The rabbi trust is a major step forward in providing benefit security for plan participants. An irrevocable rabbi trust, adequately funded, can largely eliminate the risk of nonpayment for every reason but your employer's bankruptcy or insolvency. For employees who worry about nonpayment primarily by reason of a hostile takeover or a similar occurrence whereby the employer refuses to pay, the rabbi trust is an ideal device.

IRS tax treatment

A NQDC plan informally funded with a rabbi trust is considered "unfunded" for federal income tax purposes. Even though your NQDC plan benefits may be payable from rabbi trust assets your benefits are generally not subject to income tax until they are actually paid to you. See "Tax treatment--unfunded plan," above.

Caution: IRC Section 409A provides specific rules that govern rabbi trusts. For example if your employer funds a rabbi trust while maintaining an at-risk defined benefit plan, or your employer invests rabbi trust assets off-shore, you could be subject to immediate taxation and penalties.

NQDC plans and corporate-owned life insurance (COLI)

In general

Corporate-owned life insurance (COLI) is a life insurance policy that your employer takes out on your life. Your employer is both the owner and the beneficiary of the policy. As owner of the policy, your employer is responsible for paying the premiums. As beneficiary of the policy, your employer retains all rights to the benefits under the policy. Other than being named as the insured, you have no interest in the policy. COLI can be used for a variety of reasons, and the use of COLI may or may not bear any relationship to the actual financial loss your employer may anticipate incurring upon your death. For example, COLI is commonly used as a funding vehicle for NQDC plans. When used as a funding mechanism for an NQDC plan, your employer can borrow against the cash value that accumulates under the policy. Your employer can then use the borrowed funds to pay the COLI premium payments or to fund the NQDC plan.

> **Tip:** The Pension Protection Act of 2006 requires your employer to notify you: (a) that you may be insured under a COLI policy, (b) of the maximum amount of coverage your employer may take out on your life, and (c) that your employer will be the beneficiary of the death proceeds. The Act also requires that your employer get your written consent to being insured. If your employer fails to comply with these rules, the amount your employer can exclude from income as a tax-free death benefit will generally be limited to the premiums your employer paid for the contract. Some state laws may also require your consent before you can be insured under a COLI contract.

Why would you want your employer to purchase COLI?

As an informal funding mechanism for NQDC plans, the COLI policy provides you with psychological the assurance that your employer will have assets available when benefit payments are due under the plan.

Risks associated with COLI

A number of risks are associated with using COLI to fund an NQDC plan. First, if the insurance company experiences severe financial difficulties, your employer may be unable to access the policy's cash value to pay the plan benefits. In addition, the disparity between the estimated earnings (earnings projected when the policy is issued) and the actual earnings may leave your employer with insufficient cash value to pay plan benefits when due. Also, the COLI policy remains part of your employer's general assets, and therefore is subject to the claims of your employer's creditors in the event of your employer's bankruptcy or insolvency. And if the COLI policy is held directly by your employer the policy could be cashed out at any time.

NQDC plans and split dollar life insurance

Another informal funding vehicle for NQDC plans is split dollar life insurance. In general, split dollar is an arrangement whereby you and your employer share the premium cost and/or death benefits of a life insurance policy issued on your life. Split dollar life insurance allows your employer to fund NQDC plan benefits with the proceeds your employer receives from the life insurance policy. While there are a number of variations, one way your employer can accomplish this is by establishing an unfunded nonqualified plan to provide you with a promised level of deferred compensation benefits. Your employer then purchases a life insurance policy on your life. The premiums may be split between you and your employer in any way desired. Typically you are entitled to a death benefit from the policy equal to some multiple of your compensation, for example 3 times pay. The face amount of the policy, however, is usually greater than that amount. Each year, your employer credits your nonqualified plan account with an amount specified in the NQDC plan. When distribution is scheduled to occur, your employer pays you the NQDC plan benefits from his or her general assets. Upon your death, your beneficiary receives the promised level of death benefits from the life insurance policy, and your employer receives the balance of the policy proceeds. The life insurance benefits are tax-free. By funding an NQDC plan with split dollar life insurance, you can receive death benefit protection under the life insurance policy along with deferred compensation under the NQDC plan, and your employer can recoup all or part of the cost of providing these benefits.

> **Caution:** Be sure to consult your legal and financial advisors before implementing a split dollar plan. The IRS has issued regulations that have significantly changed the tax treatment of split dollar life insurance. Also, in some cases, the Sarbanes-Oxley act may prohibit public companies from

implementing certain forms of split dollar plans.

Secular trusts

In general

A secular trust is an irrevocable trust that your employer establishes with a third party to hold assets for the exclusive purpose of paying for your NQDC plan benefits. A significant feature of the secular trust is that participants generally have a nonforfeitable and exclusive right to the contributions made to the trust and to the earnings on those contributions. This stands in contrast to the rabbi trust, where plan assets remain subject to the claims of your employer's general creditors, and your benefits may be lost in the event of your employer's insolvency or bankruptcy.

> **Tip:** Although your employer establishes the secular trust for your benefit, you may be treated, for tax purposes, as having established the trust.

Why would you want your employer to establish a secular trust?

A secular trust can provide you with the assurance that your NQDC plan benefits will not be at risk as a result of your employer's unwillingness or financial inability to pay the benefits at a future time. Unlike assets that are within a rabbi trust, secular trust assets are not subject to your employer's creditors' claims. The secular trust assets must be used for the exclusive purpose of paying benefits due under the NQDC plan.

Disadvantages of a secular trust

The IRS taxes you each year on what could be sizable income. Unfortunately, you don't receive the cash to pay the tax on that money until NQDC plan distributions are scheduled to occur. However, the plan may be designed so that you may receive a distribution from the trust to pay the taxes. Alternatively, your employer may pay you a bonus that covers your tax liability.

Types of secular trusts

There are two types of secular trusts: an employer secular trust and an employee secular trust. An employee secular trust arrangement allows you to choose to receive cash compensation or contributions to an irrevocable trust that your employer establishes for your exclusive benefit. The trust is not subject to your employer's creditors, and your employer's role is as administrator of the trust. An employer secular trust is similar, but you don't have the choice to receive cash instead of your employer's contribution to the irrevocable trust. In both cases the trust assets are placed beyond the reach of your employer and your employer's creditors.

IRS tax treatment

The use of a secular trust creates a funded plan for tax purposes. In general, this means that your employer's contributions to a secular trust are includable in your income in the year they're made to the trust or, if later, in the year you become vested in the contributions. The taxation of secular trusts is complex.

Secular annuities

A secular annuity may be used in lieu of a secular trust, or in conjunction with a secular trust. A secular annuity is an annuity your employer purchases in your name that is either a standalone benefit, or secures the benefit promised by your employer under a related NQDC plan. While there are a number of variations, typically you own and control the annuity contract, and your employer must rely on the premature withdrawal tax and the policy surrender charges to deter you from surrendering the contract for its cash value. If your employer wants more control over when you can receive the annuity proceeds, your employer might place the secular annuity inside a secular trust. By doing this you would generally not be entitled to distributions until the time specified in the plan and trust documents.

A secular annuity creates a funded plan for tax and ERISA purposes. The use of a secular annuity places the NQDC plan assets beyond the reach of your employer's creditors and provides full security to you that your NQDC plan benefits will be paid (subject to the solvency of the insurer). However, placing the assets beyond the reach of your employer's creditors generally causes you to be immediately subject to federal income tax on your employer's premium payments. Any increase in the cash surrender value is generally tax deferred until you begin receiving payments from the annuity contract.

> **Caution:** Distributions from a secular annuity may be subject to a 10 percent early distribution penalty if made before you reach age 59½, unless an exception applies.

What is a supplemental executive retirement plan (SERP) plan?

A supplemental executive retirement plan (SERP) is simply an unfunded NQDC plan that provides you with benefits that supplement benefits you are entitled to receive under your employer's qualified retirement plan. A SERP can be either a defined benefit plan or a defined contribution plan.

> **Tip:** The term SERP is also sometimes used more broadly to refer to any NQDC plan that provides unfunded deferred compensation benefits to a select group of management or highly compensated employees (i.e., a top-hat group).

What is an excess benefit plan?

An excess benefit plan is a special kind of NQDC plan. An excess benefit plan is designed solely to provide you with NQDC plan benefits in excess of the limits that apply to qualified plans under IRC Section 415. Section 415 limits contributions to defined contribution plans (like 401(k) plans and profit-sharing plans) to the lesser of $51,000 (in 2013, $50,000 in 2012) or 100 percent of pay (plus any age-50 pre-tax catch-up contributions). Section 415 limits benefits from defined benefit plans to the lesser of $205,000 (in 2013, $200,000 in 2012) or 100 percent of your average compensation for your high three years. Excess benefit plans are different from other NQDC plans because if unfunded they are entirely exempt from ERISA, and even if funded are exempt from most ERISA requirements. Also, unlike other unfunded NQDC plans, an unfunded excess benefit plans does not need to limit participation to a select group of management or highly compensated employees even though typically only highly compensated employees will be impacted by the Section 415 limits.

Split Dollar Life Insurance, Including Nonqualified Deferred Compensation Plans

What is it?

In general

A split dollar life insurance arrangement, or SDA, is an agreement between an employer and an employee to split the premium payments and the benefits (e.g., cash value, death proceeds, and possibly the dividends) of a life insurance policy on the employee's life. For an employer, split dollar life insurance arrangements offer a way to attract, motivate, and retain key employees. They also provide a source of cash to fund nonqualified deferred compensation plans for them. For an employee, an SDA offers partially subsidized life insurance.

When can you use it?

An employer can use a split dollar life insurance arrangement for the following purposes:

- To attract, motivate, and retain key employees
- To fund nonqualified deferred compensation plans for key employees
- To provide life insurance for a key employee in an amount that the employee might not be able to afford
- To fund stock purchase agreements
- To fund severance benefits

How does it work?

Cash value method

In the classic split dollar arrangement (called the cash value method), the employer pays the portion of the premium that equals the annual increase in the cash value of the policy, and the employee pays the balance. When the annual increase in the cash value of the policy equals or exceeds the net premium (the gross premium less the dividends), the employer pays the entire amount. The employer benefits from this approach because it ensures that the cash value of the policy is always sufficient to reimburse the cash outlay.

Split dollar arrangements usually take one of two forms. In the endorsement form, the employer is formally designated as the owner of the insurance contract and endorses the contract to specify the portion of the insurance proceeds payable to the employee's beneficiary. In the collateral assignment form, the employee is formally designated as the owner of the contract, and the employer's premium advances are secured by a collateral assignment of the policy.

> **Caution:** The Sarbanes-Oxley Act of 2002 makes it a criminal offense for a public company to lend money to its executives or directors. This may prohibit the use of the collateral assignment form in these companies.

Split dollar life insurance is an important part of the compensation package of many key employees. In a typical split dollar arrangement, the employer funds all or part of the cost of providing an employee with life insurance protection and then recoups that cost by sharing in the insurance proceeds at the employee's death. Split dollar arrangements have also come into wide use in gift and estate planning.

Nonqualified deferred compensation plans

A split dollar arrangement can also operate as an informal funding device for an employer's nonqualified deferred compensation plan. Split dollar life insurance allows an employer to fund benefits payable under a NQDC plan with the proceeds the employer receives from the split dollar life insurance policy. While there are a number of variations, one way an employer can accomplish this is by establishing an unfunded NQDC plan to provide employees with a promised level of deferred compensation benefits. The employer then purchases a life insurance policy on the employees' lives. The premiums may be split between the employees and the employer in any way desired. Typically the employees are entitled to a death benefit from the policy equal to some multiple of compensation, for example 3 times pay. The face amount of the policy, however, is usually greater than that amount. Each year, your employer credits employees' NQDC plan accounts with an amount specified in the plan. When distribution is scheduled to occur, the employer pays the NQDC plan benefits from his or her general assets. Upon an employee's death, the employee's beneficiary receives the promised level of death benefits from the life insurance policy, and the employer receives the balance of the policy proceeds. The life insurance benefits are tax-free. By informally funding a NQDC plan with split dollar life insurance, employees can receive death benefit protection under the life insurance policy along with deferred compensation under the NQDC plan, and the employer can recoup all or part of the cost of providing these benefits.

> **Caution:** Informal funding of a NQDC plan with split dollar life insurance may only be possible using the endorsement method. In a collateral assignment split dollar arrangement taxed under the loan regime, the employer's premium payments will not be treated as a split dollar loan if the owner does not intend full repayment. An example in the preamble of the regulations provides that if a separate agreement is entered into that the employer will make a future transfer to the employee sufficient to pay off the loan, the arrangement will not be treated as a split dollar loan. This suggests that if the employee and employer want their arrangement to be treated as a split dollar loan, they cannot enter into a separate deferred compensation agreement that will provide the employee with a future benefit sufficient to pay off the loan amount. The regulations as written do not clearly back up this assertion from the preamble.

Strengths

Low-cost benefit for key employees

A split dollar arrangement provides a low-cost mechanism for an employer to recruit and retain desirable employees. With an SDA, an employee can purchase life insurance at a cost lower than he or she could obtain outside the arrangement, or can purchase more life insurance for the same amount of money. Most split dollar arrangements allow an employee to purchase the policy from the employer at retirement, which enables the employee to continue the policy at rates that were set when he or she was younger. Some employers provide pay increases or bonuses to help employees fund their share of the premiums, while other employers loan their employees the funds at low or no interest.

Fully secured cash outlay

The employer's cash outlay is usually fully secured. At the employee's death or termination of employment, the employer is reimbursed from the policy's cash value for the cost of the premiums.

Can be limited to selected employees

An employer can selectively offer a SDA to key employees without having to offer it to all employees, since split dollar arrangements are exempt from the Employee Retirement Income Security Act (ERISA) nondiscrimination rules.

Flexible plan designs

Because split dollar arrangements can be designed in a variety of ways, they can be customized to meet employer and employee objectives.

Tradeoffs

Arrangement must remain in effect for a long period

The SDA must remain in effect for a reasonably long period (e.g., 10 to 20 years) so the policy cash values rise to a level sufficient to maximize the arrangement's benefit.

Arrangement may be terminated at age 65

The arrangement may generally end when the employee reaches age 65, since the employee's taxable cost may rise sharply after age 65.

Tax considerations

Effective as of September 17, 2003 are two mutually exclusive regimes for taxing split dollar life insurance arrangements: the economic benefit regime and the loan regime. Both the owner and the non-owner are required to fully and consistently account for all amounts under a split dollar agreement under either the economic benefit regime or the loan regime.

Under the economic benefit regime, the owner of the life insurance contract is treated as transferring economic benefits to the non-owner. This regime generally governs the taxation of compensatory arrangements in which the employee is not the owner of the contract (e.g., endorsement split dollar arrangements).

Under the loan regime, the non-owner is treated as lending premium payments to the owner. The loan regime generally governs the taxation of collateral assignment split dollar arrangements (e.g., arrangements in which the employee is designated as the owner of the contract and the employer (non-owner) pays all or a portion of the premiums).

No direct tax benefit to employer

In most cases, an employer receives no direct tax benefit. Since an employer is either a direct or indirect beneficiary of a life insurance policy underlying an SDA, the employer's share of the premiums is not tax deductible. If the arrangement is taxed under the economic benefit regime, the IRS even disallows a deduction for the portion of the employer's contribution that results in taxable income to the employee. If the arrangement is taxed under the loan regime, the employer is entitled to a tax deduction for any compensatory bonus paid to the employee to offset any interest paid by the employee. However, the employer must include these interest payments in its taxable income for the year.

Employee recognizes taxable income

If the arrangement is structured as an SDA taxed under the economic benefit regime, the employee must pay income taxes each year on the value of the economic benefits provided by the insurance policy underlying the arrangement (less any premiums paid by the employee). The economic benefits may include:

- The cost of current life insurance protection provided to the employee
- The amount (if any) of policy cash value to which the employee has current access (that has not been taken into account in a prior taxable year)
- The value of any other economic benefits (not taken into account in a prior taxable year) provided by the employer to the employee

If the arrangement is structured as an SDA taxed under the loan regime, the employer is considered to be lending to the employee the funds to make the premium payments on the life insurance policy. If the employee is paying little or no interest on these loans to the employer, then the below market loan rules apply, and the employee must pay tax annually on the imputed interest on the loans.

Death benefits received by surviving family members are exempt from income tax

Generally, death benefit proceeds attributable to life insurance protection offered under an SDA are excludable from the income of the employee's beneficiary to the extent that the employee has either paid for the coverage or taken its economic value into account.

Estate tax considerations

If death benefits are payable to an employee's estate, the proceeds are includable in the employee's gross estate for federal estate tax purposes. Similarly, these proceeds are includable in the employee's gross estate when they are payable to a beneficiary and the employee possesses incidence of ownership in the policy at the time of death. In general, an employee has incidents of ownership if he or she has the power to change the beneficiary or has access to the economic benefits of the policy.

The death benefit is not includable in the employee's gross estate if the employee had no incidents of ownership.

Below-Market Executive Loans

What is it?

Below-market executive loans are loans a nonpublicly held company makes available to its executives as a supplement to their regular compensation. Typically, such loans are interest free or made at a favorable interest rate. In other words, these loans are provided at a rate of interest below the applicable federal rate (AFR), set monthly by the IRS. (The AFR is based on the average yield on U.S. Treasury obligations.)

> **Caution:** The Sarbanes-Oxley Act of 2002 (the Corporate Responsibility Act) was signed into law on July 30, 2002. This law prohibits publicly traded companies from making personal loans, directly or indirectly, to executive officers and directors. Civil and criminal penalties will be imposed for making such loans. Loans to executives of nonpublic companies are not prohibited by the act.

Background

At one time, loans with below-market interest rates were a popular executive benefit. In 1984, however, Congress amended the tax laws to clarify that where a loan's interest is below the market rate (predetermined by the IRS monthly), interest is imputed under a series of rules. If an executive loan fails to provide for adequate interest, the loan is recharacterized as a two-step transaction in which the company is deemed to transfer additional compensation (or dividends) to the executive equaling the foregone loan interest for the period the loan is outstanding. The executive, in turn, is deemed to pay the foregone interest to the company.

Executive loans are typically offered for the following:

- Mortgage or "bridge" loans to help in the purchase of a home when the employee is moving from one of the employer's business locations to another
- College or private school tuition for members of the executive's family
- Purchase of the employer's stock through a company stock purchase plan or other method
- Meeting extraordinary medical needs, tax bills, or other personal or family emergencies such as divorce settlement costs
- Purchase of life insurance
- Purchase of a car, vacation home, or other expensive item

When can it be used?

Below-market executive loans are usually restricted by the employer to specified purposes (such as the ones listed previously). These loan programs can be very attractive as a compensation supplement to help executives meet cash needs in special situations. Employers can use these programs whenever they wish to help attract, motivate, and retain key employees and executives.

ERISA considerations

The avoidance of substantial requirements under the Employee Retirement Income Security Act of 1974 (ERISA) is usually a prime concern to employers when designing compensation arrangements (and employee plans in particular). Fortunately, below-market executive loans do not appear to fall within the definition of either a "welfare benefit plan" or a "pension plan" for ERISA purposes. Therefore, ERISA requirements should not apply.

Strengths

There are a number of advantages to below-market executive loans. These include the following:

Helps business to attract, motivate, and retain key employees

A principal challenge to employers is to attract, motivate, and retain key employees (and executives in particular). These goals can be promoted by providing below-market executive loans because obtaining a loan at favorable or below-market rate is an unusual perk.

Avoids cumbersome Employee Retirement Income Security Act (ERISA) requirements and provides flexibility

Because ERISA does not apply, executive loan programs do not need to comply with nondiscrimination rules. In other words, loans can be provided to selected groups of executives or even to a single executive. Moreover, the terms, amounts, and conditions of executive loans can be varied from one executive to another as the employer wishes.

Provides financial benefits to executives

Below-market executive loans provide a valuable benefit to executives in that these loans make cash available where regular bank loans might be difficult to obtain. Furthermore, the loans are provided at a more favorable rate of interest.

Certain of these loans are exempt from the imputed interest rules

Some below-market loans to executives are exempt from the normal imputed interest tax rules. These exclusions include the following:

- De minimis loans aggregating less than $10,000. The below-market rules do not apply to a compensation-related loan if the aggregate loans outstanding between the company and the executive do not exceed $10,000 and the loans do not have tax avoidance as a principal purpose. A husband and wife are treated as one borrower for this purpose.

- Low-interest loans without "significant tax effect" on the lender or borrower. A loan is exempt if the taxpayer can show that the interest arrangements will have no significant effect on any federal tax liability of the lender or borrower. The Internal Revenue Service will consider a number of factors here, including whether items of income and deduction generated by the loan offset each other.

- Sometimes employers will provide loans to certain employees in order to enable them to purchase a principal residence at a new place of work. In such cases, the AFR for testing the loan will be the AFR as of the date the written contract to purchase the residence was entered into.

Obviously, the topics discussed here are quite complicated; more detailed treatment is beyond the scope of this discussion. For more information, consult additional sources.

Tradeoffs

Tax rules for these loans are complex

The tax rules for below-market loans are complicated and confusing, which increases the administrative cost of the loan program for both employer and employee.

Tax treatment may be unfavorable to employee

The tax treatment of term loans (as opposed to demand loans) is unfavorable--the employee must include a substantial portion of the loan in income immediately in some cases.

Employer must bear administrative costs and risk of default

If the employee defaults, the employer will lose the money altogether or incur expenses to pursue foreclosure. Furthermore, the employer must bear the cost of administering the loan (for instance, by monitoring the payback).

How to do it

Consult an attorney and accountant to set up the plan

It is important to ensure that proper tax rules are understood and followed. An attorney will consider the goals of your business and your financial situation and advise you of the most advantageous compensation plan to adopt. In addition, it may be necessary to consult a certified public accountant to ensure that proper accounting methods are followed.

Tax considerations

Income Tax

If loan is a below-market demand loan

Interest actually paid along with any interest deemed to be paid by the executive is taxable income to the company (lender) and is deductible by the borrower, subject to the usual limitations on interest deductions. For instance, if the loan qualifies as a home mortgage loan, the interest is fully deductible. If it is a personal loan not secured by a home mortgage, it is nondeductible.

If no exception applies, the employer is treated as if it paid additional compensation to the employee in the amount of the difference between the actual rate of interest and the AFR. This additional compensation income is deductible by the employer and is taxable to the executive. The executive is treated as if he paid interest in the amount of the aforementioned additional compensation to the employer. This amount is additional taxable income to the employer. The amount is deductible by the executive, again under the usual limitations on interest deductibility.

If loan is below-market term loan

The executive is treated as if he or she immediately received an amount equal to the excess of (1) the amount of the loan over (2) the present value of all payments required to be made under the loan. This amount is treated as additional compensation income. The company can deduct this amount. Interest is also imputed at the AFR, and the company must include this interest in income. For more information, consult additional sources.

Gift and Estate Tax

Typically not applicable unless it is a small corporation and there is a family relationship. The loan must qualify as compensation-related and not a gift loan, or else there may be gift and estate tax consequences.

Questions & Answers

These loan programs are complex and involve substantial administrative costs. Are there any alternatives that would provide substantially the same benefits to executives?

Yes. You might consider providing loans to your executives at full market interest rates and then " bonus " the interest cost to the executive as additional compensation. You could also guarantee a regular bank loan taken out by your employee.

Executive Business Expense Reimbursement

What is an executive business expense reimbursement?

Executives often incur business-related expenses when furthering their company's interests off-premises. For instance, an executive might be required to take a client out to lunch or might be required to drive his or her own car somewhere for business purposes. Companies will often reimburse executives subsequently for these business expenses. When an employer reimburses an employee for travel, meal, and entertainment expenses, the entire amount of the reimbursement will be excluded from the employee's income if certain conditions are met. In particular, whether business expense reimbursements will be tax free to the executive depends on whether or not the company's expense reimbursement arrangement constitutes an accountable plan.

What is an accountable plan?

An expense reimbursement plan is accountable if it requires the executive to:

- Prove a business connection
- Substantiate expenses being reimbursed
- Return excess advances within a reasonable amount of time. If the company's plan meets the requirements for an accountable plan, expense reimbursements to executives are excluded from the executives' income

Business connection

The plan can pay reimbursements only for otherwise deductible business expenses (such as travel, lodging, or meal expenses incurred while away overnight on business). The reimbursements must be clearly identified as such when the executive is paid.

Substantiation

The plan must require substantiation of the expenses reimbursed. Two items are necessary to substantiate travel, meal, and entertainment expenses:

- Adequate records, including a summary of expenses, such as an account book or log, showing the expense's time, place, amount, and business purpose
- Documentary evidence (such as itemized receipts for payments, or paid invoices) substantiating the amount and place

Tip: Executives must submit documentary evidence, such as a written receipt, for any lodging expense (regardless of amount) and for other travel and entertainment expenses of $75 or more.

Example(s): Joe is told by his employer to take a client out for drinks and dinner after a business meeting. The bar tab and the dinner total $65, and the tip is an additional $9. Joe pays for everything with his own money and expects to be reimbursed by his employer. Because the total expenditure (bar tab, dinner, and tip) is under $75, a receipt for the expense is not necessary.

Return excess amounts

The plan must require the executive to return any advance that exceeds substantiated business expenses within a reasonable period of time. Any excess not actually returned is treated as compensation to the executive, subject to payroll tax withholding like any other compensation.

Example(s): Widget Company has an employee expense reimbursement plan that reimburses travel, entertainment, and transportation expenses for company employees. The plan reimburses only deductible business-related expenses, requires employees to adequately and timely substantiate expenses, and requires employees to timely return any excess (unsubstantiated) advances.

Example(s): Jennifer, an executive, is advanced $3,000 for travel expenses she estimates will be incurred on a company business trip. She actually spends $2,000, substantiates the $2,000, and never returns the remaining $1,000. The company's arrangement still meets the criteria of an accountable plan. However, Jennifer's failure to return the $1,000 causes the $1,000 to be treated as paid under a nonaccountable plan. Thus, the $1,000 is treated as taxable compensation income, subject to withholding and payroll taxes.

What if the company does not maintain an accountable plan?

If the company fails to comply with the accountable plan rules, business expense reimbursements are reported as compensation to the executive and are subject to withholding. These expenses are deductible by the executive only as miscellaneous itemized deductions on his or her personal income tax return, subject to the 2 percent of adjusted gross income (AGI) floor.

Obviously, this leaves many executives who do not itemize deductions (or whose deductions are limited under the 2 percent of AGI floor) with a diminished or no opportunity to exclude legitimate business expense reimbursements from income.

What about travel or mileage allowances?

Instead of receiving a reimbursement for actual expenses, some executives receive a travel or mileage allowance (a flat or stated rate without regard to the amount of expenses the executive actually incurs). A travel or mileage allowance paid under an accountable plan (e.g., a per diem arrangement) and not exceeding the federal rate is excluded from the executive's income.

The primary advantage of these allowances is that they eliminate the need for executives to gather documentation and receipts supporting the actual amount spent while on company business. Additionally, the executive can, in some instances, keep excess advances under a per diem or mileage allowance plan.

Tip: IRS Publication 1542--Per Diem Rates (for Travel within Continental United States) contains current federal per diem rates for lodging, meals, and incidental expenses paid for business travel. These federal rates will vary depending on your travel location. For more information, consult this source.

Tip: Whenever an employee uses his or her personal car for business purposes and wants to deduct the business expenses related to use of the car, there is a choice between determining the actual expenses incurred (including such items as gas and oil), and using the simpler standard mileage rate. The standard mileage rate is 56.5 cents per business mile for 2013 (55.5 cents per business mile for 2012).

To use the standard mileage rate, the taxpayer must choose the rate for the first year in which the car was placed in service for business. If actual expenses are used in the first year, the mileage rate cannot be used in later years. But if the mileage rate is used in the first year, the taxpayer can change to actual expenses in later years.

Executive Bonus (Section 162) Plans

What is it?

A bonus is an addition to regular salary or compensation that enables employees to share in profits resulting from a successful year. Bonuses are often used for executives as an incentive-oriented form of compensation, based on the attainment of profit or other goals during the year. Bonuses are sometimes used to assist executives in funding their share of the premium to a split dollar life insurance plan.

> **Example(s):** XYZ Corporation expected each of its sales executives to bring in $100,000 worth of new business in Year 1. Any executive exceeding this goal in Year 1 would be given a bonus on January 1 of Year 2 in an amount equal to 10 percent of his or her new business in excess of $100,000. Because Joe brought in an extra $50,000 worth of business, he received a $5,000 bonus check on January 1, Year 2.

When can it be used?

Employers can use bonus plans whenever they want to attract, motivate, and retain key employees. These plans can be informal or even oral. There are no tax or other legal requirements for a written plan or for filing anything with the government. However, a written plan is often desirable. First, a written plan helps to avoid disallowance of the corporation's deduction on the grounds that the bonus was unreasonable. Without a written plan, the Internal Revenue Service (IRS) is likely to conclude that a bonus is simply an excessive discretionary payment. And if this payment is made to a shareholder, the IRS may recharacterize it as a dividend instead of deductible compensation. A second reason for a written agreement is that it defines the terms of the bonus plan and assures the employee of legal grounds to require the corporation to live up to the agreement. For this reason, the terms of the agreement should be clearly defined.

> **Tip:** Other forms of deferred compensation with many of the same incentive features as cash bonus plans exist. In particular, you may wish to consider incentive stock options.

Strengths

Helps business to attract, motivate, and retain key employees

A principal challenge to employers is to attract, motivate, and retain key employees (and executives in particular). These goals can be promoted by providing executive bonus plans to key employees. Receiving a lump sum of cash in-hand for quality work can serve as a significant motivational tool for many people. In addition, it can help to make one firm more attractive than another firm that offers the same salary.

Promotes increased productivity

Bonuses represent an incentive-based form of compensation that is very effective because of the close connection between performance and receipt of the reward. Bonuses can be used for a number of purposes, such as assisting an executive in the purchase of a life insurance policy.

Tied to company performance

Bonuses allow flexibility in compensation to reflect company performance. Thus, both the employer and the employee can reap the benefits of outstanding performance.

Plan is flexible and easy to design

Bonus plans are flexible and easy to design (within certain tax restraints). This is because bonus plans need not be written and need not be filed with the government.

Employee's income tax can be deferred to next year

Because employees use the cash method (rather than the accrual method) of accounting, a bonus earned in one year does not have to be included in taxable income until it is received, usually in the following year.

You can also allow your employees to defer the receipt of a bonus until some later date. However, to avoid adverse tax consequences, make sure your bonus arrangement satisfies the requirements of IRC Section 409A if applicable.

Tradeoffs

Deductibility limited to "reasonableness"

Bonuses are limited by the requirement of "reasonableness" for the deductibility of compensation payments by the employer. More specifically, Section 162 of the Internal Revenue Code states that only reasonable allowances for salaries or other forms of compensation (which includes bonuses) will qualify for trade or business expense deductions.

> **Caution:** In the case of publicly held corporations, no deduction will be allowed if compensation to particular employees exceeds $1 million in a given year.

How to do it

Consult with an attorney and an accountant to set up the plan

It is important that proper tax rules are understood and followed. An attorney will consider the goals of your business and your financial situation, and advise you of the most advantageous compensation plan to adopt. In addition, it may be necessary to consult with a certified public accountant to ensure that proper accounting methods are followed.

Tax considerations

Income Tax

To the employer

Bonuses are generally deductible by an employer according to the same rules as other forms of cash compensation. A bonus cannot be deducted unless it constitutes a reasonable allowance for services actually rendered. Also, note that no deduction is allowed for compensation in excess of $1 million paid to certain top executives.

Since bonuses are often payable after the end of the year in which they were earned, the "2½ Safe Harbor Rule" is important for bonus planning. Under this rule, an accrual method corporation can deduct a compensation payment that is properly accrued before the end of a given year, as long as the payment is made no later than 2½ months after the end of the corporation's tax year. Note, however, that the 2½ Rule does not apply to payments made to employees who own or control 50 percent or more of the corporation. For those employees, the corporation must pay the bonus during its taxable year to deduct it during that taxable year.

To the employee

A bonus is taxed to the employee as ordinary taxable income. Since employees file taxes according to the cash method (rather than the accrual method), the bonus is taxable to the employee when it is received.

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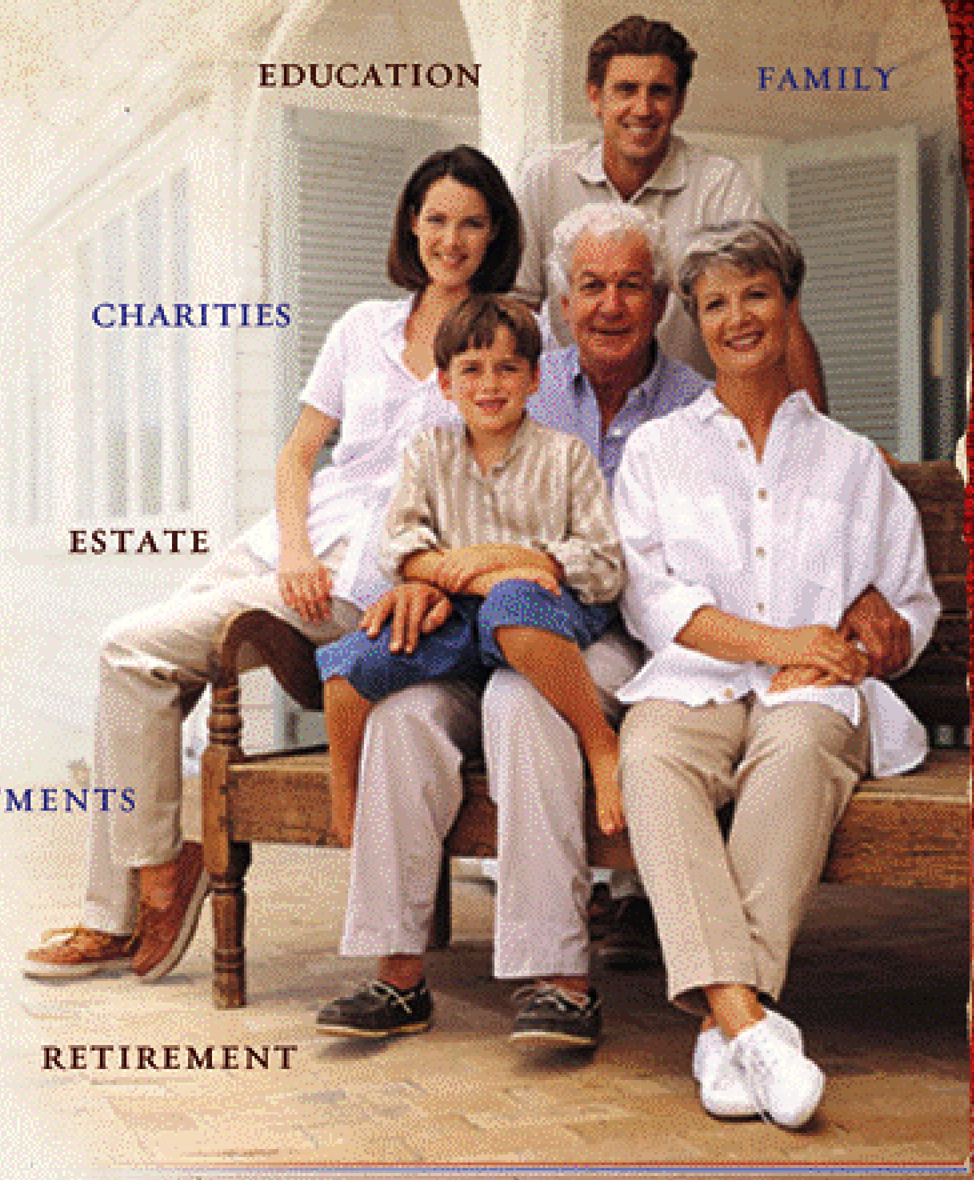

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