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A Win/Win Scenario for the Senior Key Employee and the Closely Held Business Owner: Nonqualified Deferred Compensation

Seniors are living and staying employed longer. By being strategic, a client can defer inflation-adjusted income into retirement years.

By Grace C. Wellwerts

Henry Morgan, a healthy, sixty-four-year-old client is seeking advice regarding a current employment opportunity and his tax situation. He is debt free and has sufficient assets and cash flow to maintain his lifestyle, but like many executives his age, he enjoys his career and is not currently interested in retiring. Both his parents stayed

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active into their late seventies. For Mr. Morgan, we are assuming an actuarial age of ninety. He currently works on special projects. He has been a valued employee of Comdex Consulting Corporation for several years, and he feels that the company is financially sound. In a recent conversation with the firm, he has learned that Comdex is willing to increase his current income from \$80,000 to \$100,000 if he stays with the company for five more years. As his financial planner, you suggest that he request an employment contract covering these five years. He does not currently have a mortgage and, therefore, does not have a mortgage interest deduction. He is maximizing his contributions to Comdex's qualified plan. If he receives this additional income as increased salary, he will be subject to higher tax brackets and unnecessary additional taxes. He will be in a lower tax bracket after he retires. He does not reside in a community property state. Comdex Consulting Corporation is operating as a closely held C corporation, and is in a thirty-four percent tax bracket.

Advice Requested

Should Henry Morgan continue to work, and is there an alternative method for him to receive the additional \$20,000 of income for the next five years that would be mutually beneficial to both Mr. Morgan and his employer, Comdex Consulting Corporation?

Considerations

The Senior Citizens' Freedom to Work Act was signed into law by President Clinton on April 7, 2000.¹ This

act repeals the restriction on earned income that previously existed for those who work past the normal retirement age of sixty-five. Therefore, even if Mr. Morgan continued to earn \$80,000 or more, he could begin drawing social security without a reduction in his benefits.

As an employer, Comdex Corporation must be concerned with ERISA considerations, discrimination and/or qualified plan issues. There are several additional considerations and issues that should be addressed, and procedures that must be followed to assure this arrangement provides the benefits for which we are looking. Let me start by explaining that the term "nonqualified plan" refers to an employer-sponsored retirement or other deferred compensation plan that is not qualified under Internal Revenue Code (I.R.C.) Section 401. The rules governing the taxation of nonqualified compensation plans differ significantly from those governing the taxation of qualified plans. With a qualified plan, the employee's interest in the employer's contribution is not taxed to him until it is distributed. This is true even if his rights to the employer's contributions are nonforfeitable (vested), whereas the status of the employee's interest in a nonqualified plan (vested or not) is critical in determining when it is taxable to him.² Although it is not actually held in a taxpayer's possession, income is constructively received by him until the taxable year during which it is credited to his account or set apart for him so that he may draw upon it at any time. However, income is not constructively received if the taxpayer's control of its receipt is subject to substantial limitations or restrictions.³

In a nonqualified deferred compensation plan, the employer promises to pay an employee in the future for services rendered currently. These promised payments are currently earned but will be paid at a future date or event. This plan is called nonqualified because it does not try to meet stringent requirements necessary to obtain government approval for qualified pension/profit-sharing tax treatment. To successfully utilize this strategy, an agreement should contain a contingency that might cause the employee to forfeit rights to future payments. As long as the employee's rights are forfeitable, there will be no constructive receipt of income under this agreement.⁴ The employee could still not be deemed to have constructive receipt of income if the employer's promise to make future payments is not

secured in any way. This means that no interest or asset may be given to the employee without causing it to be immediately taxable.⁵

If a nonqualified plan is funded, i.e., if the employer maintains it by making contributions to a trust, the rules for taxing the beneficiary are set forth in specific provisions of I.R.C. Sections 402(b) and 403(c) which, depending on the employee's vest-ed rights in the contribution, may or may not call for current taxation of the contribution. If the plan is not funded and merely involves the present promise of the employer to pay the employee in the future, the employee is taxed under the general tax accounting rules in I.R.C. Section 451. Since most employees are cash-method taxpayers, the money is taxed only when those amounts are actually or constructively received. Deferred amounts of income are generally considered wages for social security tax purposes in the year services are performed or, if later, when they are no longer subject to substantial risk of forfeiture.

Putting the income tax benefits aside, Mr. Morgan is assuming that Comdex Corporation will be solvent and financially sound with its creditors. He is also giving up the use and control of this money and potentially the asset that he would pass to his heirs in the event of his death or disability. From an estate tax standpoint, the commuted value of benefit payments will be included in his gross estate for federal tax purposes as income with respect to a decedent under I.R.C. Section 691, but an income tax deduction will be allowed if there is additional estate tax attributable.⁶ If Mr. Morgan accepts merely a deferral of his current income, he will risk the chance of not inflation hedging this income.

When reasonable income is paid to an employee, it is deductible by the corporation as a normal business expense. Therefore, Comdex would be giving up a current income tax deduction, and deferring it until it is actually paid to the employee. The amount earmarked for Mr. Morgan is carried on the books of Comdex as an asset of Comdex, and no current deduction is allowed for any informal funding vehicle. If Comdex offers a nonqualified plan maintained primarily for the purpose of providing deferred compensation to Mr. Morgan, it would fit into certain safe harbors, and would be exempt from almost all ERISA requirements but would be subject to certain reporting requirements and administrative and enforcement provisions. If Comdex allows Mr.

Morgan to make hypothetical investments of the deferred funds, to offset the erosion of his purchasing power, Comdex will need to pay for the cost of record keeping of hypothetical gains, losses, dividends, etc., and will be faced with the problem of providing for the actual cost of the benefit.⁷

Recommendations

Nonqualified Deferred Compensation in Conjunction with a Rabbi Trust

Mr. Morgan does not currently need the income, and his income is presumed to be higher now than it will be in five years when he retires. I recommend that Mr. Morgan enter into an employment agreement with Comdex Corporation that stipulates that a deferred payment be made to Mr. Morgan or his beneficiary in the event of death, disability, or retirement. This creates a direct and enforceable obligation; Comdex must provide the benefits. Mr. Morgan agrees to provide the services to Comdex. I recommend the use of a "Rabbi Trust" in conjunction with this plan of deferred compensation. A model grantor trust is available for use in executive compensation, and will serve as a safe harbor for taxpayers that adopt and maintain grantor trust in connection with unfunded deferred compensation arrangements.⁸

According to I.R.C. Sections 402(b) and (3), amounts contributed to the trust by the employer and earnings thereon are not currently includible in the income of a key executive who participates in the deferred compensation arrangement, if the income generated by the assets in the trust were expressly made subject to the claims of Comdex's creditors in the event of bankruptcy or insolvency. Although no guarantee can be made that the monies will be available, the use of a Rabbi Trust would provide Mr. Morgan some protection against loss of benefit in the event of a hostile takeover.

Comdex Corporation could establish this irrevocable trust to pay deferred compensation to Mr. Morgan. Mr. Morgan agrees to defer \$20,000 of income each year for the next five years. In exchange for his deferred compensation of \$20,000 for five years, Comdex agrees to pay Mr. Morgan at age sixty-nine, annual compensation of \$15,000 for ten years until he is age seventy-nine. Comdex will use a portion of the \$20,000 per year now to purchase \$150,000 of term insurance on Mr. Morgan (because

of his age, we will assume the cost of permanent insurance to be too expensive, and the cost of \$150,000 of fifteen-year level insurance including a waiver of premium until age sixty-five to be \$3,000). If Mr. Morgan dies before retirement, Comdex will agree to pay \$10,000 per year to his widow/heirs for a period equal to the number of years he was covered under this arrangement. If Mr. Morgan provides service to Comdex as agreed, until age sixty-nine, Comdex agrees to pay Mr. Morgan \$15,000 a year for ten years, until age seventy-nine in addition to any other fringe benefits to which he is entitled.

Because Comdex is in the thirty-four percent tax bracket, each \$1,000 of benefit paid to Mr. Morgan or his widow/heir would actually cost Comdex only \$660. Retirement benefits could be paid out of current earnings, and the corporation could continue the insurance policy in force for the ten-year period after Mr. Morgan retires or until the tax-free proceeds are received. (With younger executives, permanent insurance is generally used. Therefore it is unlikely that this insurance will be cost effective beyond the term period.) If Mr. Morgan dies at age sixty-eight, before he retires, Comdex would receive \$150,000 of tax-free policy proceeds.⁹ Comdex would have paid \$12,000 (\$3,000 per year for four years) for the cost of the life insurance and \$50,000 (\$10,000 for five years to his widow). The after-tax cost of making these payments to the widow would only be \$34,000 (66% x \$50,000). This results in a net gain to the corporation of approximately \$104,000 (\$150,000 less \$12,000 of premiums and \$34,000 after tax cost of payments to his widow.)

If Mr. Morgan dies at age seventy-nine, the corporation receives \$150,000, and it has paid \$45,000 in premiums and lifetime payments of \$150,000 (\$15,000 for ten years). Thus, its net after tax deduction cost for those deferred compensation payments has been \$99,000 (\$150,000 - {\$150,000 x 34%}), and its total cost to provide the promised benefits is approximately \$6,000 (\$150,000 insurance proceeds minus \$45,000 premiums paid, minus \$99,000 of deferred compensation payments). The client has thus deferred inflation adjusted income into the future and provided the employer with a cost effective method to do so.

Endnotes

1. Social Security Administration, Social Security Legislative Bulletin No. 106.20, *The President Signs*

- the "Senior Citizens' Freedom to Work Act of 2000," at http://www.ssa.gov/legislation/legis_bulletin_040700.html (April 7, 2000).*
2. CCH-EXP, 99FED (Par) 18,209.01, Beneficiary of a Nonqualified Plan: Types of nonqualified deferred compensation.
 3. *See* Amend v. Commissioner, 13 T.C. 178 (1999); Gullett v. Commissioner, 31 B.T.A. 1067 (1935).
 4. *See* C.F.R. §§ 1.451-1, 1.451-2.
 5. *See* Priv. Let. Rul. 84309012. Under an executive's deferred compensation plan, his compensation was placed in a trustee bank account, but his rights were only those of an unsecured general creditor of the company. No income was recognized by the executive as a result.
 6. I.R.C. § 691(c).
 7. The rules governing employee direction of investments in nonqualified deferred compensation plan are not clear. To avoid accelerated taxation, plans probably should not allow employees to control the actual investment of funds. Plans allowing employee input would probably also include that the asset holder need not follow the employee's wishes.
 8. Rev. Proc. 92 Fed Par 46,429, Deferred compensation arrangements: Constructive receipt: Grantor trust income: Executive compensation: "Rabbi trusts."-A model trust for use in executive compensation arrangements that are popular, Revenue Procedure 92-64, I.R.B. 1992-33,11 (July 1992).
 9. It is possible that the company will be subject to alternative minimum tax on the proceeds.