Using Non-Qualified Deferred Compensation in Business Exit Strategies

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Presentation Outline

- **Overview of Business Financial Planning Process**
  - Where does Deferred Compensation typically fit in?
- **Types of Compensation Planning**
  - Incentive Compensation Strategy Spectrum
  - Deferred Compensation Mechanics: Qualified vs. Non-Qualified
- **Exit Strategy Options**
  - How might NQDC be a useful tool?
- **Exit Strategy Planning Scenarios with NQDC**
  - Retaining key management to preserve company success while active owner “exits” into retirement and retains ownership.
  - Structuring a Non-Qualified Deferred Compensation as a tax-efficient component of a retiring business owner’s liquidation.

Business Financial Planning Process

Business Equity Liquidation & Succession Strategies

Equity Buyout at Death, Disability, or Retirement

Business Value Building & Employee Incentive Strategies

Employee Benefits & Qualified Retirement Planning

Executive Compensation & Bonus Planning

Business Continuation Strategies

Business Profit Protection Planning – Owners

Business Profit Protection Planning – Key Employees

Personal Financial Planning

Asset & Income Protection Planning

Long-Term Tax Efficient Savings & Investing Strategies

Wealth Distribution & Tax Planning with Wills & Trusts

Employee Compensation & Benefits

Incentive Compensation – Strategy Spectrum

	Immediate	Deferred
Equity	Common Stock / Non-voting Stock (or LLC, Partnership Interest)	Stock Options / Restricted Stock
Non-Equity	Cash / Employee Benefits / Perks (e.g. car, memberships, etc.) / Phantom Stock / 401(k) contributions / Insurance (e.g. Life, Disability, LTC)	**Phantom Stock / Stock Appreciation Rights / Supplemental Executive Retirement Plan (SERP) / Elective Deferred Compensation**

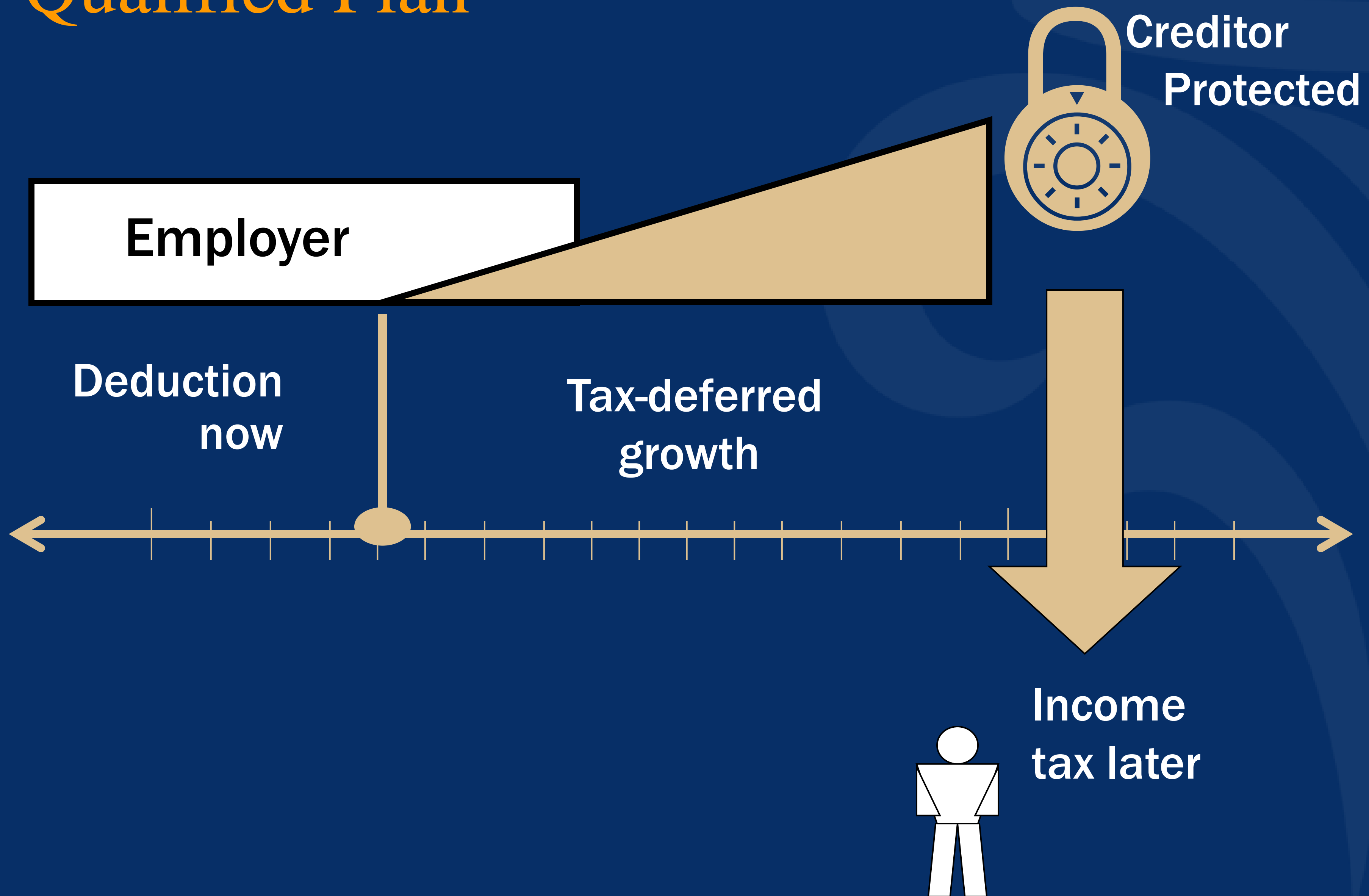
Deferred Compensation Mechanics

– **Qualified Plan**

vs.

– **Nonqualified Plan**

Qualified Plan



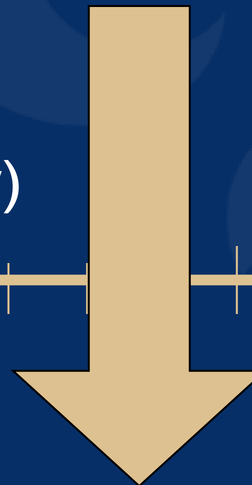
Non-Qualified Plan

Not Creditor Protected

Employer

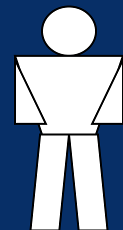
No Deduction now

Tax-deferred growth (if structured properly)



Employer Deduction Later

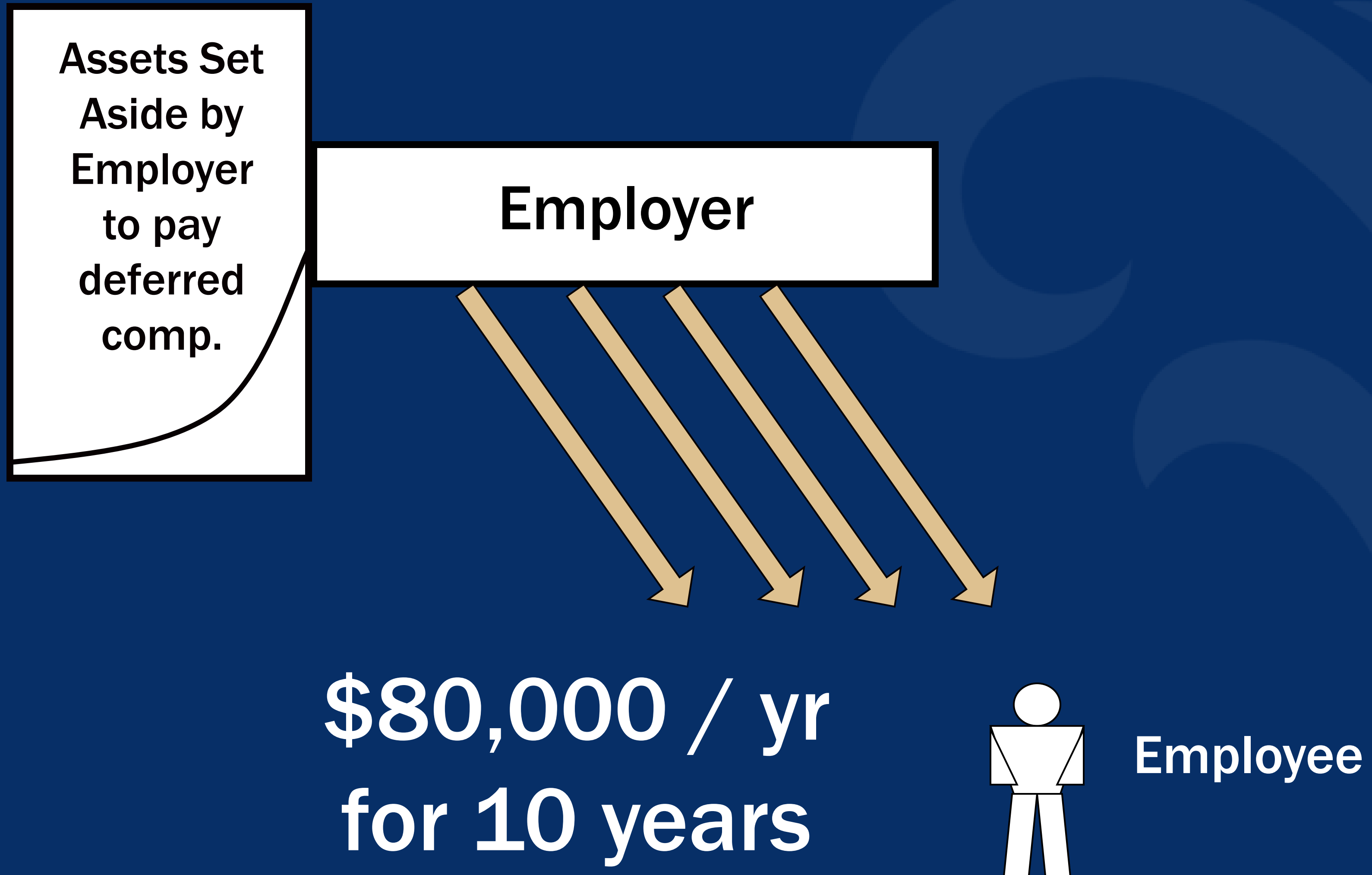
Employee Income Tax Later



Non-Qualified Plans –

- Company can have more control over assets & benefits.
- No explicit contribution limits (e.g., can defer $100,000 per year, or more).
- Wide flexibility regarding vesting – (i) cliff vest after 10 years (leave before year 10 and get nothing); (ii) vest in portions over time (25% each year over 4 years); (iii) fully vest immediately. Can be different for each participant.
- Not required to cover rank-and-file, so you can pick only Top Hat employees or other key employees.
- Fewer ERISA requirements than qualified plans when covering only Top Hat employees.

Paying Deferred Compensation



Exit Strategy Options

- Sale to 3rd party buyer
- Internal sale to current business partners or to key employees
- Family business transfer
- Employee Stock Ownership Plan (ESOP)
- Private Equity Recap
- Retire & retain equity
- Close up shop…

Exit Scenario #1 – Retire & Retain

Retire & retain ownership

- Service Firm –
  - Operated for last 30+ years;
  - Clients throughout U.S.;
  - Owner is 69 and starting to think about exiting;
  - Married but no children.
- 55 Employees – 12 “key employees”
  - 5 executives / senior mgt (early 40s – 50s)
  - 7 middle management (early 30s – mid 40s)

Exit Scenario #1 – Retire & Retain

Bottom Line: Owner doesn't want to sell.

- Owner's 'Name' and 'reputation' are key to company success, but his day-to-day roles could be delegated and transitioned.
- Owner has no idea what he'll do if he were to retire. Just wants freedom and flexibility.
- No family to take over business; Legacy isn't important to owner.
- Management isn't financially able to buy.
- How could NQDC be used as an exit tool?

Exit Scenario #1 – Retire and Retain

Goal – 25 more years of company success

- Gets owner to mid 90s
- Gets most employees to retirement or close

Required Steps –

- Deconstruct and delegate owner's activities
- Management & Operations restructuring
- Compensation plans to retain personnel critical to new management structure.
  - Enter Non-Qualified Deferred Comp.

Exit Scenario #1 – Retire and Retain

Supplemental Executive Retirement Plan

- Company promises key management an extra retirement income stream as added bonus for management roles assumed.
- Retirement income stream can tie to company success measures like profitability or valuation formula.
- Vesting schedules can "handcuff" key employees to company as retention strategy. Vested benefits can feel like "skin in the game" similar to equity.

Exit Scenario #1 – Retire and Retain

Supplemental Executive Retirement Plan

- Company sets aside a portion of profits each year to "informally fund" the future obligation to pay retirement benefits.
- Assets "informally funding" the plan may be allocated to cash, investments, or insurance, but they are company assets available for any company purpose.
- Consider timing, taxation, and triggering for benefits when selecting assets to fund SERP obligations.

Exit Scenario #1 – Retire and Retain

Supplemental Executive Retirement Plan

- 36 year old manager
- Current salary – $80,000

Benefit Option #1

- Retirement – $90,000 income per year for 10 years starting at age 65
- Vesting schedule – 100% vested by 60

Funding Vehicle & Assumptions - Investments

- $XX,000 invested annually up to employee's retirement

Exit Scenario #1 – Retire and Retain

Benefit Option #2

- Retirement – $85,000 income per year for 10 years starting at age 65
- Salary continuation at employee's death – $80,000 per year to family for 10 years
- Vesting schedule – 100% vested by 60

Funding Vehicle & Assumptions – Insurance

- $XX,000 annual premiums up to employee's retirement

Exit Scenario #2 – Internal Buyout

Sell to Partners or Key Employees

- Professional Service Firm – S-Corp.
  - Operated for 20 years;
  - Clients throughout north Georgia;
  - Senior Partner is 50 and planning to exit in 10 – 15 years;
- 10 Employees – 2 junior partners
  - Junior partners are early 30s and want to take over practice and client base established by senior partner.

Exit Scenario #2 – Internal Buyout

Typical buy-sell transaction

- Junior Partners buy Senior Partner's Stock
  - Agreed valuation – multiple of earnings or collections
  - Payment Terms –
    - Seller Financing – ?? years at ??% interest;
- Double Taxation?
  - Junior partners use after-tax dollars to pay purchase price to Senior Partner.
  - Senior Partner pays capital gains on equity sale and ordinary tax on interest.

Exit Scenario #2 – Internal Buyout

- Senior Partner's Equity is valued at $1 Million with $100,000 of basis
- Junior Partners pay 40% effective tax rate.

Pre-Tax Cash Flow needed to make Stock Payment to Senior Partner	Gross to Senior Partner	Tax Paid by Senior Partner (20%)	Net to Senior Partner
$1,666,667	$1,000,000	$180,000	$820,000

- 52% - Effective tax rate between company earnings and Senior Partner's wallet.

Exit Scenario #2 – Internal Buyout

Enter a NQDC Plan

- Company agrees to pay Senior Partner a 10-year retirement income of $100,000 starting at age 65.
  - Retirement payment is deductible to the firm and ordinary income to the Senior Partner.
- Junior Partners will still buy Senior Partner’s Stock, but the firm’s equity value is reduced because of the retirement payment obligation to the Senior Partner.

Exit Scenario #2 – Internal Buyout

- Targeting $820,000 after-tax to Sr. Partner

Pre-tax Cash Flow needed to make Stock Payment to Senior Partner	Gross to Senior Partner	Tax Paid by Senior Partner (20%)	Net to Senior Partner
$300,000	$180,000	$16,000	$164,000
Pre-Tax Cash Flow needed to make SERP payment to Senior Partner	**Gross to Senior Partner**	**Tax Paid by Senior Partner (30%)**	**Net to Senior Partner**
$1,000,000	$1,000,000	300,000	$700,000

Exit Scenario #2 – Internal Buyout

- The Company's cash flow ultimately funds the deal for the Partners. The less stress on the Company's cash flow, the better the odds of success for all involved.
- We cut company cash flow needed to fund this deal from $1.667 million down to $1.3 million, and we got $44,000 more cash into Sr. Partner's pocket in the process.
- Total taxes paid by all Partners at all stages went from $846,667 to $436,000.

Summary

- Familiarize yourself with non-qualified deferred compensation concepts and get to know some experts in that area if it isn't your cup of tea.
- When dealing with exit strategies, consider NQDC as a tool to retain key employees who will continue company success.
- Don't automatically count out NQDC as a component of an owner's liquidation and exit strategy. It might streamline company cash flow needs to fund the exit and reduce total tax costs in the transaction.

Questions
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Thank You