Executive Benefits in a Changing Economy

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read my FORBES column at
http://blogs.forbes.com/steveparrish

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Agenda

- Owner, Employer, and Employee Issues
- Recent research
- Tax topics
- Executive Benefits
  - **Salary/Wage** IRC 61
  - **Legislative** (“qualified”) IRC 401
  - **Property** (stock grants and options) IRC 83
  - **Deferred Compensation** (“nonqualified”) IRC 409A

Owner Issues related to Executive Benefits

- ✓Bottom line effectiveness
- ✓WIIFM?
- ✓Cost and cash flow
- ✓Taxes

Employer Motivations for Executive Benefits

- ✓Recruit/Retain/Reward
- ✓Golden Handcuff
- ✓Incentive
- ✓Financial

Executive Attitudes

- ✓Job and financial security
- ✓Benefit security
- ✓Motivation and incentive
- ✓Taxes
- ✓Employer vetting of benefits

2012 Harris Interactive Research

Small Business Owner Rankings of 10 key Business Priorities

RANK	2012	RANK	2010
1	Business Protection	1	Business Protection
2	Health & Wellness Solutions*	2	Group Health Benefits
3	Income Protection	3	Income Protection
4	Qualified Retirement Plans	4	Qualified Retirement Plans
5	Non-Medical Benefits (Dental, Vision, Life, Long-Term Disability and Short-Term Disability)	5	Group Non-Medical Benefits (Dental, Vision, Life, Long-Term Disability and Short-Term Disability)
6	Supplemental Key Employee Benefits*	6	Supplementary Retirement Income
7	Voluntary Benefits	7	Voluntary Employee Benefits
8	Wealth Transfer	8	Wealth Transfer
9	Survivor Income	9	Survivor Income
10	Exit Planning	10	Exit Planning

For finan

Steve Parrish

OWN IT: HELPING BUSINESS OWNERS PLAN THEIR FUTURE

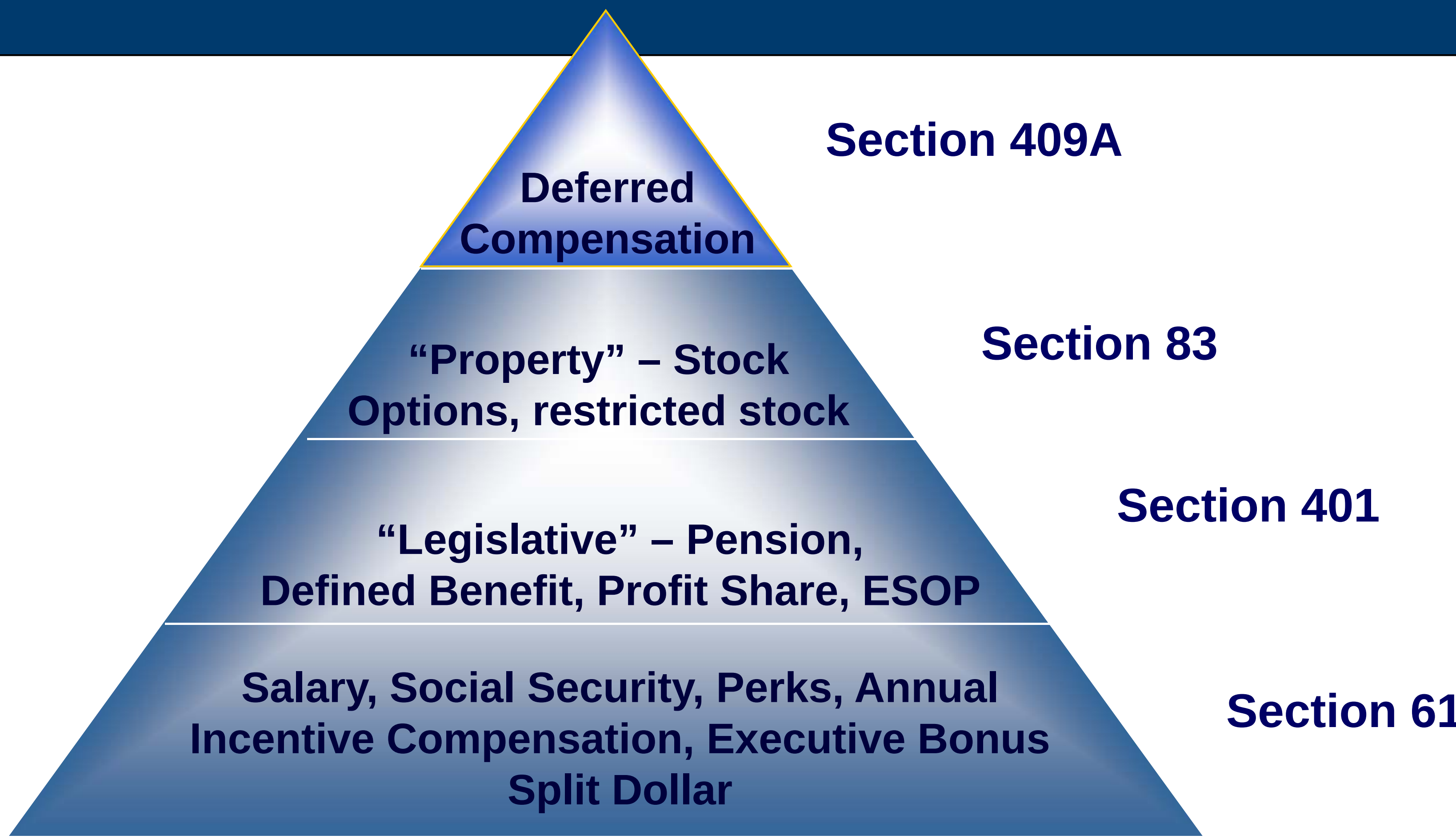
Jul. 16 2012 – 11:55 am | *149 views* | *0 comments*

Fiscal Cliff … or Fiscal Con?

My Premise: Business owners should plan on taxes going up … their own, as well as their clients'. These taxes will not appear overnight, they will not be limited to just one demographic, and they will generate from more than one taxing authority (federal, state and local).

My Rationale: Congress and the President are using scare tactics talking about the impending "Fiscal Cliff" coming on January 1, 2013. First, it's not a *fiscal* cliff – we're already there. In the next few days, the public debt clock turns over to a stunning $16 trillion IOU of public debt. Rather, what we're facing is a *tax* cliff.

Potential Executive Benefits



For financial profes

Competing Interests

- Human Resources
- C.E.O.
- Employees
- C.F.O.

Who cares about taxes? The employer does

BY STEVE PARRISH
October 25, 2011 • Reprints

When I'm asked to help with an employee benefit design, one of my first questions concerns the employer's tax structure. Unfortunately, sometimes the response is, "Who cares?"

The best answer is: The *employer* cares.

An employer will not offer an employee benefit unless it will benefit the company. Perhaps it will help improve morale or increase productivity; maybe it will help reduce turnover or motivate employees to take fewer sick days.

But the bottom line is this: The employee benefit design must benefit the employer's bottom line. It must work for the employer *financially*. This is where the employer's tax structure can have a dramatic effect.

Different employee benefits yield different financial outcomes for employers depending on whether the firm is a C Corp, an S Corp, an LLC or a not-for-profit. For example, extolling the virtues of a tax-deductible benefit to a not-for-profit can end up an embarrassment to the advisor. The benefit package must have tangible value for employees, but to be adopted it still needs to align with the tax structure of the employer.

Below are some ways various tax entities are affected by different employee benefits. Given

Cumulative Maximum Rates

		2011	2012	2013
Earned Income **Top Marginal Bracket**		**36.45%**	**36.45%**	**41.95%**
Unearned Income		**35%**	**35%**	**Up to 43.4%**
Qualified Dividends		**15%**	**15%**	**Up to 43.4%**
Capital Gains		**15%**	**15%**	**Up to 23.8%**

NOTE: Does note include AMT

The Tale of Walker Smith Jr.

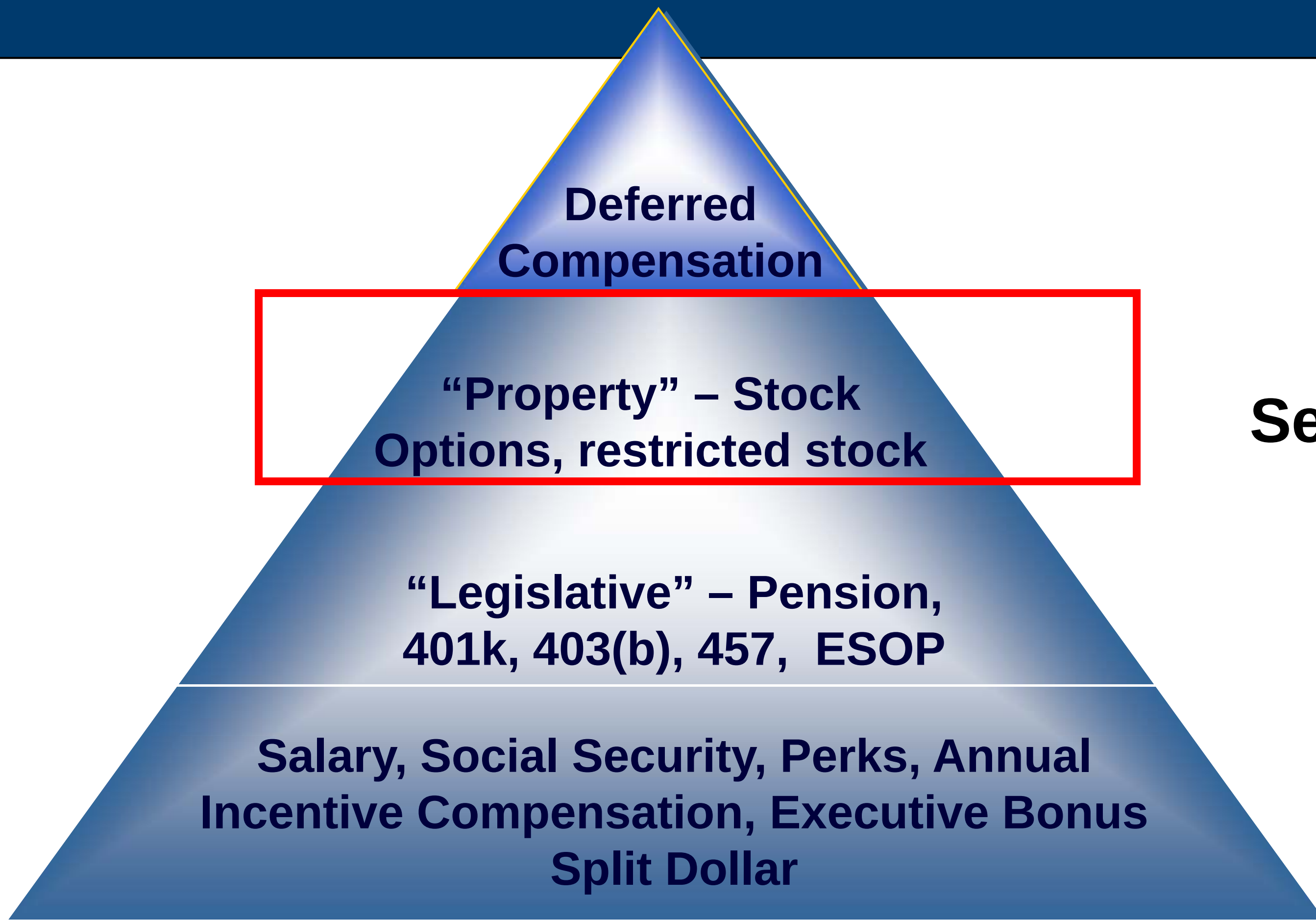
- **High Income Potential**
- **Short Livelihood**
- **Income not yet earned**
- **Question:** ***can you defer income into the future before it is earned without Constructive Receipt?***

Rev Ruling 58-301

Basic Taxation Concepts

- Constructive Receipt
- Economic Benefit
- Substantial Risk of Forfeiture
- When include in income / when deduct?
- Recent TRENDS and ISSUES
  - TARP and health insurer executives
  - Off-shore accounts (UBS, etc)
  - Stock Option uses and abuses
  - Bank executive compensation
  - 15% tax rate and "Buffett tax" debate

Potential Executive Benefits



Section 83

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Types of Equity Plans
Advantages and Challenges

- Restricted Stock
- Incentive Stock Options
- Stock Options
- Stock Appreciation Rights
- Phantom Stock

Nonqualified Stock Options

- **Promissory in nature - right to purchase stock at a fixed price within a specified time period**
- **Typically granted with rolling vesting periods**
- **Strike price doesn't have to be fair market value, however 409A applies if issued at a discount**
- **Can be discretionary (one or more employees)**

NSO Tax Treatment

- **At grant - No Tax**
- **At exercise - Ordinary Income on gain over grant price**
- **Upon sale - Cap Gain or Loss**

NSO Example

Grant **100 options @ $100 on *1/1/12* fair market value of stock is $100 – No Tax**

Exercise **options @$150 fair market value on *1/03/13* – ordinary income (and employment taxes) on fair market value less grant price (($50 x 100) x 35%)**

Sell **stock @ 200 *2/1/14* – capital gains on additional appreciation (($50 x 100) x 15%)**

The Challenge with Stock Options
Congressional Research Service, 6/15/2012

- Public Co: Comp limits, SOX, SEC approval
- FASB 123(r): expensing stock options
- IRC 409A: valuation challenges
- Proposed bill S 1375: immediate deduction of stock options

Company stock: Benefit or burden?

BY STEVE PARRISH
May 30, 2012 • Reprints

What can be better than giving employees a benefit that doesn't cost anything? Plenty if that benefit is company stock. In a cash-strapped economy it is often tempting for an employer to assuage the sting of decreased wages by making a grant of stock options or restricted stock.

With a privately held company, this is rarely a good idea. Unless the company wants the recipient of the stock to actually become a successor owner, or unless the stock is part of an overall benefit plan like an employee stock ownership plan or employee stock purchase plan, stock as a benefit can be a mistake. Why? I can name 10 good reasons:

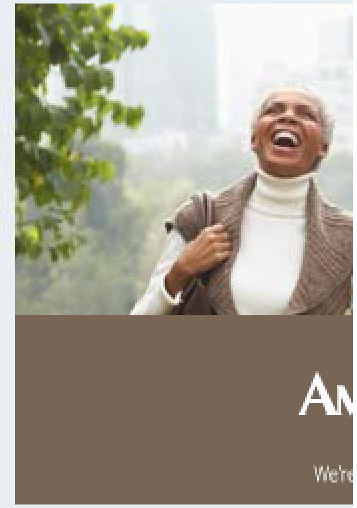
1. Dilution – a grant of stock, or even a stock option, does have a cost. It dilutes the value of stock to the existing owners. Just as a gift of a kidney doesn't involve cash, it still takes something from the grantor

2. Tax Trouble 1 – if the company is an S Corp, enough stock grants can end up pushing against the 100 stockholder maximum.

3. Tax Trouble 2 – if the benefit is a restricted stock grant, it may generate an unwanted tax burden for the employee when the stock vests. I know of situations where a stock unit vested, generated a sizeable taxable gain, and then the value of the stock plummeted. The employee ended up paying more in income taxes than the value of his shares.

4. Tax Trouble 3 – if an employer provides a stock option, and applies an incorrect valuation, the whole transaction can fall under the draconian penalties of IRC 409A. Here's the scenario: An employer issues a stock option, making a best effort attempt at assigning a value for the untraded stock. If the IRS finds the value to be higher than that declared by the company, the IRS will claim the stock option was issued at a discount. This could lead to immediate taxation, plus interest, plus a 20% penalty, all landing on the executive.

5. Accounting – a stock option is tempting until one realizes that the company must currently book the value of the option. Particularly with a privately held company, valuing a stock option can be both expensive, and a complete guess.



6. Employee Disenchantment 1 – Twice I've had non-owner CFOs complain to me that their business's owner is short changing them by rewarding them with small stock grants. Said one CFO "the owner uses the business as a personal checkbook, so I have no control over what that stock will really be worth."

7. Employee Disenchantment 2 – the employee has a stock option that is in the money. But, to exercise the stock option, the employee needs cash. In a period of tight credit, this credit isn't always forthcoming.

8. Owner disenchantment 1- the owner now has a new critic. If the employee becomes a stockholder, he or she is also privy to the company financials. I'm aware of an engineering firm where the employer is desperately trying to buy back all the stock from the employees. The engineers' penchant for detail is causing the employer to respond to constant inquiries, complaints and challenges.

9. Owner disenchantment 2 – if the owner wants to sell the business to an outside buyer, the small amounts of stock scattered among the employees can cause a serious impediment to transacting the sale. The majority shareholder has lost the privacy of a negotiated sale, has increased legal expenses, and may scare off the seller. Some buy-sell agreements mitigate this risk by including a "drag-along" feature which gives a majority owner the right to force minority owners if the majority owner decides to sell.

10. No one wants a "lose/lose" benefit - With many privately held businesses, there is no upside to granting stock. If the stock does not increase in value, the employee is not only unmotivated, but possibly upset. If the stock value goes up, the owner is giving up valuable equity, and the employee may not appreciate the true value of that hard earned equity. Whether the value goes up, down, or stays the same, the owner has to explain it, defend it, and justify it to the employees.

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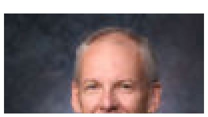
About the Author



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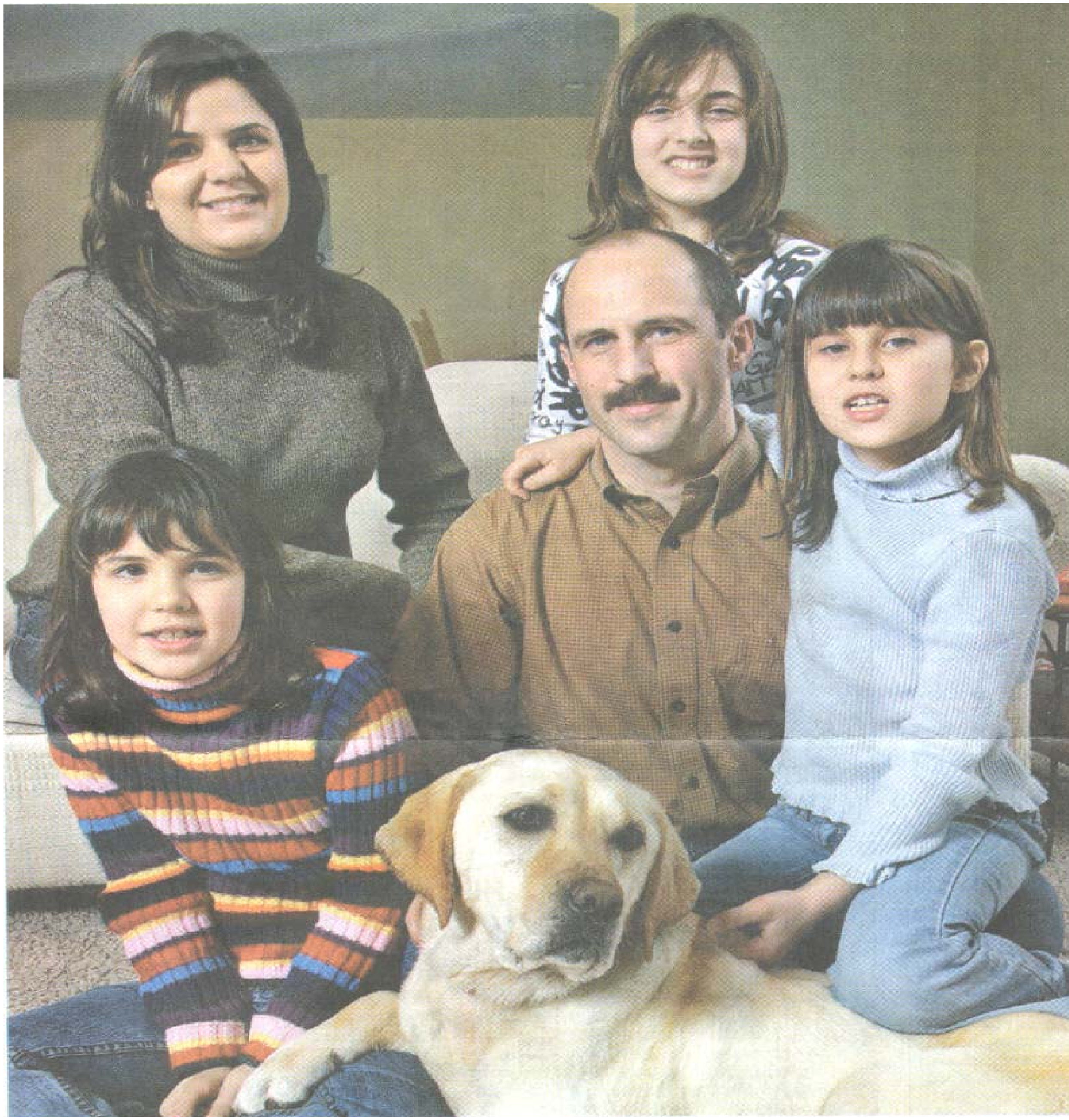

Ron Speltz,

McLeodUSA

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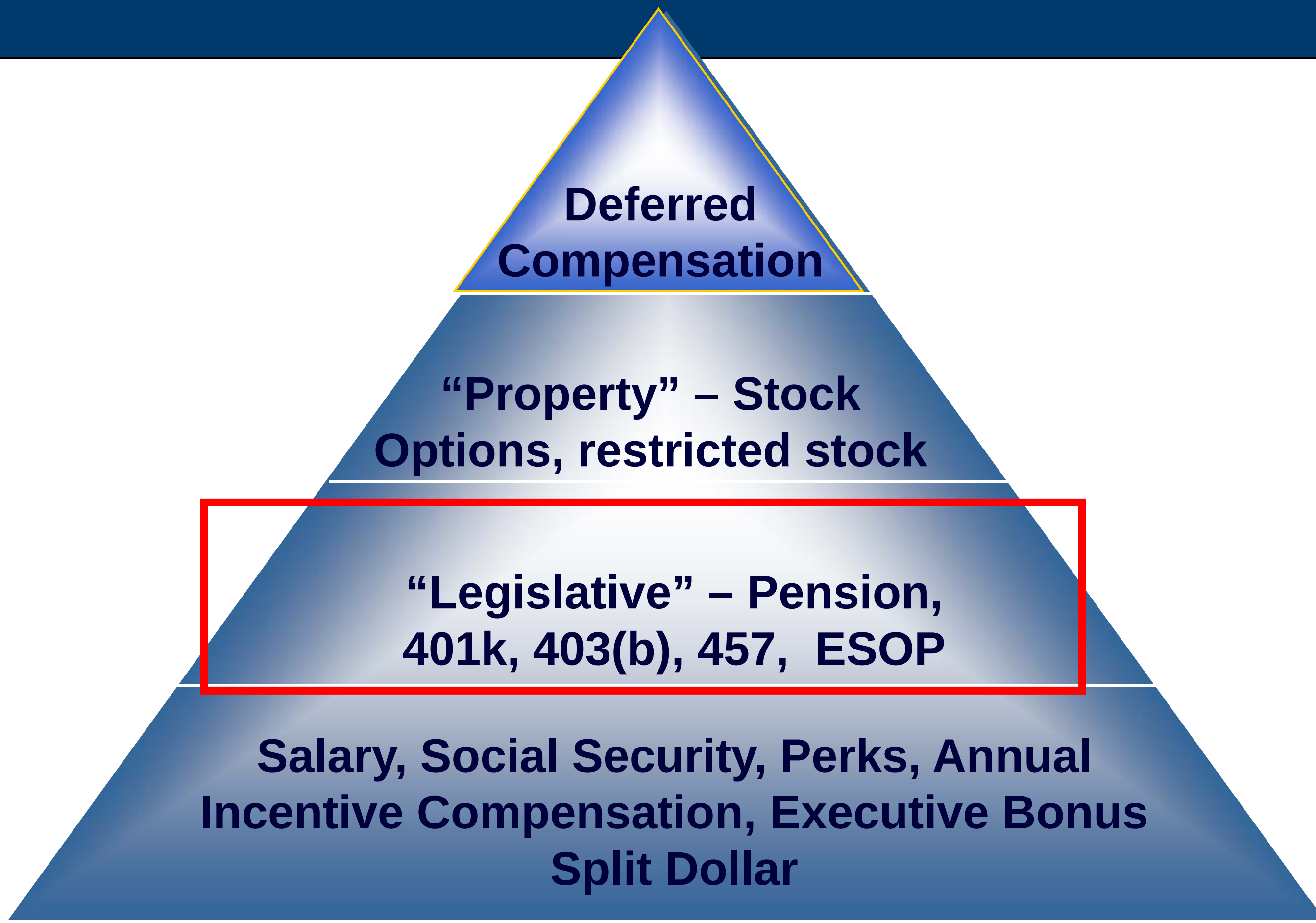
Ron Speltz, McLeodUSA

- Granted stock options over many years
- Exercises options, but defers selling
- $700,000 becomes $2,000
- In 2000, earned $70,000 but owed $252,893 State and Federal Income Tax (&Alternative Minimum Tax)

Source: Des Moines Register, February 5, 2006

Potential Executive Benefits



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Qualified Plans

- 401(k) Example:
  - $17,000 maximum contribution
  - $5,500 catch-up
  - $6,800 match
  - **TOTAL: $29,300**
- **Profit Sharing**
- **Defined Benefit**
- **Cash Balance (hybrids)**
- **E.S.O.P.**

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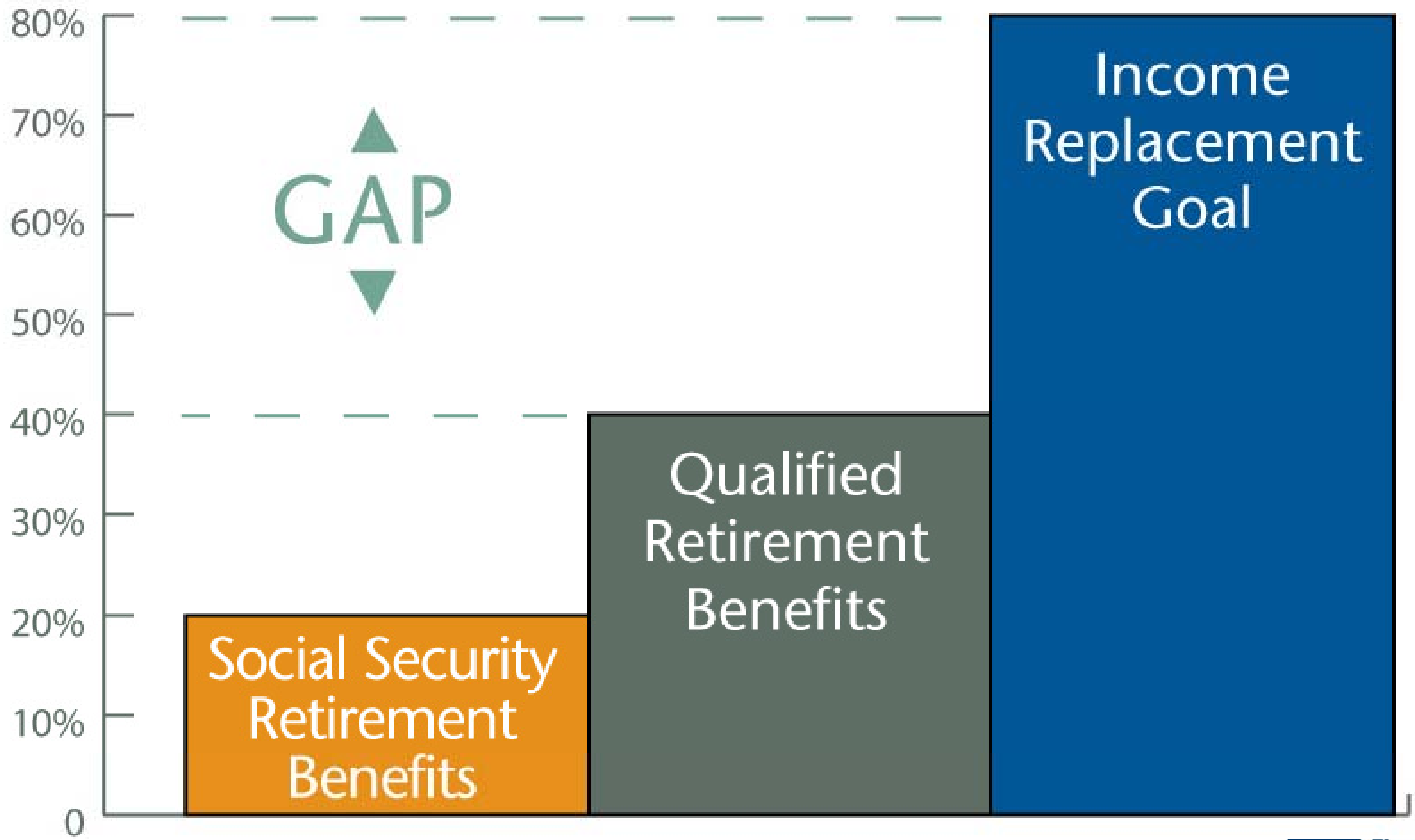
2012 Pension Plan Limits

- **Defined Benefit Max: $200,000**
- **Defined Contribution Max: $50,000**
- **Compensation Limit: $250,000**
- **Highly Compensated: $115,000**
- **401(k): $17,000**
- **SIMPLE: $11,500**
- **Age 50+ Catch-up: $5,500**

The Retirement Gap for HCEs



Financial Group

Nonqualified and Equity/Property Plans

Qualified Plans

415 Limits

Coverage Limits

Split Dollar Life Insurance

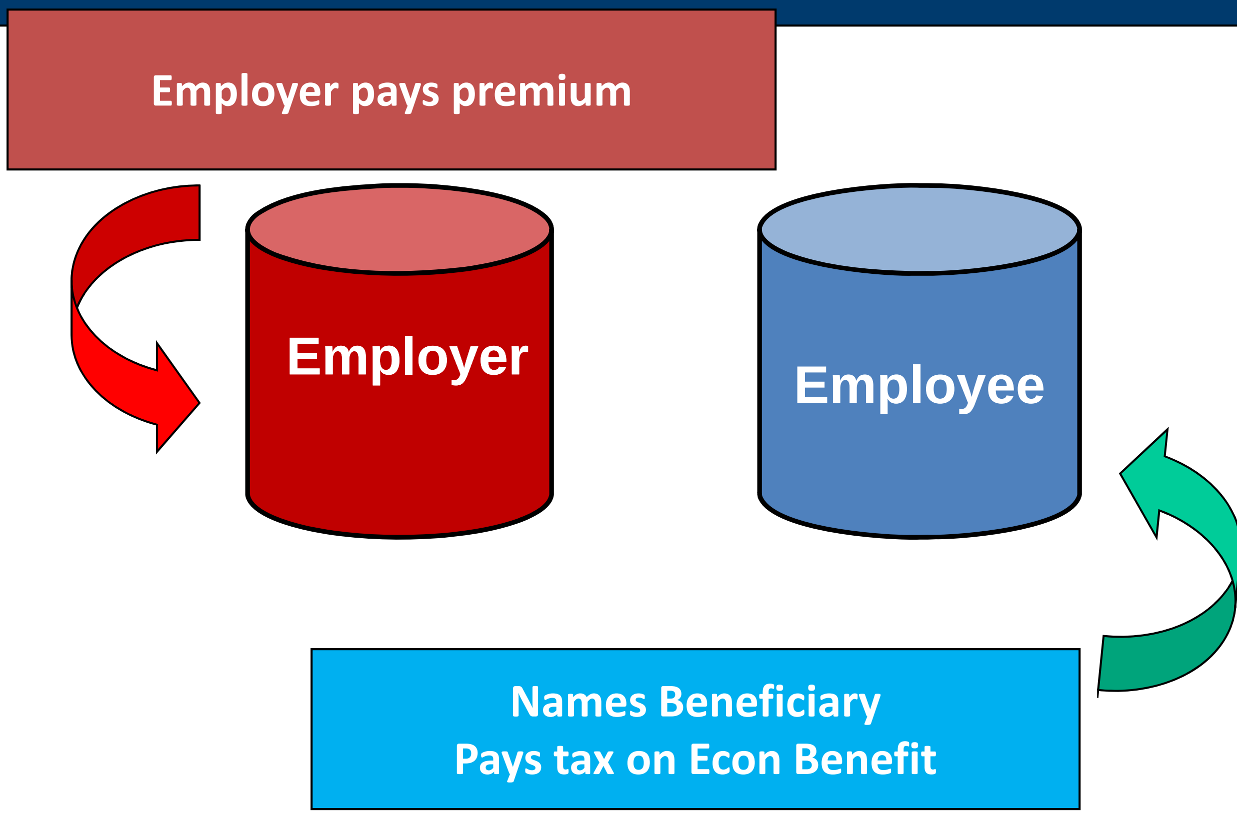
Endorsement

- Co. owns and endorses death benefit – no deduction
- Employee pays "economic benefit" cost
- No Retirement benefit
- At Death
  - Company gets C.V.
  - Employee beneficiary gets remainder
  - Tax free to both

Collateral Assignment

- Co. loans premium for collateral assignment – no deduction
- Employee pays minimum IRS interest
- Retirement: pay off loan
- At Death
  - Company gets premiums
  - Employee beneficiary gets remainder
  - Tax free to both

Split Dollar



- **Low tax cost to employee**
- **Cost recovery for employer**
- **Golden Handcuff**

Executive Bonus Life Insurance

Employer

- Co. pays premium as wages
- Immediate tax deduction
- Can use restriction, but company cannot share in benefit

Employee

- Premium is taxable to employee
- "Double Bonus" can neutralize the tax affect to employee
- At Retirement: cash values available for income
- At Death: tax free death benefit to beneficiary

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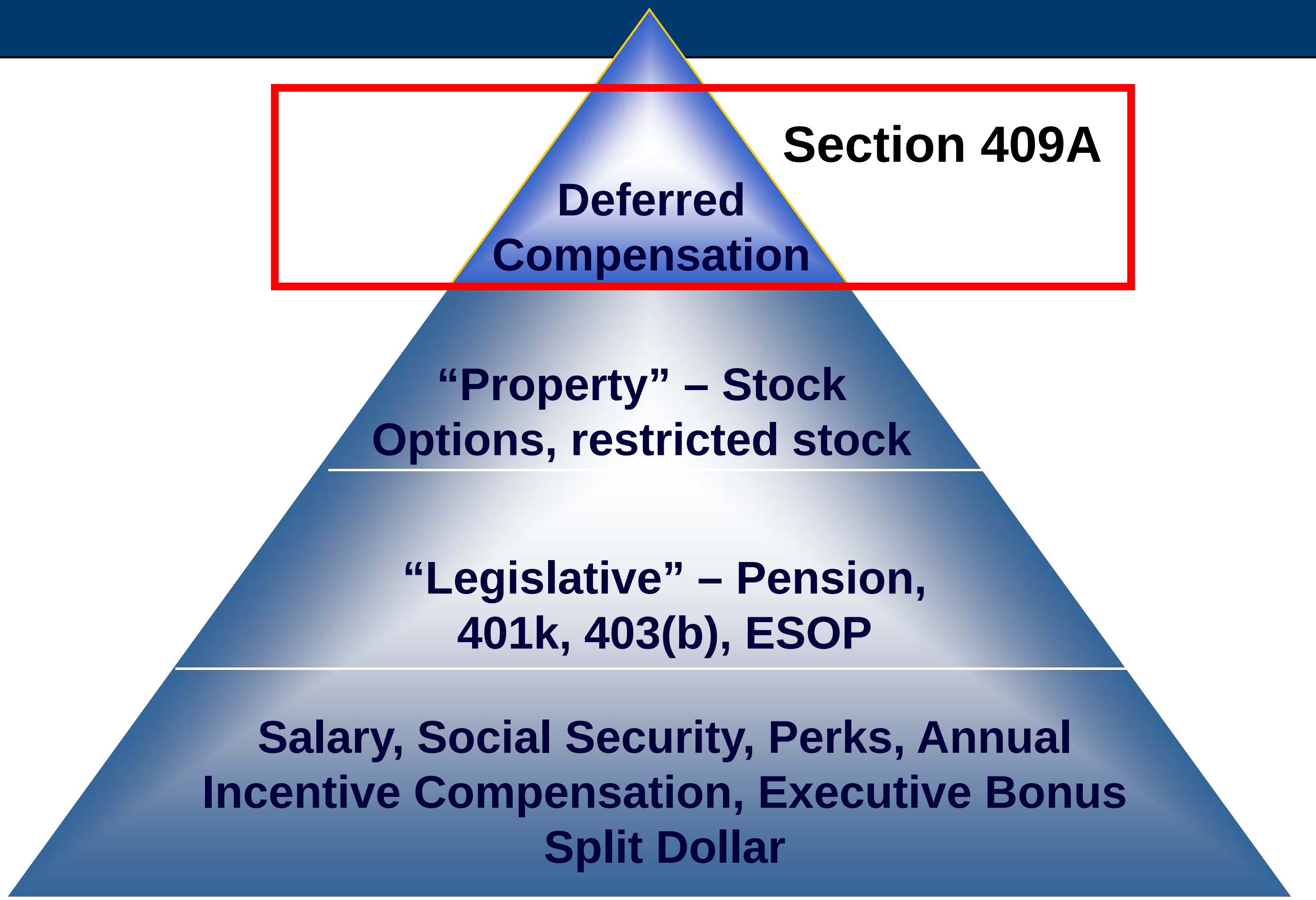
Potential Executive Benefits



Deferred Compensation

- **Defer Income on Pre-tax Basis**
- **Money Grows Tax-deferred**
- **No Contribution Limits**
- **Pre-retirement Withdrawals Allowed**

IRC Sec. 409A: nonqualified deferred compensation (NQDC) regulations regarding:

- Deferral of compensation elections
- Distribution events
- Payment options and restrictions
- Compliance

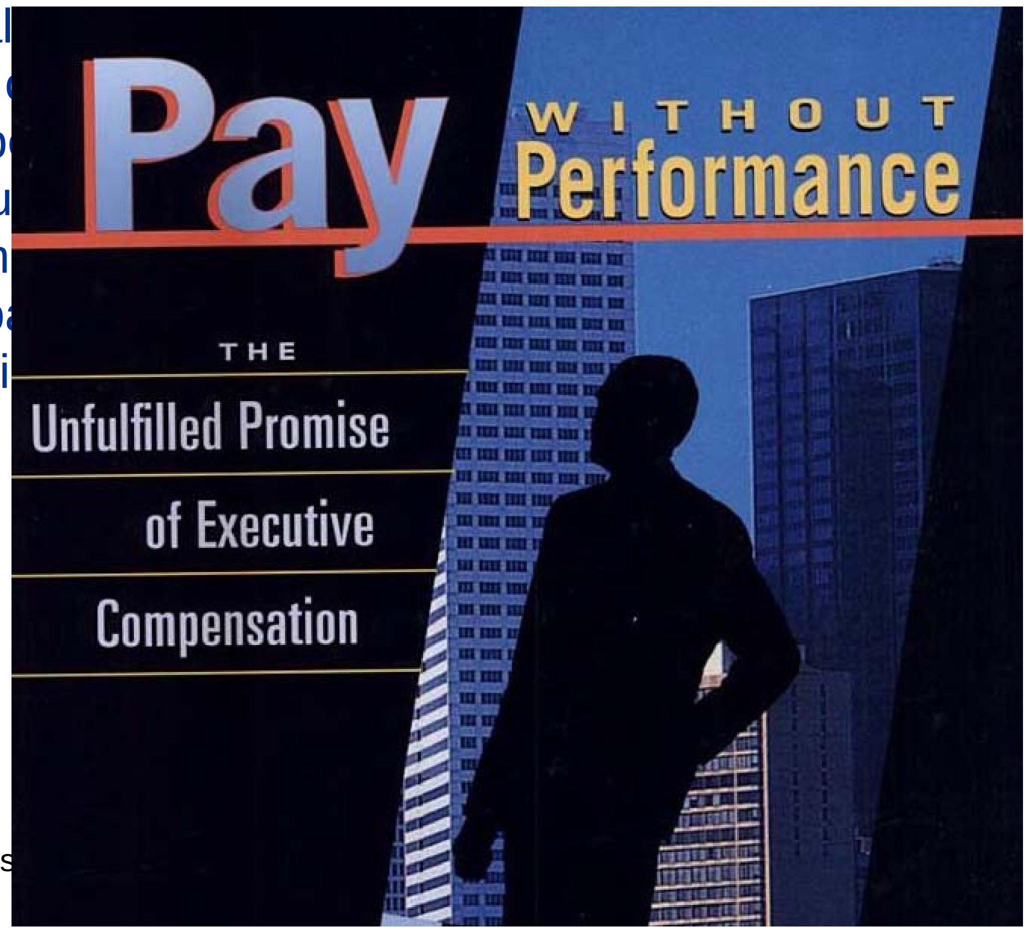
NQ: SIDE-BY-SIDE LOOK

	Deferred Comp	Executive Bonus
Reporting	Less than qualified required	Limited
Employee Tax	Pre -tax contribution	After-tax contribution
Employer Tax	No deduction for employee contribution	Employee and employer contributions deductible
Policy Ownership	Employer	Employee
Accounting	Employer liability	No liability
Admin. Fees	Yes	Low or no

[Several major investment banks reduce compensation ratio]

[Perspective:] The great overpaid CEO debate

OPTION "EXORCISING." A new survey by an Alpharetta, Georgia, research firm finds that stock options are gradual
status as the most
equity-based comp
Culpepper chalks u
rules requiring com
expense options, b
scandals, and decli
market.



GAO
Accountability * Integrity * Reliability

PRIVATE PENSIONS Sponsors of 10 Underfunded Plans Paid Executives Approximately $350 Million in Compensation Shortly Before Termination

Apple Inc

- "the 2003 Plan"
  - I.S.O.s
  - N.S.O.s
  - R.S.U.s
  - S.A.R.s
  - Stock Purchase Rights
  - 37 million shares reserved for future issuance under the Plan
- Rule 10b-5-1 Plan

- Non-equity
  - Bonus
  - L.T.I.P.
  - Nonqualified Deferred Compensation
  - Other

Non-qualified Questions

Retirement, Death Benefit
or Incentive?

409A or not?

Equity/non-Equity?

Before Tax/
After Tax?

Variable or Fixed?

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Pre-tax Solutions

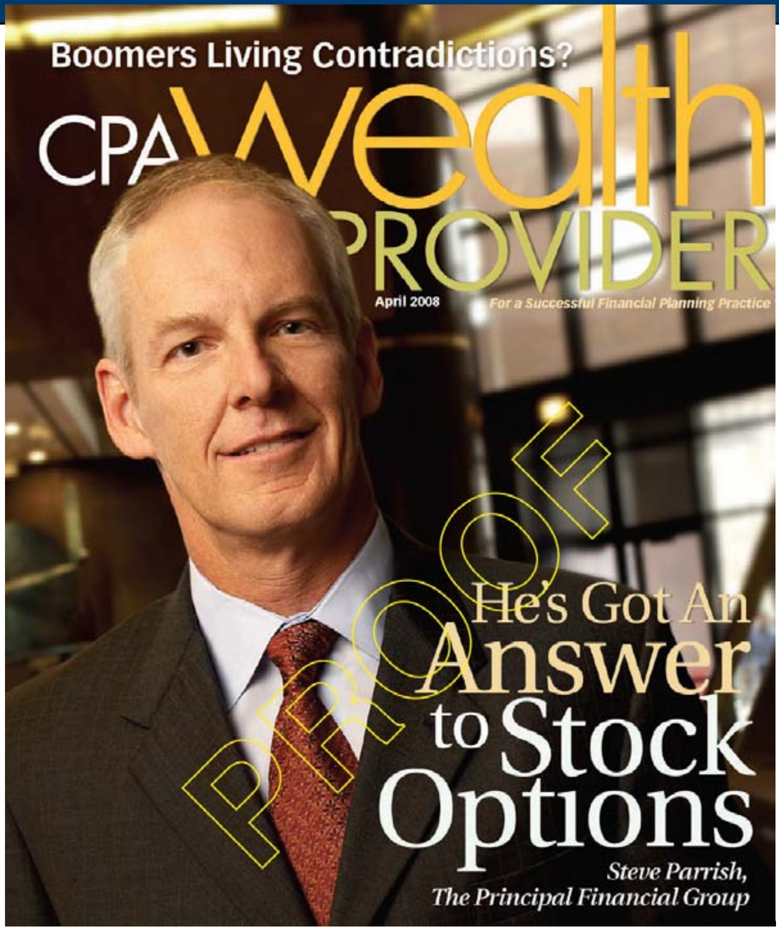
Employee $$

Excess Plan
(voluntary, employee contributions)

PLUS

Phantom Stock Plan
(performance based, employer provided)

Employer $$



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Non-traditional Uses/ Issues

- Performance Based
  - Vesting
  - Payout
- Use for employee buyout
- Retention tool at Owner sale
- “Bad Boy” clauses

Deferred Compensation Example – Inside Sale

- Closely held business
- Owner has three possible exit plans:
  - ✓ Non-shareholder employees are possible future owners
  - ✓ Sale to outside purchasers
  - ✓ Daughter in the business takes over

- Closely held corporation funds a deferred compensation account for current executives who are potential future owners
- The account is set to vest and distribute on a Change in Control of the company
- Provides incentive/reward for key executives and retains options for current owner

Sale of Business	Change of Control	Vesting
Sale to insiders	YES	Account vests and distributes to executives and is used to execute purchase
Sale to outsiders	YES	Account vests and distributes to executives as reward for years of service
NO	NO	Optional triggering event can be retirement

Post-tax Solutions

- S Corps and LLCs
  - Deductibility
  - Liability accounting
- Key Employee security concerns
- Administration

Deferred Compensation or Bonus?

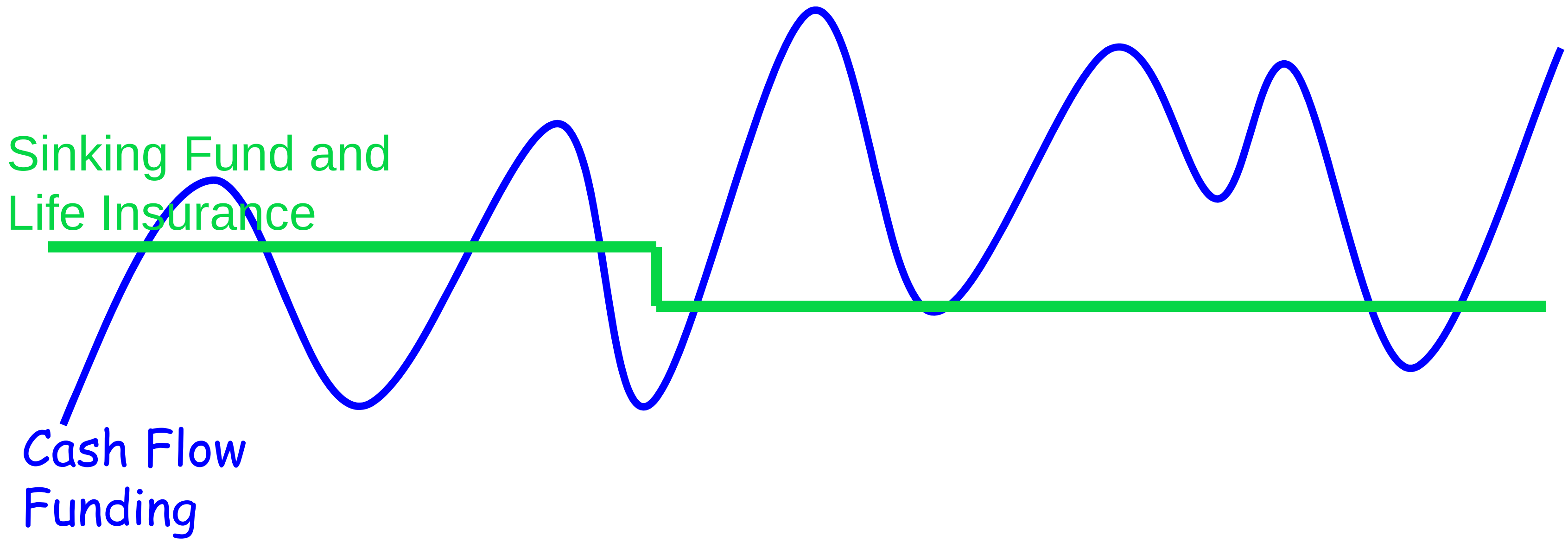
Deferred Comp

- Pre-tax for Executive
- Known law (IRC 409A)
- Employer controls
- In-service distributions

Executive Bonus

- Current tax deduction
- "In Hand" benefit
- Self-completing
- Simple and Easy

Funding the Liability



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Questions / Answers