Nonqualified Deferred Compensation for Management Affiliated Service Groups

Scenario

Assuming that the demographic of a company is such that the cost/benefit of a qualified retirement plan is not attractive or such a plan is not practical for any other reason, a Nonqualified Deferred Compensation arrangement may offer a tax deferral solution. First, establish a "C" Corporation to provide management services to the company. Transfer owner/management employees to the new Management Company who would own 100% of the management company as well as being substantial owners of the Operating Company. Depending on the ownership of the Operating Company and the number of management companies created (IRC Sec 1653), such an arrangement may not create a controlled group. However, a Management Affiliated Service Group (ASG) will have been created (IRC Sec 414(m)(5)) thereby eliminating the possibility of a qualified plan. However, an ASG does not inhibit the use of a nonqualified deferred compensation plan, as well as other tax subsidizes benefits available to employees of a "C" Corporation.

Funding the Management Company

As an example, the Operating Company pays a management fee to the Management Company sufficient to create earnings of $50,000, leaving $42,500 of retained earnings after corporate tax. The annual retained earning provides the Corporation (Management Company) with the financial resources to satisfy its obligation relative to the nonqualified Deferred Compensation contractually promised to its employee(s).

Constructive Receipt

The theory of Constructive Receipt asserts that stockholders be taxed on funds received by the corporation whether or not they withdrew the funds on the premise that said stockholders could have withdrawn the funds. Historically, there has been an invisible wall between the stockholder and a "C" Corporation with regard to retained earnings and taxation based on this theory of Constructive Receipt. See William A. Carnahan v. Commissioner, United States Tax Court 1994, as the latest authority for the ruling that control and authority to withdraw funds cannot support the application of constructive receipt.

However, some of the protection of the invisible wall seems to have been eroded by IRC Sec 409A added to the Code by the American Jobs Creation Act of 2004. IRC Sec 409A stipulates that all amounts of compensation deferred under a Nonqualified Deferred Compensation Plan are included in the taxable gross income of the employee to the extent such benefit amounts are not subject to a substantial risk of forfeiture, unless "certain requirements" are met.

As to the substantial risk of forfeiture, in QA-10(b) of IRS Notice 2005-1, the IRS specifies that a stockholder owning 20% or more of the corporate stock is not considered to have a substantial risk of forfeiture by virtue of control. The IRS may have exceeded its authority in this regard; however, since you can avoid taxation by satisfying the "certain requirements," the substantial risk issue can be disregarded. The deferrals should therefore satisfy these "certain requirements both in form and substance" i.e. operationally.

The "certain requirements" are the following (IRC Sec 409A(a)(2),(3) and (4)):

Section 409(a)(a)(2) - deferred compensation shall not be distributed until the earlier of the following:

1. Separation of Service. This event may be difficult to satisfy as long as the employee continues as a substantial owner.
2. Date of Disability. The employee is disabled if unable to engage in gainful activity as a result of a physical or mental impairment expected to result in death or can be expected to last for not less than 12 months.
3. A specified time set forth under the Plan.
4. A change in ownership of the Corporation. The IRS has published special rules for this event.
5. The occurrence of an unforeseeable emergency defined as severe financial hardship of the employee attributable to an illness or accident of the employee, the employee's spouse or dependent; loss of employee's property as a result of events beyond the control of the employee. This distribution must be limited to amounts necessary to satisfy the emergency.

Accumulated Earnings Tax

A Nonqualified Deferred Compensation Plan offers an additional advantage by avoiding Accumulated Earnings Tax. If the earnings and profits of a corporation are permitted to accumulate beyond the reasonable needs of the business, the corporation shall be subject to an accumulated earnings tax. The deferred compensation liability established by the Plan will avoid the potential imposition of this tax.

Plan Administration

The Nonqualified Deferred Compensation plan has evolved as a means to defer personal income tax and increase the disposable income of a substantial owner of a profitable business and his heirs, avoiding Constructive Receipt and Accumulated Earnings issues. Such a Plan, although minimal, requires a formal document and some amount of administration.

The scenario described above is best served by a plan referred to as a Non-Account Balance Plan, meaning there are no assets specifically set aside by the corporation to fund the promised benefits of the agreement (IRS Reg Sec 31.3121(v)2-1). The administrative requirements of the employer are the following:

1. Form W-2 - Issue a Form W-2 each year to the employee reporting in Box 12, using Code Y, the Present Value for
   the future benefit accrued by the employee under the terms of the Plan. The actuarial assumptions and discount rates must be reasonable.
2. Annually the Present Value of the cumulative total of all future payment accrued under the terms of the Plan must be determined as the liability of the corporation for financial reporting.
3. The Market Value of any investment made by the corporation with its retained earnings must be determined as an asset for financial reporting in order to meet its obligations under the terms of the Plan.

Although these responsibilities require certain sophisticated professional service, the end result will prove rewarding for the employee/stockholder.

Example of Promised Deferred Benefits

In exchange for services rendered to the Corporation and its Affiliated Company, the employee can be awarded the following benefits (NB: These promised benefits anticipate the purchase of a life insurance policy by the Corporation on the life of the employee to meet the obligation of the Corporation.):

1. Retirement: After 10 years of service, employee will have earned the following monthly benefit:
    a) Fixed Years of Payment -

Fixed Number of Years	Monthly Payment
10	$4,800
15	$3,400
20	$2,750

    b) Life Annuity 60 -

Years Guaranteed	Monthly Payment
10	$2,200
15	$2,085
20	$2,040

    c) Lump Sum: $500,000

2. Death: $2,000,000
3. Disability: Present Value of the Retirement Benefit accrued to date paid under option 1.a.
4. Unforeseeable Emergency: Present Value of the Retirement Benefit accrued to date as needed.

<u>Administrative Functions</u>

Assuming a calendar year tax year and that the employer purchases a life insurance policy to provide the promised benefits, the Contract Third Party Plan Administrator (TPA) would need the “in-service illustration” for the insurance contract as of the premium due date in the year of question in order to provide the information outlined above under Plan Administrators.