The 2013 Rate Increases and Deferred Compensation

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For many executives, the 2013 tax year began with an increase in the marginal federal income tax rate applicable to their compensation, from 35% to 39.6%. It also saw the expiration of the temporary payroll reduction for the employee's share of OASDI, which consequently increased from 4.2% to 6.2%, plus an additional 0.9% increase in the Medicare tax rate for compensation above a threshold amount.

Along with these increased rates, 2013 saw the reinstatement of the limitations on itemized deductions and the phase-out of the personal exemption for high-income taxpayers. These changes further increased the effective tax rate for many executives.

While many executives may have been troubled by these developments, they are not helpless to deal with them. Indeed, in the case of the closely-held business, there are some compensation-planning techniques which may be used by employers, in cooperation with their executives, to address the increased tax burden; specifically, non-qualified deferred compensation.

Nonqualified Deferred Compensation

In general, a nonqualified deferred compensation plan allows an executive to defer the receipt of a portion of his compensation. This defers the imposition of tax on such compensation, thereby reducing the impact of the increased rates. The amount deferred may even be significant enough to move the executive into a lower tax bracket currently. If the employee's deferred compensation is also credited by the employer with any investment earnings thereon, the tax on these earnings is also deferred. Of course, when the deferred compensation, and the earnings thereon, are ultimately paid out to the executive, they will then be subject to income tax as compensation, though the pay-out period may extend over several years, during which time the executive's effective tax rate may also be lower.

Deferred compensation occurs when the payment of compensation is deferred to a tax period after the period in which the compensation is earned (i.e., the time when the services giving rise to the compensation are performed). Payment is generally deferred until some specified event, such as the individual's retirement, death, disability, or other termination of services, or until a specified time in the future (e.g., ten years).

There are a number of valid business reasons for deferring compensation. Employers often use deferred compensation arrangements to induce or reward certain behavior; e.g., to retain the services of an employee, or to encourage the employee to attain certain performance goals.

Structure

In general, nonqualified deferred compensation arrangements are contractual arrangements between the employer and the employee covered by the arrangement. They are structured in whatever form achieves the goals of the parties and, so, may vary greatly in design.

A nonqualified arrangement may provide for deferral of base compensation (salary), incentive compensation (bonuses), or supplemental compensation (above qualified plan limits), or it may permit the employee to elect whether to defer compensation or to receive it currently. It may be measured by reference to the value of the employer's equity (as in the case of phantom stock or stock appreciation rights). It may provide for compensation that is only payable on the occurrence of future events (e.g., upon attainment of performance goals, or a change-in-control). It may be structured as an account for the employee, to which amounts -- including "investment income" -- are credited; the benefits payable are based on the amount "in the account". It may provide for specified benefits to be paid to the employee.

Tax Principles

The determination of when amounts deferred under a nonqualified deferred compensation arrangement are includible in the gross income of the executive earning the compensation depends on the facts and circumstances of the arrangement. A variety of tax principles and Internal Revenue Code (IRC) provisions may be relevant in making this determination, including the doctrine of constructive receipt, the economic benefit doctrine, the provisions of IRC Section 83 (relating to transfers of property in connection with the performance of services), and the provisions of IRC Section 409A.

The following general rules regarding the taxation of nonqualified deferred compensation result from these provisions. In general, the time for inclusion of nonqualified deferred compensation depends on whether the arrangement is unfunded or funded. Most nonqualified

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deferred compensation arrangements are unfunded; i.e., the compensation is payable from the employer's general corporate funds that are subject to the claims of its general creditors. It represents an unfunded and unsecured promise to pay money in the future. (Contributions to a so-called "rabbi trust" will not cause the plan to be funded for tax purposes.) The compensation is generally includable in income when it is actually or constructively received by the employee (as when it is made available so that he could draw upon it at any time, without substantial limitations), when the employee realizes the economic benefit of the compensation (as when he can pledge it to secure a loan), or when the deferral plan fails to satisfy the requirements of Section 409A.

Section 409A

Under IRC Section 409A, all amounts deferred under a nonqualified plan are currently includible in gross income to the extent they are not subject to a "substantial risk of forfeiture" (i.e., the person's rights to the compensation are conditioned upon the performance of substantial services or the occurrence of a condition related to a purpose of the compensation, such as the attainment of a prescribed level of earnings), unless certain requirements are satisfied; for example, the deferred compensation may not be distributed earlier than the employee's "separation from service," disability, death, or at a specified time (or pursuant to a fixed schedule) specified under the plan, or upon a "change-in-control;" in general, the plan may not permit the acceleration of the time or schedule of any payment.

Planning Considerations

An executive and his employer may utilize the forgoing rules to structure a deferred compensation plan which may satisfy the closely-held employer's goals to incentivize and reward a key employee, while also deferring the imposition of income tax on a significant portion of the executive's compensation. These rules are complex, however, and the terms of the plan must be approached with care; otherwise, the executive may be faced with current income tax liability with respect to amounts which, contractually, he cannot yet access. Such a situation will likely prove costly for the closely-held business as well as the executive.