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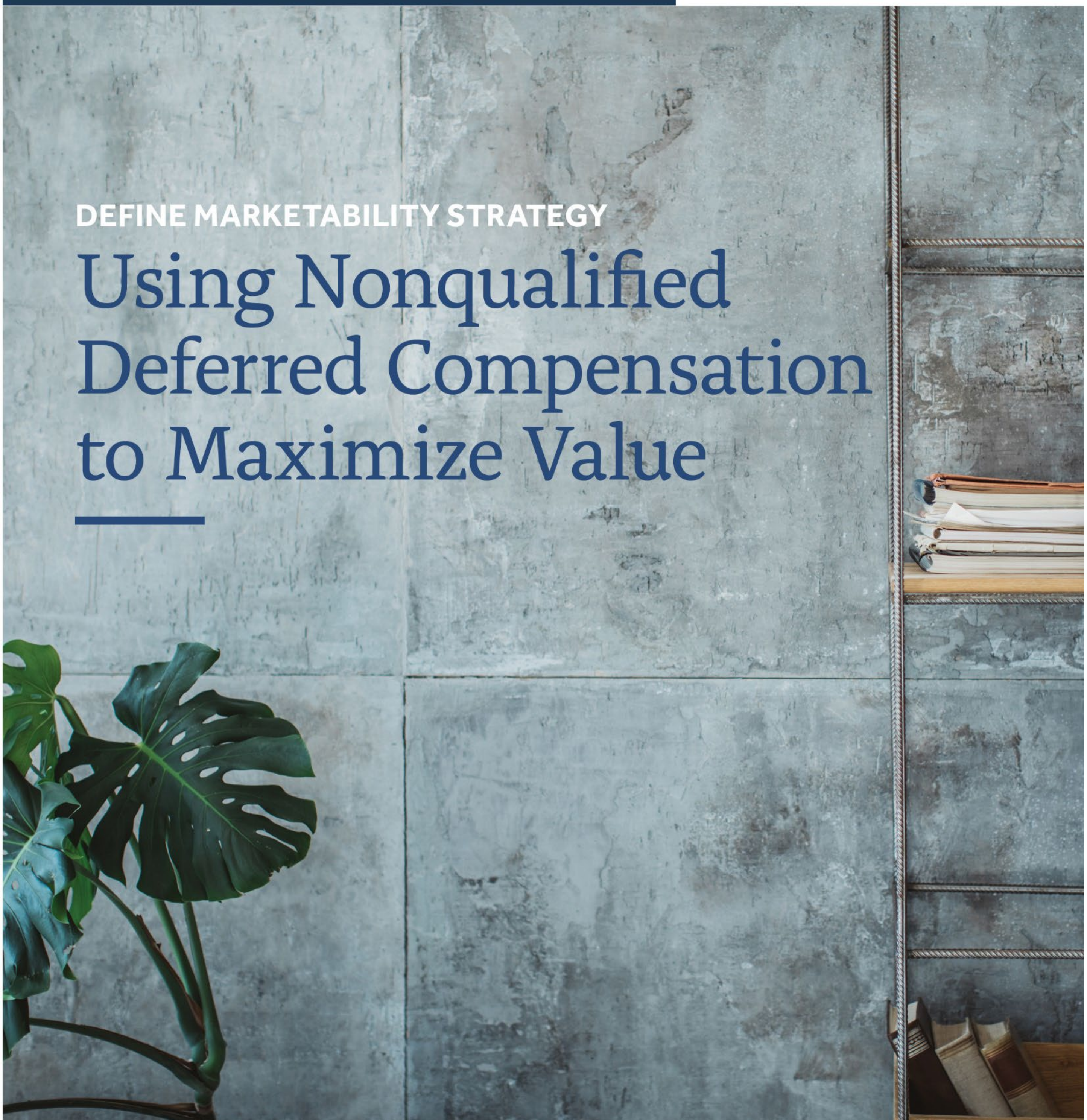
DEFINE MARKETABILITY STRATEGY

Using Nonqualified Deferred Compensation to Maximize Value



Using Nonqualified Deferred Compensation to Maximize Value

General

Many business owners understand the importance of key employees as a component of a business succession plan. For owners who plan on selling their business to a third party, retaining key employees, post-sale, can be critical to maximizing the value received for the business. Additionally, if an exiting owner has no management team in place, the owner may need to attract talented individuals to position the business so that it can remain profitable after the owner's departure. Owners looking to retain or attract key contributors should consider a nonqualified deferred compensation arrangement. A nonqualified deferred compensation arrangement is a promise by an employer to an employee to pay compensation at an agreed upon time or upon some event the in future.

In order to avoid the most burdensome requirements of ERISA (the rules that apply to qualified retirement plans), a nonqualified deferred compensation arrangement must be for a "select group of management or highly compensated employees" and must be an unsecured promise to pay. The arrangement can be informally funded but the funding mechanism must remain part of the company's general assets. A key employee benefiting under a nonqualified deferred compensation arrangement has no claim to any particular asset and remains a general creditor of the company in the event of bankruptcy.

When a company distributes benefits to employees as part of a nonqualified deferred compensation arrangement, the company can deduct the payment as a compensation expense, assuming reasonable, and the employee will pay income taxes on the amount received. It is additionally important to comply with the requirements of Internal Revenue Code Section 409A (generally limiting the scope of permissible payment events) to ensure an employee is not taxed on any benefits accruing under a deferred compensation plan prior to the receipt of payment.

Advantages of nonqualified deferred compensation:

- As compared to qualified retirement plans, nonqualified deferred compensation plans are easier to administer and allow (and in fact, require) a business owner to discriminate in favor of key employees.
- The amount of benefits payable under a nonqualified deferred compensation plan are not subject to limitations, as is the case with qualified plans.
- Flexibility in plan design allows business owners to customize plans to align with the specific needs of the business and the key employee.

Disadvantages of nonqualified deferred compensation:

- To remain exempt from ERISA, nonqualified deferred compensation plans must be unfunded, and the employee has no protection beyond that of an unsecured creditor.
- The business will not receive a deduction until the employee is taxed on the benefit at ultimate payment.
- Nonqualified deferred compensation plans must satisfy the requirements of Internal Revenue Code Section 409A.

Funding considerations

It is good practice to informally fund deferred compensation obligations. The employer owns and controls the underlying assets, resulting in no current income taxation to the employee. To closely align available resources to the benefits payable, many businesses use insurance to informally fund a deferred compensation plan. The cash value of the life insurance policy can accumulate, tax-deferred, and can be accessed through loans and withdrawals, tax-free up to basis, to fund the company's payment obligation. In the event something happens to a key employee before the obligation is paid out, a portion of the insurance proceeds can be used to pay a benefit to the employee's family, and the balance, if any, could be retained by the company to cover the costs of replacing him/her.

Case Study - Using a “stay bonus” to plan for a third-party sale

The problem:

Kelly is the owner of a successful bakery. She plans to retire in three to five years and believes that a sale to a competitor will enable her to receive the most value for her business when she retires. Although Kelly spent over 20 years building her bakery from the ground up, she knows that the bakery would not have been as successful without her lead baker, Brandon. Since Brandon knows all of Kelly’s recipes and has developed strong working relationships with the bakery’s suppliers and vendors, Kelly believes that retaining Brandon could be crucial to her negotiations with potential purchasers. Even though Kelly believes Brandon is happy in his current role, she is concerned that the news of her planned retirement could result in Brandon evaluating other employment options.

The solution:

The bakery offers a 401(k) plan to its employees, but Kelly would like to provide Brandon with an additional financial incentive to ensure that he remains with the bakery for at least five years after the transition. Her plan is to provide him with a lump sum payment of $50,000 upon the completion of five years of service after the sale of the bakery. If Brandon leaves prior to that time, he will forfeit the $50,000 payment.

Kelly and Brandon enter into a formal nonqualified deferred compensation agreement that defines the obligations of both Kelly and Brandon. Brandon will receive a $50,000 lump sum payment upon the completion of five years of service post sale, assuming he fulfills the terms of the agreement. The agreement is structured to comply with the requirements of Internal Revenue Code Section 409A.

Kelly anticipates using $10,000 of revenues each year for the next five years to assist with funding the future obligation. While she could simply save $10,000 annually in an interest-bearing account for the bakery, any interest earned will be taxable each year.

To avoid exposure to such income tax, Kelly instead utilizes $10,000 to annually fund a life insurance policy on Brandon’s life. At the time benefits are owed to Brandon, the company can take tax-free withdrawals from the policy’s cash value, up to basis, to fund the obligation.

Additionally, utilizing life insurance will provide Brandon’s family with an added benefit of death benefit protection should something happen to him prior to the payment of benefits owed to him under the arrangement. The bakery would receive policy death benefits, income tax free, and could use a portion of the proceeds to pay a taxable survivor benefit to Brandon’s family. The bakery can use the balance to recoup any funding costs of the policy.

The result:

Potential buyers will see that although the bakery has created a deferred compensation liability on its books for the future benefit payment, the bakery also has an offsetting asset to ensure that the money is available to pay the benefit without having to pull dollars from its working capital.

Additionally, potential buyers will likely understand that by ensuring Brandon stays with the bakery for five years after its sale, the bakery’s chances of ongoing success are heightened, making the bakery more attractive to a purchaser.