Untaxingly Yours
The Neglected Variable

By Brian T. Whitlock

Almost every estate tax or inheritance tax system in the United States attempts to tax the transfer of a person’s Net Worth at death. The greater the Net Worth, the greater the potential transfer tax.

Those of us who are tax planners traditionally begin the process of reducing the potential transfer tax by maximizing the utilization of available exclusions, such as the gift tax annual exclusion, and deductions, such as the unlimited marital deduction or the charitable deduction.

Second, we seek to maximize the available Estate and Gift Tax Credits and the Generation Skipping Tax Exemptions by shifting assets between spouses, in hopes of obtaining full utilization of both the Federal and State Credit Equivalent Amounts, and in the process, minimizing the losses (i.e., Federal and State Estate taxes paid).

Next, we encourage clients to make annual exclusion gifts to children, grandchildren and irrevocable trusts that qualify for present interest exclusions. These irrevocable trusts may seek purchase life insurance on the life of our client, or the irrevocable trusts may invest the assets in hopes of excluding the assets and the growth from not only the client’s taxable estate but also multiple future generations of taxable transfers.

Finally, planners focus on reducing the apparent value of assets by fractionalizing assets or creating restrictions that will limit the marketability of assets or creating opportunities for applying valuation discounts. Perhaps, we will even consider using split-interest charitable trusts, Grantor Retained Annuity Trusts, Sales to Irrevocable Grantor Type Trusts or other strategies that leverage off of the income generated by closely-held businesses and real estate in order to shift these appreciating assets.

It strikes me as odd that most traditional strategies employed by today’s tax and wealth transfer planners focus on only one-half of the Net Worth equation, the assets, while ignoring the other half of the equation, the liabilities: Net Worth = Assets − Liabilities.

The “Net Worth equation” is taught to every entry level accounting student. The equation has two variables Assets and Liabilities. The equation does not read $2 \times \text{Assets minus Liabilities}$, it is simply $\text{Assets minus Liabilities}$. Each variable has the equal billing, equal weight. As a result, we can reduce a client’s Net Worth by...
either reducing Assets or by increasing Liabilities. A change in the value of either variable is equally effective. If we accept that mathematical hypothesis as true, then why do we focus so much on the Assets variable? Why are the Liabilities the neglected variable? Are there no liabilities to be identified, recognized, quantified, memorialized, recorded and thus secured? Where should we be looking to identify potential Liabilities?

**Uncovering Liabilities**

Generally Accepted Accounting Principles (GAAP) only require the financial professionals to record a relatively narrow subset of a company’s total known liabilities on the balance sheet of the business enterprise. One of the jobs of an effective estate tax planner may be to assist the valuation and appraisal professionals in analyzing the financial information that is prepared for business clients and presented to the valuation experts.

As most Certified Public Accountants know, the best way to read a financial statement is to begin with the footnotes to the financial statements. A careful reading of the footnotes may uncover narrative descriptions of risks and liabilities that have not been reflected on face of the Balance Sheet of the business enterprise. Typical undisclosed liabilities include such things as: environmental hazards (related to Underground Storage Tanks or potential Environmental Protection Agency “Super Fund” liability); product liability and warranty claims; unencashed coupons and gift certificates; ongoing or threatened litigation; market and business risks (e.g., high levels of customer or supplier concentrations); “going business” concerns; underfunded defined benefit pension plans; union contracts that contain withdrawal liabilities or underfunded welfare benefit plans; long-term lease obligations; and Nonqualified Deferred Compensation (NQDC) Plans.

Once these liabilities have been identified and quantified, they can be properly brought to the attention of the valuation professionals and factored into the business valuation.

**Moral Obligations and Undisclosed Liabilities**

Third-party business obligations (e.g., leases, warranties, pension plans and union contracts) are routinely formalized and reduced to writing. The fact that they are in writing makes them easy for the auditors to identify and at least list them in the financial statement footnotes.

Family businesses often operate under moral obligations and handshake agreements. These unwritten promises are nearly impossible to uncover. Larger businesses routinely enter into nondisclosure agreements with suppliers and employment contracts or noncompete agreements with key-employees. Closely-held family businesses, rarely if ever, have family members sign employment agreements and other restrictive covenants.

Founders and first generation business owners frequently operate under handicap that I refer to as “scarcity.” Capital, credit and talent are scarce, and these three foundational components can be hard to attract to a start-up business. As a result, the first generation entrepreneur takes on a greater burden. He or she tends to be over worked and undercompensated during the early years of the business enterprise. It does not make sense for an entrepreneur to subject the business to the strain of additional debt, plus the costs associated with securing and paying that debt, merely to turn around and have the business pay the same cash to the entrepreneur in form of higher personal compensation, subject to current income and payroll taxes. The pragmatic entrepreneur pays him/herself only enough to pay the home mortgage, put food on the table and clothe and educate the kids. All other cash is generally retained in the business in an effort to keep the cost of capital as low as reasonable.

In reality, many family businesses operate under a sort of moral obligation to the founders and first generation business owners. That moral obligation is the unspoken promise to reward them “someday” for all of the blood, sweat and tears that they have either put into the business in the past or may promise to put into the business in the future before they ultimately retire. That unspoken promise is usually manifest in the fact that the business will continue to pay the business owner and the spouse of the business owner for some indefinite period of time. That payment may be in the form of continuing compensation or a lump-sum payment in the event of the individual’s sudden death.

**The Income Tax Aspects of Compensation**

Section 162(a) of the Internal Revenue Code of 1986, as amended, permits a business to deduct as a trade or business expense “a reasonable allowance for salaries or other compensation for personal services actually rendered.” Where an individual is highly qualified, working 60–70 hours a week, and doing the job of 3 or 4 different people, the limit of what might be
“reasonable” would be expected to be quite high and rarely subject to challenge by the IRS. However, as the entrepreneur ages, slows down, works less, vacations more, spends more and more time away, the amount that is considered reasonable will decrease. The second half of Code Sec. 162(a) requires the payment to be “for personal services actually rendered.” When, if ever, is it reasonable to continue pay someone after they are disabled? How much is deductible where either monthly payment or a lump sum payment is made to a surviving spouse that has not worked in the business for over 30 years.

If the payment is not deductible under Code Sec. 162(a) then its mere payment will subject to numerous income tax risks. If the amount is paid to a current equity owner of the business, which is operated as a corporation taxable under Subchapter C, then the payment may be treated as a nondeductible distribution of either current income, or accumulated earnings and profits. This type of payment will be treated as a nondeductible dividend. If the amount is paid to a current equity owner of an entity, which is taxed under Subchapter S, then the fact that the payment is not made pro rata to all of the equity holders may jeopardize the business’s S Corporation election.

If the payment is not deductible under Code Sec. 162(a) and it is paid to a person that is not a current equity owner, then the payment may subject the related family members to multiple levels of tax. The equity owners may be subject to income tax, if the payment is deemed to be a dividend, and it may be additional subject to gift tax if the cash finds its way into the pockets of parents or children that are not providing adequate personal services to the business.

The Solution

If the family wishes to formally acknowledge, recognize, quantify and memorialize this otherwise moral obligation to provide some form of tax deductible compensation to the founder or senior entrepreneurial family member, then the business should consider entering into a written employment agreement with that person. The written agreement would contain provisions in which the business would agree to pay the employee a reasonable level of current compensation for current services. In addition, the agreement could also provide one of the following: a death benefit payable to the employee’s designated beneficiary in the event that the employee dies before normal retirement age, or some amount of periodic payment in the form of deferred compensation that would become payable after the person retires, becomes disabled or dies.

In order to be deductible the total of the death benefit or deferred compensation when added to the current compensation must still satisfy Code Sec. 162(a). In other words, the total amount must be “reasonable” for services “actually rendered.” The larger the promised payment, the greater the value of the promised services must be in order for the transaction to satisfy the standard of qualifying as reasonable compensation. The services may have been performed in the past, during a period in which it could be documented that the individual was undercompensated relative to his effort and experience, or the services may be contracted for on a prospective basis, where the employee promises to defer retirement and continue working for a reasonable period of time during which both the current and deferred compensation will be earned.

If the employee seeks lifetime benefits payable to themselves personally, then the employment agreement and benefit plan will take the form of an NQDC Plan. If the employee seeks only a benefit payable after death, then the benefit plan will take the form of a Death Benefit Only (DBO) Plan. Part 1 of this column will explore the income tax, payroll tax and estate tax aspects of DBO Plans. Part 2 of this column, next quarter, will explore the income tax, payroll tax and estate tax aspects of NQDC Plans.

Death Benefit Only Plans

Under a DBO Plan, there can be no other promise for other deferred compensation payments. The agreement should limit itself providing a death benefit to the employee’s named beneficiaries. The reasonableness of the payment for the purpose of determining its deductibility under Code Sec. 162 will be based on the value of both
past and current services. The only known Tax Court case dealing with DBO plans is A.F. DiMarco Est. The Tax Court in DiMarco looked at a death benefit plan payable to employees of IBM. Under the plan, a class of employees were eligible to irrevocably name a beneficiary that would receive a lump sum death benefit equal to three times the employee's salary if the employee died while employed by the company.

### Income Tax Aspects of DBO Payment

If reasonable, the benefit paid by the employer represents a deductible expense under Code Sec. 162 as compensation. The benefit received by the beneficiary would be subject be gross income in the hands of the recipient. If both the employer and the employee are in the same relative tax brackets, then the burden of the income tax should be offset by the benefits of the deduction.

### Ancillary Corporate Income Tax Benefits of DBO Plans

If the employer does not attempt to fund the accrued liability for the payment of the death benefit, then it should be expected that the employer will pay this unfunded liability either out of its accumulated surplus operating or its operating income. If the employer is a corporation operating under Subchapter C of the Internal Revenue Code, then the creation of a DBO liability should reduce corporation's exposure to the Accumulated Earning Penalty Tax under Section 531 of the Internal Revenue Code of 1986, as amended. The purpose of the accumulated earnings tax is to prevent corporation from accumulating its earnings and profits beyond the reasonable needs of the business for the purpose of avoiding income taxes on its shareholders.

Code Sec. 533 permits earnings to be accumulated beyond “the reasonable needs of a business.”

Code Sec. 537(a) defines “the reasonable needs of a business” as reasonable anticipated business needs, redemption needs of a business relative to the death of any shareholder that might need to redeem stock in order to pay death tax; excess business holding redemption needs related to a tax exempt shareholder that might need to redeem stock in order to avoid excise taxes; and product liability loss reserves as defined in Code Sec. 172(f). If the accrual of the DBO liability satisfied the reasonableness standard for deductibility under Code Sec. 162, then the payment of a DBO liability should arguably be a reasonably anticipated business need.

### Payroll Tax Aspects of Death Benefits

Any payment or series of payments made to an employee or his dependents after the termination of employment due to death under a plan established by the employer for an entire class of employees as described in Code Sec. 3121(a)(13) and Code Sec. 3306(b)(10) are not subject to either FICA or FUTA taxes.

Accrued compensation and death benefits paid out in the same calendar year during which the employee also performed services (i.e., the year of death) are subject to FICA and FUTA and should be reported on IRS Form W-2. Conversely, if the DBO benefit is paid in a calendar year after death (during which the employee did not provide any services), then the payment should be reported on IRS Form 1099 and it is not subject to payroll tax or income tax withholding.

### Computation of Liability (DBO Plans)

If the death benefit is fully insured and the employer owns a life insurance policy on the life of the employee equal to the death benefit, then the only benefit of accruing a liability would be to offset the value of the life insurance policy that is owed by the employer for the purpose of satisfying the death benefit obligation. This would be a limited benefit.

On the other hand, if the death benefit is uninsured and a general obligation of the employer, then it would be a clear tax planning advantage for the employer to accrue a liability for this unfunded death benefit obligation.

There is no clear directive from the IRS or the Treasury regarding the appropriate tables for computing the present value of DBO Plans. Since the liability is a lump sum that can be expected to be paid at some point following death of the employee, it would be logical to assume that the accrued liability would be equal to the present value of a lump sum. The computation of the present value of a lump sum requires the selection of a life expectancy factor and the selection of an applicable interest rate (sometimes referred to as the discount rate). The higher the discount rate, the lower the present value of the future amount. The shorter the life expectancy, the sooner the death benefit would be expected to be paid and the greater accrued liability. Conversely, the greater the life expectancy, the longer the beneficiary must wait for the payment and the smaller the accrued liability.
The Internal Revenue Code relies on life expectancy tables for the purposes of computing the following: the expected return for annuity contracts and the exclusion ratio for the recovery of cost basis on annuity contracts for income tax purposes are computed and are derived from the experience of life insurance companies that sold annuities in 1983 at the time that the $1.72 Table was published; the value of Required Minimum Distributions from qualified plans are derived from the experience of life insurance companies that sold annuity contracts in 2002 at the time that Reg. §1.401(a)(9) was published. The 2000 U.S. Census statistics Table 2000CM is used for computing gift and estate tax values of life estates or remainder interests in property. The $1.72 Table is based upon mortality tables that were available to insurance companies when the regulation was first published in 1983. The Reg. §1.401(a)(9) RMD Tables are based upon mortality tables that were available when the regulations were published in 2002. As should be expected, the life expectancy estimates under the RMD Tables are greater than the life expectancy estimates under the Annuity Tables.

Example

As a reward for her past service, Acme enters into a DBO plan with Ann, the founder and Chair Emeritus of the Board of Directors that will pay her beneficiaries $5 million in the form of a single lump sum payment. Ann is currently 65 years of age and has a life expectancy of 21 years based on Reg. §1.401(a)(9). Using the annual long-term Applicable Federal Interest rate of 1.9 percent. The Present Value of a $1 million Lump sum receivable in 21 years under these assumptions is $3,367,535.

Estate Tax Aspects of DBO Plans

If the liability is fixed and determinable, and if the value of the liability is material, then it is appropriate under Generally Accepted Accounting Principles (GAAP) to accrue and record the liability for financial statement purposes. If the value is significant, then the accrual of the liability will act to reduce the Net Worth of the business enterprise. Unlike valuation discounts which may be related to voting and nonvoting rights, which are currently under attack by the Treasury and the subject of the proposed Regulations under §20.2704 published in August of 2016, the recognition and recording of a liability would not affect liquidation rights and thus would not be addressed by the proposed regulations. A detailed discussion of the Proposed Reg. §20.2704 is beyond the scope of the column.

Estate Tax Aspects of the Benefits

Identifying a moral obligation, quantifying the obligation, reducing it to writing and converting that obligation into a liability that can be carried on the balance sheet of the business will reduce the Net Worth of the business enterprise. If the value of the business enterprise is smaller, it should be easier to transfer the equity ownership on to the next generation during life by either gift or sale.

On the flip side, the receipt of the survivors benefit will not be deemed to be as asset of the deceased employee’s gross estate at death if the beneficiary is a person other than his estate or his surviving spouse. In DiMarco, the Tax Court ruled that if the employee irrevocably named the beneficiary of the DBO Plan and no longer had the power to change the beneficiary of the benefit, then the receipt of the benefit is not an asset of the decedent’s estate.

This represents a Win-Win. The acknowledgement and recording of the liability reduces the value of the business, whereas the irrevocable death benefit receivable by the heirs is excluded from the Gross Estate of the deceased.

Summary

In the second installment of this column, we will look at a second type of deferred compensation liability, NQDC Plans. We will explore the income tax, payroll tax and estate tax aspects of NQDC Plans as well as how to compute the liability under such plans.

ENDNOTES

1 Internal Revenue Code of 1986, as amended, Code Secs. 301, et seq.
4 If an employer is a C Corporation, and it does fund the anticipated liability with the purchase of insurance policies it should be acknowledged that while the proceeds of the life insurance policies in the hands of the C Corporation may not be subject to regular income tax under Code Sec. 101 which generally excludes the proceeds of life insurance from gross income, the proceeds do represent book income and may cause the C Corporation to be subject to the Alternative Minimum Income Tax if the book income is in excess of the taxable income.
5 Code Sec. 3121(a)(14) and Code Sec. 3306(b)(15).
7 Id.
8 Id. Using Estate Planning Tools the Life expectancy of a person age 65 under the 1980 Census was calculated to be 17.2 years. The life
The life expectancy of a person using the 1990 Census information was calculated to be 17.2 years. The life expectancy of a person under the 2000 Census was calculated to be 17.7 years. The life expectancy under the 1.72 Tables was calculated to be 20 years. The life expectancy under Code Sec. 1.401(a)(9) was calculated to be 21 years.
