Untaxingly Yours
The Neglected Variable: Part II

By Brian T. Whitlock

Last Quarter, this column looked at the “Net Worth equation” (i.e., Net Worth = Assets – Liabilities), its relevance in estate taxation and its significance in succession planning for the owners of closely-held businesses. We discussed the fact that most estate planning professionals ignore the second variable in the equation (i.e., “liabilities”), and they focus primarily on the first variable (i.e., “assets”). Most planners utilize strategies that attempt to discount or transfer “assets.” We discussed the importance of acknowledging, quantifying, memorializing and recognizing for tax purposes those moral obligations that frequently exist within a closely-held business. This process of converting moral obligations into legal obligations of the business can provide the tax practitioner a means of supporting the payment of tax deductible compensation to the founder or senior entrepreneurial family members in their later years through the creation of deferred compensation plans.

In the Part I of this analysis, we focused on the income tax, payroll tax and estate tax aspects of Death Benefit Only Plans. Here in Part II, we will explore the income tax, payroll tax and estate tax aspects of Nonqualifying Deferred Compensation (NQDC) Plans, as well as how to compute the liability under such plans.

Nonqualifying Deferred Compensation Plans

NQDC Plans at their core are employment agreements. In order for compensation to be deductible for income tax purposes the total of the deferred compensation when added to the current compensation must satisfy Section 162(a) of the Internal Revenue Code of 1986, as amended (IRC). In other words, the total amount of compensation must be “reasonable” for services “actually rendered.”

NQDC Plans are frequently structured as a series of periodic payments (monthly, quarterly or annually) to be paid by the business to the employee after retirement or termination. This series of periodic payments can be paid for a fixed term of years, as an annuity over a single life, or as a joint and survivor annuity over multiple lifetimes. The NQDC Plan can contain other fringe benefits such as health insurance, club dues and other perks.

The larger the amount of the promised payment, or the longer the number of promised payments, the greater the value must be of the services provided by the employee for the transaction to satisfy the standard for qualification as reasonable compensation. The reasonableness test may rely on the value of both

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“past and future services” or it may rely solely on the value of “future services.” The choice of services will limit value of the services and thus the income tax deductibility of the payments. The choice of services may also affect not only when the payments will be taxable for payroll tax purposes but also what portion of the promised payments will be subject to Social Security tax (FICA) and Medicare tax (MHIT).

Past and Future Services vs. Future Services

Whether the employment agreement chooses to cover “past and future services” or merely “future services” will be shaped by the facts and circumstances of each individual client.

We must first evaluate an employee’s work history and his or her past compensation in order to determine whether an employee was undercompensated or overcompensated for past services. The past is fixed. The future remains to be molded. The future services that an employee intends to provide is flexible. The longer a person waits before beginning to receive payments, and the longer that the employee agrees to continue to provide valuable services into the future, the higher the value that may be assigned as “reasonable” payments that can be made in the future.

Payroll Tax Implications

Whether the employment agreement actually relies on both past and future services or merely future services will shape the payroll tax aspects of deferred compensation benefits. Code Sec. 3121 and Section §31.3121(v)(2)-1 of the Treasury Regulations (Tres. Reg.) determine when amounts deferred under NQDC plans are subject to payroll tax. The payroll taxes at issue are: the Federal Unemployment Tax (sometimes referred to as FUTA); the State Unemployment Tax (sometimes referred to as SUTA); the “Social Security” portion of the tax under the Federal Insurance Contributions Act (sometimes referred to as the FICA tax); the Medicare Hospital Insurance Tax (sometimes referred to as MHIT); and the Additional Medicare Tax (sometimes referred to as the Obamacare Supplemental Tax).

FUTA and SUTA

FUTA and SUTA are generally subject to low annual thresholds. In 2016, only the first $7,000 of wages paid to an employee were subject to FUTA. The FUTA tax rate in 2016 continued to be six percent. Most employers received a credit of 5.4 percent, so the net tax rate was only 0.6 percent before adjustments. The credit is available provided that you timely paid into the applicable state unemployment systems. If your state did not repay all of its unemployment loans, the 5.4-percent credit was reduced. The thresholds and rates for SUTA vary from state to state (from a low of $7,000 to a high of $42,200), but the thresholds are generally at a level under $20,000 per employee.

FICA and MHIT

In 2016, the FICA tax of 12.4 percent was assessed on the first $118,500 of taxable wages (taxable wages increase to $127,200 in 2017). One-half of the tax (6.2 percent of the taxable wages) is withheld from the wages of the employee, and the other one-half of the tax (6.2 percent of taxable wages) represents a matching contribution paid by the employer. The MHIT of 2.9 percent is assessed on all taxable wages, without regards to any FICA limitation. One-half of the MHIT tax (1.45 percent of taxable wages) is withheld from the wages of the employee, and the other one-half of the MHIT tax (1.45 percent of taxable wages) represents a matching contribution paid by the employer. The Obamacare tax (0.9 percent of taxable wages in excess of $200,000 for a single individual or $250,000 for a married couple) is assessed against only the employee.

FICA, MHIT and Obamacare Taxable Wages

Reg. §31.3121(v)(2)-1 determines when amounts deferred under a NQDC plan are subject to payroll tax. Under the “Special Timing Rule” found at Reg. §31.3121(v)(2)-1(a)(2)(ii) amounts deferred under a NQDC Plan are required to be taken into wages as of the later of “(A) The date on which the services … are performed … ; or (B) The date on which the right to that amount is no longer subject to a substantial risk of forfeiture.” The terms of the employment

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agreement will dictate the when the deferred amounts are vested and thus subject to tax.

Furthermore, Reg. §31.3121(v)(2)-1(a)(2)(iii) contains a nonduplication provision which states that once deferred wages are subject to payroll tax, then the deferred wages will not be treated as wages and subject to FICA tax when the payments are in fact made to the employee.

**Computation of Liability (NQDC Plans)**

Unlike deferred compensation plans, where the benefit is based upon a specific dollar amount that is carved out of current compensation and deferred to a later date for payment (i.e., an “account balance plan”), the benefit under a NQDC Plan is based upon the present value of a defined benefit amount and perks that will be paid over either a term of years, or over the life expectancy of one or more individuals (similar to an annuity). This type of plan is referred to as a Nonaccount Balance Plan. Reg. §31.3121(v) directs that the present value of a nonaccount balance plan should be calculated “using actuarial assumptions and methods that are reasonable” as of the date specified date. This broad language of the regulation allows planners a large amount of flexibility in computing the liability.

Using Reg. §31.3121(v) a reasonable method for calculating the accrued liability for a nonaccount balance plan could be the formula for calculating the present value of an annuity. The number of annuity payments would either be a specific term of years, if fixed by the provisions of the NQDC Plan, or the life expectancy of the annuitant, if the benefit is structure as a payment over one or more lifetimes.

If the NQDC Plan is structured over one or more lifetimes, we must look the Internal Revenue Code and the Treasury Regulations for guidance in determining life expectancy. A number of provisions of the Internal Revenue Code rely on life expectancy tables. 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 under Code Sec. 72 using life expectancy tables that can be found under the Reg. §1.72. The value of Required Minimum Distributions from qualified plans is computed using life expectancy tables that can be found at Reg. §1.401(a)(9). Various estate tax valuation provisions rely upon U.S. Census statistics. Table 2000CM is generally used for computing gift and estate tax values of life estates or remainder interests in property.

Similar to the Death Benefit Only computation, if the payments continue throughout the life expectancy of a single or joint and survivor annuity, we would first be required to select a Mortality Table in order to determine the life expectancy of the annuitant. The longer the projected life expectancy, the greater the projected number of payments that would be made under the agreement, and thus, the higher the accrued deferred compensation liability.

Second, we would need to select an applicable interest rate (sometimes referred to as the discount rate). The higher the discount rate, the lower the present value of the accrued liability. The Internal Revenue Service (IRS) publishes the Applicable Federal Rates (AFRs) of interest each and every month in the form of Revenue Rulings. Each month the AFRs may change depending upon fluctuations in the market rate of interest experience throughout the United States.

Each monthly revenue ruling prescribes interest rates for federal income tax purposes. Table 1 contains the short-term rate (zero to three years), mid-term rate (three to nine years) and the long-term rate (over nine years) for the purposes of Code Sec. 1274(d). Table 5 contains the rate for determining the present value of an annuity, an interest for life or a term of years, or a remainder or a reversionary interest for the purposes of Code Sec. 7520.

Since Reg. §31.3121(v) permits us to use “any reasonable method” for calculating the accrued liability for a nonaccount plan, we would appear to be free to use any reasonable interest rate. For a series of payments that is greater than nine years, it may be reasonable to use the Table 1 the long-term AFR. Similarly, since this periodic payment resembles an annuity, even though Code Sec. 7520 might not be directly applicable in the calculation of this liability, it might seem reasonable to use the Table 5 rate which is equal to 120 percent of the mid-term AFR under Table 1 (rounded to nearest even number). The long-term rate under Table 1 will generally be higher than 120 percent of the mid-term AFR under Table 1. The interest rate is inversely proportional to the present value of the accrued deferred compensation liability. In other words, the higher the interest rate, the lower the present value of the annuity. Conversely, the lower the interest rate, the higher the present value of the annuity.

**Financial Reporting Requirements**

The execution of the employment agreement creating the NQDC Plan creates a liability which should be booked for accounting purposes. The footnotes that accompany an audited or reviewed financial statement should disclose the salient aspects of the plan. Lenders and bonding companies may require that the employee agree to subordinate this liability to their debt obligations.
Estate Tax Savings

The recognition of the liability for the present value of the NQDC Plan will reduce the net worth of the business and make it easier for the current shareholders of the business to transfer shares of equity via lifetime gifts.

If the NQDC Plan payment is structured in the form of an annuity, rather than as payments for a fixed term of years, then the payments will cease upon the death of the annuitant. If death occurs before the calculated life expectancy, then the payments which were structured as a simple annuity or a joint and survivor annuity will cease prematurely. Since the accrued liability was not deducted for corporate income tax purposes, its cancellation will represent a nontaxable cancellation of indebtedness for corporate income tax purposes, and similarly the termination of the annuity will not be subject to estate or gift tax.

Department of Labor Reporting Requirements

If the plan is unfunded, then it will be a general obligation of the business. Unfunded deferred compensation plans are deemed to be “Top Hat Plans” under The Employee Retirement Income Security Act of 1974 (ERISA). Top Hat Plans are not subject to the same stringent disclosure rules as qualified plans. A “Top Hat” Plan must file a single notification with the Department of Labor (DOL) within 30 days of the execution of the plan. The DOL notification discloses the name of the employer, the name and existence of the plan to DOL and the number of employees covered under the plan. Failure to file the notice could subject the employer to a $10,000 penalty.

Payroll Tax Reporting Requirements

Once the amount of the benefit is fixed and vested, the present value of the deferred compensation should be computed and added to the employee’s payroll. FICA and MHIT should be withheld from the employee’s wages, matched by the employer and paid to the U.S. Treasury as part of the normal payroll tax reporting. The amount of the deferred compensation will be reported as FICA Wages and MHIT Wages on IRS Form 941 and W-2, but the deferred compensation will not be considered to be taxable wages until they actually paid.

The payment of FICA and MHIT taxes on the present value of the deferred compensation will likely involve a significant pre-payment of payroll taxes. However, because the FICA Taxes are capped at $118,500 in 2016 ($127,200 in 2017), much of the present value of the deferred compensation will escape FICA Tax.

Employer Income Tax Reporting Requirements

For corporations, the income tax reporting is clear, the deferred compensation is a current expense that reduces the income for book purposes, but it is not currently deductible tax purposes. The present value of the deferred compensation should be reported on IRS Form 1120 (or 1120-S) Schedule L as an accrued liability, and it should also be reported as an item on IRS Form 1120 (or 1120-S) Schedule M-1, on the line labeled “Expenses recorded on books this year not deducted on the this return.”

Once actual payments of the deferred compensation begin, the payments may be reflected on Schedule M-1, on the line labeled “Deductions on this return not charged against book income this year” and the payments may be deducted on Page 1 of the corporation income tax return. A portion of the payment will simultaneously begin to reduce the deferred compensation liability on Schedule L. The balance of the payment to the employee is treated as the payment of interest on the deferred compensation payment. The interest portion of the payment is deductible for income tax purposes when paid, but it is not subject to either FICA tax or MHIT, either at the time of the accrual or at the time of payment.

In the year of payment, the interest and principal portions of the payment will both be taxable income to the employee and the total will be reported as Gross Wages on IRS Form 941 and IRS Form W-2. The total payment, however, will not be considered to be FICA Wages or Medicare Wages under the nonduplication rules of Code Sec. 3121. Similarly, the total payment will not be subject to FUTA or SUTA taxation in the year of payment.

Summary

A business’s Net Worth can be reduced by acknowledging, quantifying, memorializing and recognizing liabilities (i.e., the neglected variable in the Net Worth equation). Nonqualified plans such as Death Benefit Only Plans and NQDC Plans allow businesses to reduce their transfer tax value by acknowledging moral obligations of the business to its founders and the families of its founders. Converting the moral obligations to legal obligations will permit the parties to recognize and accrue liabilities that will reduce the net worth of the business.
The accrued liabilities give the business, its shareholders and its key employees the opportunity to save multiple levels of taxation.

- Estate tax savings can be realized by recognizing the obligation and reducing the net worth of the business, thus making it easier for shareholders to make lifetime transfers of stock.
- Corporate income taxes can be lowered by permitting businesses to substantiate the deductibility of benefits to key employees as reasonable compensation post-retirement.
- Payroll taxes savings are available. Death benefits paid in the calendar year after the employee’s death escape payroll taxation. NQDC payments are subject to payroll tax at the computed present value of the payments, rather than the gross value of the payments actually made. Even though the payment of the payroll taxes may constitute a prepayment of FICA and MHIT, it may nonetheless result in a substantial savings by causing present value to be taxed for FICA purposes during a year before retirement, when taxable wages will be in excess of the FICA limitation.
- Additional estate tax savings can be realized if the annuitant(s) dies before the computed life expectancy. The annuity obligation will escape estate taxation since it will not be an asset which is includable in the gross estate of the deceased.

ENDNOTES

2 Arizona, California, Florida, and Puerto Rico according to the Ernst & Young US Employment Tax Rates and Limits for 2016—Final, 2016 Ernst & Young LLP.
3 Hawaii according to the Ernst & Young US Employment Tax Rates and Limits for 2016—Final 2016, Ernst & Young LLP.
5 Account Balance Plan—Reg. §31.3121(v)(2)-1(c)(1).
7 Reg. §31.3121(v)(2)-1(c)(2)(ii).