COMPENSATION STRATEGIES

Wolters Kluwer

Compensation Strategies

One of the most fundamental issues facing every business is providing a fair and competitive compensation package for employees. A competitive compensation package only begins with wages or salary. It also includes:

- Bonuses;
- Fringe benefits;
- Deferred compensation; and
- Retirement plan benefits.

As a business owner, three of your most important concerns in connection with compensation are:

(1) Its cost to you and whether it fits in your budget;
(2) The tax consequences to you and to your employees; and
(3) Whether the compensation package meets your employees' expectations.

This guide will introduce you to the elements commonly contained in a small business compensation package and help you understand the tax treatment of these benefits for you and your employees. With this knowledge, you, with the help of your tax advisor, can implement your compensation strategy.

SALARY: THE FOUNDATION

The key ingredient in every compensation package is salary. The tax consequences of

cash compensation are simple. As an employer, you get an immediate dollar-for-dollar deduction in the amount of salary paid for services rendered. Your employees must include the amount of the cash compensation in their taxable incomes.

The same rule generally applies in the case of non-cash compensation. The only difference is that you get a deduction for the fair market value of any property given to your employee for services rendered while your employee includes the same amount in his or her taxable income.

Deferring salary

Among the many issues that you should consider when setting employees' salaries, two have important tax ramifications. The first of these issues is whether you want to defer some of the salary currently being earned until sometime later or until retirement.

Your employees may be interested in doing this if they do not need all the money they are earning to meet current

expenses. However, income deferral is not always a win-win for you and your employees. As an employer there is a potential downside for you in connection with your employee's successful deferral of income. You may lose your current deduction for the compensation paid.

Reasonable compensation

The IRS requires that salary be "reasonable" to be fully deductible. If your business is very small and you and your family are either the only employees or the majority of employees, this may raise a red flag for the IRS to question the reasonableness of compensation.

The IRS will also question the reasonableness of your compensation if it is excessive compared to others in similar businesses. If your salary is unreasonable, you will be taxed on the excess as a dividend and your company will not be able to deduct it as a business expense.

Sometimes, the IRS will claim that your salary is too low to be reasonable. For example, a business might pay a low salary to an owner to avoid employment taxes on payments to the owner.

Bonuses

A bonus is generally treated like salary. This means that it must be included in the employee's taxable income and your business receives a deduction for the amount paid.

However, a large bonus may be a sign that the total compensation package is unreasonable. Many businesses, especially corporations, determine their profits and distribute them at the end of the year. The IRS may review carefully the payment of large year-end bonuses to ensure the payments are not really a nondeductible distribution of profits.

If you can show that the payment of year-end bonuses is customary in your company and industry, it is less likely that the IRS will treat the bonus as nondeductible. However, failure to set the amount of the bonus as an absolute dollar amount or as a percentage of net profits before the end of the year could provide the IRS with strong evidence of intent to convert profits into compensation.

FRINGE BENEFITS

When you provide a fringe benefit to an employee as part of his or her total compensation, as a general rule, the value of the fringe benefit is required to be included in taxable income. However, some fringe benefits are tax-free. The good news for you, as the employer, is that you still get a tax deduction for providing the benefit based on the value of the benefit.

Tax-free fringe benefits

There are a large number of valuable fringe benefits that your employees are not required to include in their taxable compensation:

- Medical coverage, including any type of accident or health insurance;
- Dental insurance;
- Life insurance;
- Education (tuition) assistance;
- Cafeteria plans;
- Adoption assistance;
- Meals and lodging;
- Dependent care assistance;
- Stock options; and
- Gifts of nominal value.

You can deduct the cost or the value of these fringe benefits either as compensation for services rendered or as an "ordinary and necessary" business expense.

Affordable Care Act (ACA) reforms. Beginning in 2015, applicable large employers (generally, employers averaging 50 or more full-time employees, with some exceptions) are subject to the shared responsibility rules, popularly known as the employer mandate. Under those rules, a large employer may be subject to assessable payments if one or more of its full-time employees obtains individual coverage on a Health Insurance Exchange and is eligible for a premium tax credit or subsidized cost reduction. Transition relief postpones application of these rules for employers with 50 - 99 full-time employees to 2016.

An eligible small employer may claim a tax credit for premiums it pays towards health coverage of its employees.

> **Comment.** As enacted, the employer mandate was scheduled to apply starting in 2014. However, the IRS pushed back the starting date for this mandate and its reporting requirements from January 1, 2014, to January 1, 2015.

Here are some more tax-free fringe benefits:

- No-additional-cost services;
- Employee discounts;
- Working condition fringe benefits;
- De minimis fringe benefits;
- Moving expense reimbursements;
- Transportation fringe benefits; and
- Retirement planning services.

No-additional-cost services and employee discounts. If you provide a service, which you regularly sell to the public, to your employees without incurring any substantial additional cost, your employees will not be taxed on the value of the service. (Free stand-by flights to airline employees and free telephone service to phone company employees are examples). Similarly, if you sell goods or services to your employees at a discount from the price paid by the public, the amount of the discount is tax-free. The discount cannot exceed the amount of your profit and is limited to 20 percent for services.

Working condition fringe benefits. Working condition fringe benefits are

benefits your employee would have been entitled to deduct as deductible business expenses if he or she had paid for the benefits. Employer expenses for on-the-job training are an example.

De minimis benefits. Some fringe benefits may be excluded from income as de minimis if their value is so small that accounting for them would not be practical. The lower the value of the benefit, the more likely it is de minimis. Value cannot be an estimate. It must be a determinable amount.

Here are some examples of de minimis fringe benefits:

- Occasional use of an employer's photocopy machine;
- Picnics for employees;
- Soft drinks, coffee, and donuts; and
- Pens and pencils.

Transportation fringe benefits. Transportation benefits are among the fastest-growing types of employee benefits. Transportation fringe benefits are tax-free so long as they meet IRS monetary thresholds. Some common transportation fringe benefits are:

- Van pooling;
- Transit passes; and
- Qualified parking.

Employers can provide qualified transportation fringe benefits for parking, van

pooling and transit passes. For 2014, the benefit for parking is $250 a month. For van pooling and transit passes, the benefit is $130 a month.

Moving expenses. If you pay or reimburse an employee's moving expenses, the amount may be excluded from the employee's income. Reimbursements for moving expenses are subject to strict substantiation requirements. In addition, the employee may not retain any excess reimbursements.

Retirement planning services. If you provide financial counseling services, they are not excludable from your employees' wages unless they are "qualified" retirement planning services. These include "any retirement planning advice or information provided to an employee and his or her spouse by an employer maintaining a qualified employer plan." The exclusion applies to highly compensated employees only if qualified retirement planning services are available on substantially the same terms to all employees of the group who

normally receive information and education about the plan.

Taxable fringe benefits

Some fringe benefits must be included in income as a part of an employee's compensation. Examples of taxable fringe benefits include:

- Flights on employer-provided aircraft;
- Employer-provided vacations;
- Employer-provided discounts on property or services (to the extent that they are not considered no additional cost services); and
- Employer-provided memberships in country clubs or other social clubs.

If you provide any of these benefits to your employees for their personal use, special valuation and substantiation rules apply for determining the amount your employee must include in his or her income.

DEFERRED COMPENSATION

Deferred compensation arrangements postpone payment of salary, bonuses, incentive compensation, or supplemental retirement benefits. If you establish these arrangements properly, your employee's income tax is also deferred. You will be able to deduct the payment as the employer at the time your employee is taxed on it.

There are two types of deferred compensation plans. One type sets money aside for the employee (funded plan). Another type contains a promise to pay benefits in the future (unfunded). Generally, strict rules dictate how many employees must be included in a deferred compensation arrangement.

> ***Caution.*** It is important to distinguish this type of deferred compensation arrangement, usually referred to as a "nonqualified" deferred compensation arrangement, from arrangements that are referred to as tax-qualified retirement plans.

Qualified plans. A tax-qualified retirement plan is a special type of funded deferred compensation arrangement and must comply with complex rules. There are special rules for vesting and funding, requirements that benefits are not unfairly skewed in favor of your highest paid employees, and other requirements designed to guarantee that plan benefits are provided to an appropriately broad group of employees.

Nonqualified plans. Nonqualified deferred compensation plans are not subject to these special rules and can therefore be restricted to selected employees and designed without regard to the limitations of the qualified plan rules.

Deferred compensation arrangements permit your employees to defer income tax by deferring receipt of compensation.

These plans may also be used to provide employees with additional retirement benefits or incentive compensation. You can establish these arrangements with your employees either individually or establish a plan that covers a number of employees.

Unfunded plans. In an unfunded arrangement, you essentially give your employees an unsecured promise to pay the deferred compensation at some time in the future. In an unfunded arrangement, you do not pay amounts into a trust or other funding vehicle. You may, however, place funds in special accounts or trusts that you establish in the United States for your employees' benefit.

The IRS had provided some leeway for "funding" an unfunded plan, but legislation tightened the rules for unfunded plans. Amounts contributed to a trust whose assets are available to the employer's general creditors will be immediately taxable to the employee. Amounts set aside in a trust are also immediately taxable if the plan provides that the amounts will not be restricted to the payment of benefits if the employer's financial health declines. Similarly, if assets in a trust or other funding vehicle are located outside the United States, or are transferred out of the United States, the amounts in the trust or funding arrangement will be immediately taxable to the employee.

Caution. If your creditors cannot reach the funds in trust, your employees will also have to pay immediate taxes on the funds you have set aside for them in the trust.

Rules also restrict an employee's ability to elect when to defer and when to receive deferred compensation under an unfunded plan. If these rules are violated, deferred amounts must be included in the employee's income immediately. In addition, the employee will owe interest on the amount deferred plus an additional 20 percent penalty tax on the amount included in income.

Elections and payment dates

Elections to defer compensation must be made by the close of the preceding year before the amounts will be earned. Elections in the same year will trigger taxation. An election to defer a bonus must be made at least six months before the end of the bonus period (of at least 12 months) over which the bonus will be earned. Payments within 2 ½ months after the end of the earnings period are not deferred compensation.

Payments must be made on a fixed date or schedule, or upon one of the following: separation from service, death, disability, a change in control of the employer, hardship, or an unforeseeable emergency. If an employee wants to push

back the payment date, the election must be made at least 12 months before the original payment date and must push payments back at least five years.

If an employee cashes out part of his benefits before the payment date, the entire deferred amount becomes taxable. Employers generally cannot re-establish a plan within five years after the plan is terminated.

Exclusions. The new deferred compensation rules do not apply to:

- Short term deferrals;
- Some separation pay agreements;
- Some independent contractors; and
- Some foreign arrangements.

Funded plans

Deferred compensation under an unfunded arrangement is not taxable until it is actually paid to your employees, unless amounts are made available to employees earlier. Amounts contributed to funded nonqualified plans are generally taxable under special rules applying to the transfer of property for services. Under these rules, an employee will be taxed when his or her rights to the funded amounts become non-forfeitable or freely transferable.

Deduction

Your deduction for deferred compensation paid is generally available in the tax year

in which the amount is included in the employee's taxable income. To be deductible, the payments must be reasonable in amount and must satisfy the requirements for ordinary business expenses.

Other benefits to you

Nonqualified deferred compensation arrangements can provide another benefit to you that is somewhat unrelated to the tax deduction. Arrangements can be structured in such a manner requiring employees to perform services for you for a number of years before the benefits become available or vested. For this reason, some nonqualified deferred compensation arrangements have been referred to as "golden handcuffs." They can provide an incentive that gives your employees an additional reason to stay with you for a number of years.

Tax-qualified retirement plans

A tax-qualified retirement plan generates very favorable income tax consequences for you and your employees. A strict set of requirements (qualification

requirements) must be met to attain these income tax advantages. Failure to meet qualification requirements may lead to disqualification of plans and loss of tax advantages.

> ***Caution.*** Responsibility for administration and enforcement of the rules governing tax-qualified plans is divided between the U.S. Department of Labor and Treasury Department. Compliance with the requirements of the Tax Code and these government agencies can make these plans difficult and expensive to administer.

Here are some of the tax advantages of qualified retirement plans:

- As the employer, you are entitled to an immediate deduction, to be taken within specified limits, for contributions made to the plan on behalf of your employees;
- The income earned by qualified plans generally is not subject to current income tax;
- Your contributions to qualified plans generally are not included in the taxable incomes of participants until these amounts are actually distributed from the plan and received by the participants; and
- Your employees that participate in the plan and their beneficiaries are often entitled to special tax treatment on distributions.

Qualified plans and some non-qualified plans are subject to the *Employee Retirement Income Security Act of 1974 (ERISA)*, which imposes many reporting and disclosure requirements.

Types of tax-qualified plans

Qualified plans are classified as either defined contribution plans, which include profit-sharing, stock bonus, target benefit and money purchase pension plans, or defined benefit plans, which include annuity plans.

Several types of plans, such as 401(k) plans, church or governmental plans, simplified employee plans (SEPs) and savings incentive match plans (SIMPLE IRAs) are subject to special, additional rules. SEPs and SIMPLE plans generally have significantly fewer administrative requirements than other tax-qualified plans.

Requirements for tax-qualification

All tax-qualified plans, regardless of type, must meet basic requirements to keep qualified status and for you and your employees to gain the tax benefits. These requirements cover not only the initial start-up of the plan, but provide rules on how the plan must operate.

A plan must be written and in existence in the tax year for which tax benefits are being sought. To be a qualified plan, you must intend for the plan to be permanent.

A plan is not tax-qualified until you tell your employees about the establishment of the plan. Specific requirements govern this communication. Qualified plans must exist for the exclusive benefit of your employees and their designated beneficiaries.

You are generally required to keep the funds invested in a tax-qualified plan in a trust. The trust must be a valid, written domestic trust and you as the employer must have established the trust. With some exceptions, the written document that contains the rules for the plan must prohibit the alienation, assignment or anticipation of benefits.

Withdrawals. Special rules govern the rights of your employees to withdraw contributions or receive distributions from the plan. The severity of the restrictions depends on the type of plan. There are also rules that require participants to start taking minimum distributions from the plan generally beginning in the year after they attain age 70½.

Incidental benefits. Although you generally establish a tax-qualified retirement plan to provide for retirement benefits, you are nevertheless allowed to provide other benefits that are incidental to the plan's primary purpose. These include benefits such as life, health or accident insurance. There are specific restrictions as to the amount and type of benefits that can be considered incidental.

Dollar limits. There are specific dollar limits (most of them inflation adjusted each year) for how much you can contribute to a plan for each of your employees. There are also limits on how large of a deduction you can take annually for the contributions you make to the plan on behalf of your employees.

Plan year. Qualified plans must adopt an accounting period, known as a plan year. This need not coincide with the employer's tax year, but if it does not, special rules determine the deductible limit for the employer's tax year.

> ***Caution.*** Changes to the plan year must be approved by the IRS. Under some circumstances, approval is automatically granted.

STOCK OPTIONS

Stock options have become a very important component of competitive compensation packages in the past 20 years. They can give your employees a feeling that they have a stake in your business' success.

Since you set the terms of when and how an employee can exercise a stock option, using stock options as part of your compensation package can have the "golden handcuffs" effect. Stock options help retain valuable employees.

Types of options

A stock option is a right that you as an employer extend to an employee, if your business is operating as a corporation, to buy

stock in the corporation at a stated price for a stated amount of time. Stock options are either statutory or nonstatutory.

"Statutory stock options" are incentive stock options and options issued under employee stock purchase plans. "Nonstatutory stock options" are all other options; that is, they do not usually qualify for favorable tax treatment.

Generally, if an employee acquires stock under a statutory stock option arrangement, the employee is taxed at capital gains rates and only when he or she disposes of the stock. On the other hand, if an option is acquired under a nonstatutory program, the employee may be taxed when:

(1) The option is granted;
(2) The employee exercises the option;
(3) The employee sells or otherwise disposes of the option; or
(4) Restrictions on disposition of the option-acquired stock lapse.

The income that the employee must recognize under a nonstatutory program is considered compensation, rather than capital gain, and is taxed at ordinary income rates.

Incentive stock options

Incentive stock options (ISOs) are granted to key employees. The options granted for a given year must be for stock worth $100,000 or less. The ISO

plan must be approved by shareholders, and must specify the number of shares to be issued and the class of employees granted the options. The plan's length cannot exceed 10 years, and the option's term cannot exceed 10 years. Options must not be transferable. The option exercise price must equal the value of the stock at the time the option is granted.

> ***Caution.*** If you provide an incentive stock option to your employees, there may be some alternative minimum tax (AMT) consequences. If you are planning to offer this type of benefit to your employees, AMT can be discussed in detail with your tax advisor.

Employee stock purchase plans

Employee stock purchase plans (ESPPs) provide benefits for rank and file employees. Options under the plan must be granted to all employees, except members of groups specifically excluded. In the case of an employee stock purchase plan, all employees who are granted options must have the same rights and privileges. Options under the plan may

not be issued to shareholders possessing five percent or more of the voting power or the value of the corporation. If you want to primarily benefit your top executives and yourself, this is not the type of stock plan to offer

To establish an ESPP, you must get the approval of the shareholders of the corporation. In addition, options must be granted only to employees of the corporation. No employee can accrue the right to buy more than $25,000 worth of stock in any year. Options cannot be transferred except at death and cannot be exercised by anyone other than the employee during his or her lifetime.

Nonstatutory stock options

Options may be intentionally issued in nonstatutory form, or may be nonstatutory because they fail to meet the requirements for statutory options. A nonstatutory stock option is taxed to the employee when the option is granted or exercised. The employer is entitled to a deduction when the employee recognizes income, equal to the amount included in the employee's income.

EMPLOYEE VERSUS INDEPENDENT CONTRACTOR

You may have two different types of workers "employed" in your business:

(1) Common law employees; and
(2) Independent contractors.

An independent contractor should be working for you under the terms of a very clear contract. The contract should spell out the extent of the work he or she is expected to do for you and the price you are paying for that work. Your contract with an independent contractor should clearly state that it is the intent of the parties to the contract that this individual is working with you in the capacity of an independent contractor.

> ***Note.*** The IRS continues to aggressively investigate situations in which employers are incorrectly treating employees as independent contractors for tax purposes. In a carrot-and-stick approach, the IRS currently has a Voluntary Classification Settlement Program (VCSP) for employment taxes owed by employers that agree to treat their workers as employees prospectively. The program offers reduced penalties in return for compliance going forward.

Whether a worker is an independent contractor or an employee determines if you have income tax withholding and employment tax obligations. For income tax withholding purposes, common law employees and corporate officers are considered to be employees. For FICA (Social Security taxes) and FUTA (unemployment taxes) tax purposes, common law employees are considered to be employees.

Compensation paid to independent contractors is not subject to income tax withholding, FICA or FUTA taxes.

Caution. When an employer provides the various elements of a compensation package as discussed here, the employer generally does not intend to include independent contractors as employees eligible for these benefits. Tax-qualified plans can only be maintained for employees, not independent contractors. Unfortunately, sometimes the IRS and the courts don't see things the same way as employers do. It is important to set things straight with a clear contract with an independent contractor.

CONCLUSION

Establishing a compensation strategy for your employees is a very complicated endeavor. If it is not handled properly, you can end up with unintended tax consequences and you can also alienate your employees.

The best way to establish a workable compensation strategy is to take an accounting of your financial situation, your needs for employees, and look at the type of compensation packages that similar businesses in your industry are offering. Sit down with your tax advisor and establish a strategy that works for your business financially, from a tax perspective, and that will satisfy your employees.