Non-Qualified Deferred Compensation for Public Accounting Firms and their Clients

Management Services International
Risk Management Made Profitable ™
Servicing Client Nationwide

North Carolina Association of CPAs

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Learning Objectives

- Learn about Non-Qualified Deferred Compensation (NQDC), uses and benefits for Business Owner(s) & Key Employee(s).

- Understand IRC 409A and other Codes related to NQDC

- Identify situations where Non-Qualified Deferred Compensation Plans would benefit business owners & key employees.

Jeremy Colombik, CPA
Managing Partner

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Jeremy Colombik is an experienced, licensed CPA and financial professional who has worked with NQDC plans and Captives for 15 years.

He is a member of the North Carolina Association of CPAs and the American Institute of Certified Public Accountants

Jeremy frequently works with the North Carolina Department of Insurance Commissioner as well as U.S. Congressmen and Senators in Washington D.C. regarding regulatory and compliance issues.

He is a sought-after speaker at state and national conferences and a published author for various financial and insurance industry resources.

Richard M. Colombik JD, CPA

Richard Colombik has 40 years of taxation experience as both a tax attorney and a CPA. He is also a Partner of Management Services International.

Recognized nationally as a former liaison committee member to the IRS Commissioner's office in Washington, D.C.

He also headed the Bar Association Taxation Committees on National, State and Local levels. Mr. Colombik is also a best-selling author for his recently published book on tax planning, Keep It.

Mr. Colombik has been a member of the Tax Staff for one of the world's wealthiest families. He was also a Tax Manager for one of the largest Tax Practices in the World.

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Who are we?

2019, 2020, 2021 & 2022
US Captive Awards Finalist

- Turn-key Non-Qualified Deferred Compensation (NQDC) plan provider serving clients for more than 15 Years
- Proprietary NQDC structure for Business Owners
- Award winning Captive Insurance Company Manager, MSI creates and manages Captive Insurance Companies for Business Owner(s). Servicing Clients Nationwide.
- **www.themsicorp.com**

What is Non-Qualified Deferred Compensation?

- Non-Qualified Deferred Compensation (NQDC) is a program where compensation that would otherwise be paid, and taxable, in the current year, is deferred until a later tax year. NQDC provides benefits for business owners and key employees.

- Business Owner has control
  - Business Owner(s) can participate
  - Owner chooses participants, if any employees
  - Owner makes the rules, $ and Vesting
- No contribution limits or age restrictions

Protect Investment in Employed CPAs

- CPA Practice Advisor reports that many CPA firms have turnover rates above 25 percent

- Other professions report an 11.6 percent turnover rate

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- Hiring costs, average 50% or more of annual compensation

NQDC the 3 Rs, RETAIN

1 Recruit

2 Retain

3 Reward

- Recruit
- <u>Retain</u>
  - **Mitigate risk so a good CPA does not leaves firm**
  - New hire costs, 50% or more of Annual Comp
  - Avoid revenue lost when employee leaves
  - Many clients would follow CPA to another firm
  - High-caliber CPAs ***<u>start their own practices</u>***
- Reward

Jones Acct protects investment in Kim, CPA

- 5 CPAs, 3–5 years, ***risk of them leaving to another firm or corporate***
  - Kim is important. Firm realizes revenue will drop & clients would leave
- Jones Accounting defers $20,000/year for Kim, 5-year vesting
  - Firm protects investment in Kim who is paid $60,000/year
  - Minimum Hiring costs to replace Kim = $20,000

NQDC KIM POWELL, CPA - 5-YEAR VESTING

Year	Jones Contributes	Balance	Kim Vesting	Kim Leaves	Jones Retains
1	$20,000	$20,000	20%	$4,000	$16,000
2	$20,000	$40,000	40%	$16,000	$24,000
3	$20,000	$60,000	60%	$36,000	$24,000
4	$20,000	$80,000	80%	$64,000	$16,000
5	$20,000	$100,000	100%	$100,000	$0

Non-Qualified Plan Myths & Misconceptions

- Only for big companies
- IRC 409A documents & compliance are too complicated
- Business owners cannot participate in NQDC

NQDC works best when…

The participant is in a high tax bracket.

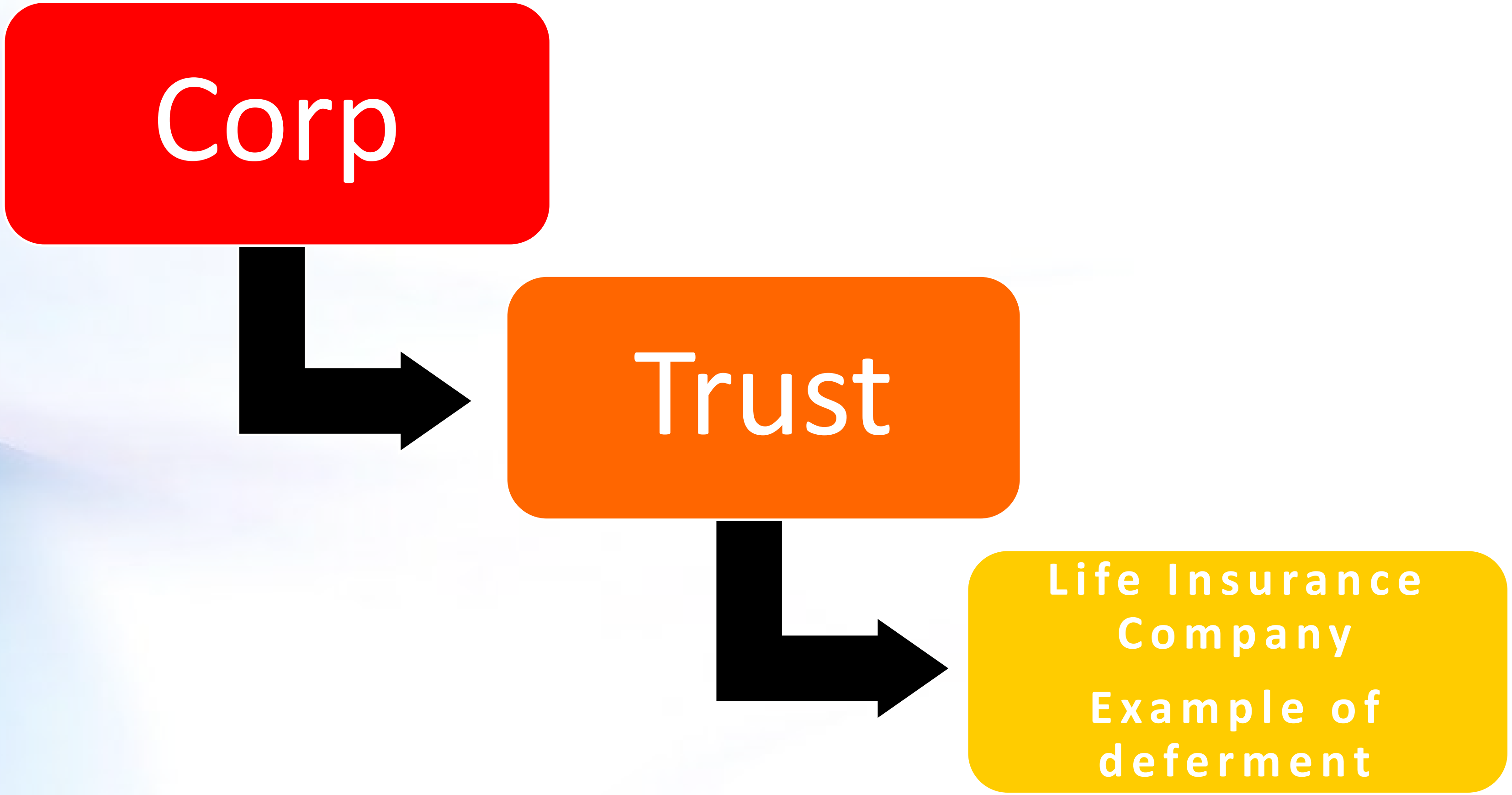
NQDC Takeaway Points

- NQDC allows business owners, and key employees, to defer a much larger portion of their compensation, and to defer taxes on the money until the deferral is paid.

    - NQDC is commonly used for business owners and key employees.

- No contribution limits or age restrictions
- Save for more than just retirement
- Flexible distributions

Understanding how the money flows



Who qualifies for Non-Qualified plans?

- Business Owner(s), if properly structured
    - Employee(s)
        - Business owner controls who participates
        - Owner chooses contribution amount & vesting schedule
        - No ERISA requirements

Susan Jones CPA, owns 15% of Smith Accounting

- Income: $300,000, $200,000 needed to live comfortably
  - Maxes out qualified plan(s), seeks other ways to save
  - 8-year-old twins, Sally & Sam
  - Always wanted a Vacation home

- Defers $75,000/year, 10 years, Defers $30,000/year income taxes
  - NQDC could delay qualified plan distributions by years
  - Money for Sally and Sam's College Fund
  - Vacation Home

NQDC the 3 Rs

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- **Recruit**
  - High-caliber employees difficult to hire
  - Employee less likely to Job Hop
- **Retain**
  - High-caliber employees ***open competing businesses***
  - **Prevent loss of revenue, clients follow the CPA**
  - Employee hiring costs average 50% of salary paid
- **Reward**
  - Shows appreciation to productive, long-term employees
  - Employee loyalty

Recruit

Retain

Reward

Recruit, Richard Jones CPA Senior Tax Manager

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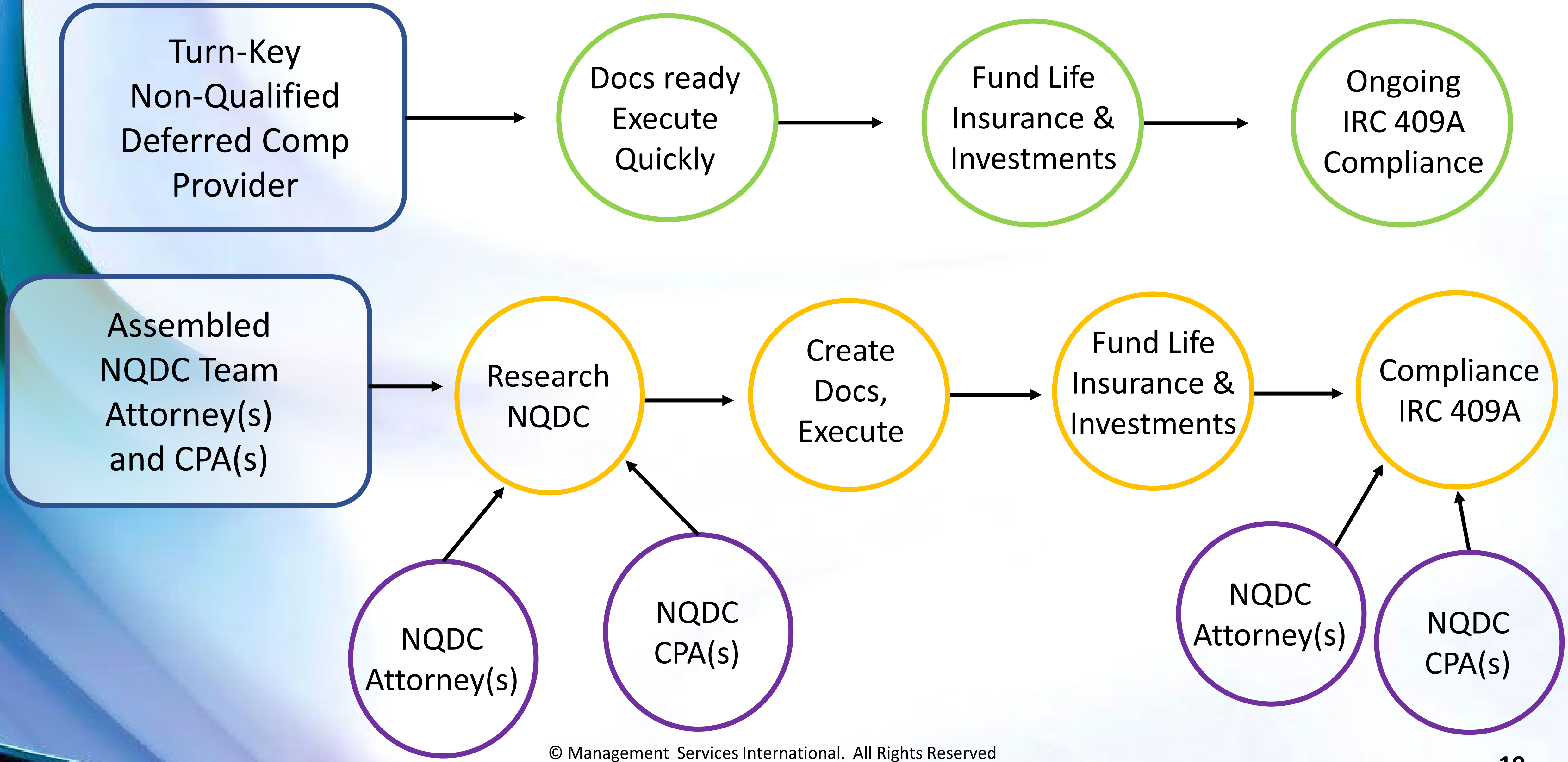
Jones Accounting

- Salary $200K
- Health, Life, D.I.
- 401K with match

Capital Accounting

- Salary $187K
- Health, Life, D.I.
- 401K with match
- **Capital contributes 40K/year 5-year vesting for Richard**

Non-Qualified Process



Non-Qualified Decisions

Turn-Key
Non-Qualified
Deferred Comp
Provider

Create
NQDC team
Attorney(s)
& CPA(s)

Eligibility

Business
Owner(s)
& Key
Employee(s)

Deferrals

$$ Deferred
&
Source(s)

Deferred by

Business Owner
Employee
or
Owner & Employee

Vesting

Business
Owner(s)
Decision

Sources of Non-Qualified Money

- Employer
- Employee
- Employer & Employee

Capital Accounting, LLC

- CPA firm founded 1998
- 2 partners
- Partners work part-time

- 9 CPAs
- 19 Employees

Capital Accounting, LLC Retain Sarah

- Sarah Wu, CPA 10 years at Capital, clients followed from prior company
- Sarah's clients generate ***20% of Capital's Revenue***
- Capital Accounting is concerned:
  - Sarah's clients will follow her if she opens her own business
    - Replacing 20% revenue could take years
      - Solution: NQDC for Sarah
        - Capital contributes $50,000 per year in Sarah's NQDC
        - Capital chooses a 9-year vesting schedule

Retain & Reward

Capital Accounting

- Pat Jones CPA worked for Capital for 10 years
  - Pat plans to buy 40% of Capital Accounting, LLC when Senior Partner retires
- Capital defers 50K/year for Pat, 6-year vesting
  - Pat defers 60K/year of his income into NQDC, 6-year vesting

Recruit (future owner), Retain and Reward

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IRS defines deferred compensation

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- A Non-Qualified Deferred Compensation plan is *any plan*, including "any agreement or arrangement that provides for the deferral of compensation *other than* a qualified employer plan and any bona fide vacation leave, sick leave, compensatory time, disability pay, or death benefit plan."

- IRC **§409A(d)**

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Requirements

For an NQDC to defer recognition of income it must satisfy three requirements:

1. IRC Sec 83
2. Constructive Receipt Doctrine and
3. The Economic Benefit Doctrine

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How do you comply?

- IRC Sec. 83 and the economic benefit doctrine will not require recognition if:
- Plan must be unfunded
- Must have an unsecured promise to pay funds in the future and
- Beneficiary must be prohibited from assigning his or her benefit
- See, Treas. Reg. Sec. 1.83-3 and Minor v. U.S., 772 F. 2d 1472 (9th Cir. 1985) discussing the economic benefit doctrine

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NQDC Distribution per IRC 409A

- Death
- Disability
- Separation from service (as defined by the plan)
- Financial Emergency
- A specified time or according to a fixed schedule
- A change in the ownership or effective control of the corporation, or a change in the ownership of a substantial portion of the assets of the corporation (defined by the plan) [(see Treasury Regulation 1.409A-3).]

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NQDC Evolution & § 409A

- Enron & WorldCom fiascos, and perceived abuses
- 2004 Congress tightened NQDC rules
- Severe penalties for non-compliance

- IRC § 409A & IRS regulations constrain timing of elective deferrals, assets held, & when amounts must be paid
- Deferral election made prior to start of Tax Year

NQDC Evolution 2

- Payout death, disability, separation service, change in control, unforeseeable emergency, or other payment date
- § 409A addresses plan funding until paid
- Amounts represent unsecured promise of employer to pay
- Deferrals subject to the claims of the employer's creditors.

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NQDC Evolution 3

- Fixing Section 409A: Legislative and Administrative Options, 57 VILL. L. REV. 635, 638 (2012) (to avoid application of the constructive receipt doctrine deferral elections must occur before the related services are performed and must be irrevocable; to avoid application of the economic benefit doctrine, the participant must remain in the position of a general unsecured creditor). Treas. Reg. § 1.83-3(e) (2014) (excluding such promises from the definition of property, the transfer of which would be immediately taxable under I.R.C. § 83).

- This is one of several requirements that must be satisfied to achieve an advance ruling from the IRS that a nonqualified deferred compensation arrangement will not run afoul of the constructive receipt doctrine. Rev. Proc. 92-65, 1992-2 C.B. 428.

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NQDC Evolution 4

- An exception for newly hired employees.

  I.R.C. § 409A(a)(4)(B)(ii). Requirement unchanged from prior law.

  Rev. Proc. 92-65, 1992-2 C.B. 428. 39 I.R.C. § 409A(a)(2)(A).

- Distribution rules ensure that deferrals are essentially irrevocable

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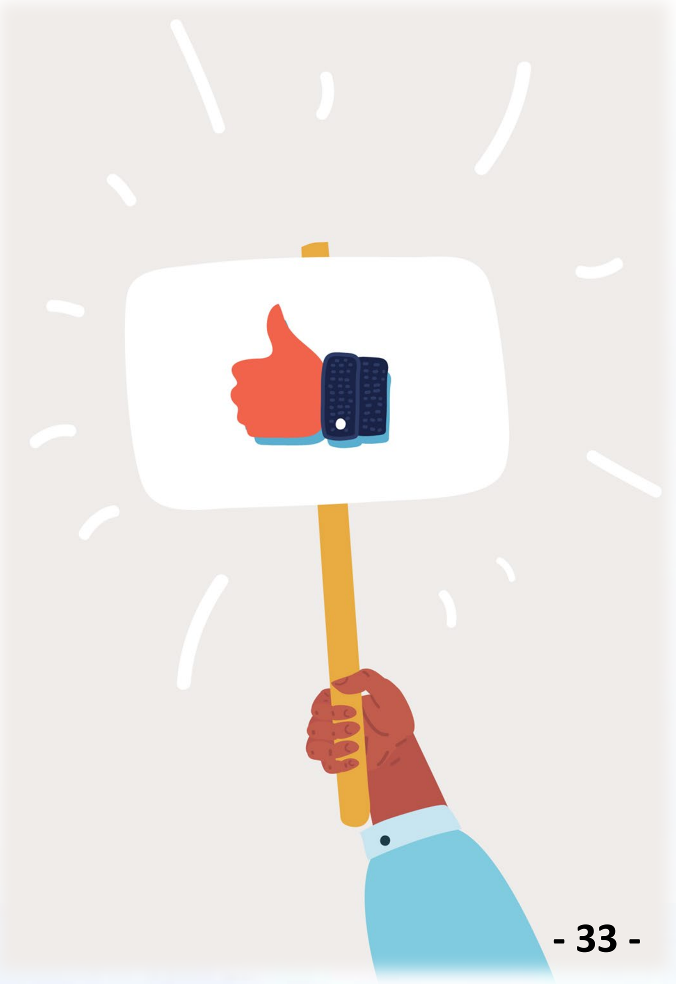
Constructive Receipt Doctrine

- IRS in Publication 538 describes constructive receipt as “**an amount [that] is credited to your account or made available to you without restriction.**”



Law Supporting NQDC, tax perspective

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- Goal of non-qualified deferred compensation arrangement is to defer taxation of the participant (and the employer's tax deduction) for deferred payments until the payments are received. In the interim, the employer will pay tax at its regular rate on any income arising from its use of the deferred funds, and the employee will be taxed on any compensation that is not deferred.

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Law Supporting NQDC, tax perspective

- Several doctrines, including ***constructive receipt*** and the ***economic benefit rule***, might be invoked to require employees to include amount deferred in tax in the year of deferral, or at some point between deferral and payout, if access to deferred amounts is not sufficiently limited or if the arrangement otherwise fails to comply with IRC § 409A an additional penalty tax of 20% and interest may also be imposed to the employee in case of a noncompliant arrangement.

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Law supporting NQDC 2

- A participant in a Non-Qualified Deferred Compensation Plan will have rights no greater than others “general unsecured creditors” of the employer. This is essential to ensure a valid deferral of taxation, but many other rules must be followed in design and administration of the NQDC plan.

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Can you Use an Annuity?

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- Why a Life Insurance policy as a funding vehicle?
- Why not use an annuity?
- Owner of NQDC funds is a Grantor Trust.
- Does this make a difference?

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What is a Rabbi Trust?

- A rabbi trust is a trust created to support the non-qualified benefit obligations of employers to their employees.

- A rabbi and his congregation first used this type of trust after an Internal Revenue Service (IRS) private letter ruling approved its use; it has been referred to as a rabbi trust ever since.

- In essence, a Rabbi Trust is a non-qualified employee trust created for the benefit of both the employer and employee.

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Let's Compare…

401k	409A

▪ Strict limits on \$ deferred amounts
  ▪ \$20,500 in 2022
  ▪ Over 50, \$6,500 catch up
▪ Employees treated the same, ERISA
▪ Penalties for early withdrawals (prior to age 59 ½)
▪ Protected from claims of company's creditors (and participants creditors while amount remains in plan)
	▪ No limits on \$ deferred
	▪ No age restrictions
	▪ Employer selects participants
	▪ Retain, Recruit, Reward
	▪ Participants are unsecured creditors of company during deferral period

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Who qualifies for Non-Qualified Deferred Comp?

- Business Owner(s) if properly structured
- Key Employee(s), high income and high-caliber talent
- Owner can create different plans & vesting by participant.
- NQDC can be in addition to Qualified Plans. Very small businesses might choose NQDC instead of a Qualified Plan

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NQDC Key Takeaway Points

- Small, mid-sized and large businesses are <u>all eligible for NQDC</u>
- NQDC allows business owners and key employees to defer more compensation, and defer taxes until the deferral is paid

- **No contribution limits**
- **No age restrictions**
- NQDC plans offer great flexibility in distribution scheduling

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