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Executive Benefits for ESOP-Owned S Corporations Post-IRC Secs. 409A and 409(p)

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Abstract: *For S corporations owned in whole or in part by an ESOP, the passage of IRC Secs. 409A and409(p) created issues that must be considered when planning for nonqualified executive benefits. ESOP-owned S corporations must comply with IRC Sec. 409(p), whose classification of most traditional nonqualified plans as "synthetic equity" can cause pre-IRC Sec. 409(p) plans to violate the provision. For this reason, ESOP-owned S corporations may be discontinuing or avoiding deferred-compensation plans. An executive bonus plan can be an effective alternative for companies to provide executive benefits for the selling shareholder, family members, and key executives*.

History of ESOPs in S Corporations

In 1996, Congress passed the Small Business Job Protection Act,[1] which allowed a trust associated with an employee benefit plan to hold shares of S corporation stock. However, it was only when the Taxpayer Relief Act of 1997 removed provisions discouraging ESOPs that these plans became viable for S corporations.[2]

As with other legislation, loopholes existed and some practitioners found creative ways to leverage the new law, sometimes contrary to the law's intent. One such loophole allowed a 100% ESOP-owned S corporation to eliminate all federal corporate taxes and, in most cases, state corporate taxes, and direct a substantial portion of these savings into large benefit packages for the welfare of a select few.[3] IRC Sec. 409(p) is an antiabuse provision introduced by the Economic Growth and Tax Relief Reconciliation Act of 2001 to close this loophole that allowed disproportionate benefits to a select few and eliminate perceived abuse of the law.[4]

The 2001 legislation imposed stringent testing to determine who benefits from the ESOP at certain levels. The law includes an expanded definition of "family." It also defines equity to include most traditional executive benefit plans. These restrictions can give rise to a conflict between a company's desire to be an ESOP-owned S corporation and its interest in employing common executive benefit techniques. Based on comments from the Treasury Department and those close to the legislative efforts, no legislative relief is currently being considered. For some companies, this may pose a threat to the long-term viability of maintaining both an ESOP-owned S corporation and valuable executive benefits.

IRC Sec. 409A and Nonqualified Plans

The American Jobs Creation Act[5] contained many provisions regarding taxes, estate planning, and nonqualified plans. To some, the Act was welcome news that finally provided long-awaited guidance on the design of acceptable nonqualified plan provisions. It also provided a 12-month window, which expired December 31, 2005, in which to bring existing plans into compliance. The major items addressed in IRC Sec. 409A and the legislation creating it fall into four categories: deferral elections, distributions, financing, and withholding/reporting.

Deferral Elections

Generally, deferral elections must be made prior to the beginning of the plan year, with two exceptions: 1) in the first plan year, participants may make elections during the plan year, within 30 days of their eligibility,[6]and 2) elections to defer performance-related compensation that is measured for a period of at least 12 months may be made no later than six months prior to the end of the period.[7]

Distributions

Generally, distributions are to be made as originally elected. Any subsequent change to a distribution election requires that the election take effect at least 12 months after the change. In addition, if the change of election relates to separation from service or change of control, the payment date must be deferred for a period of at least five years from the original date. There is an "any occupation" standard in the definition of disability.[8]

Financing

Informal financing by a corporation to prepare for the contractual promise to pay, either with or without a rabbi trust, is acceptable. However, offshore rabbi trusts are no longer an option; plans with offshore trusts will be considered funded and, therefore, immediately taxable. Additionally, financial triggers and early withdrawal "haircut" provisions have been either limited or eliminated.[9]

Withholding/Reporting

The Act provides that deferrals must be reported on W-2 forms at the time they are deferred, even though the deferred amount is not yet taxable.[10]

IRC Sec. 409(p) and ESOPs

Once an S corporation with an ESOP has met Sec. 409A provisions, it must address the Sec. 409(p) antiabuse and related provisions. The purpose of Sec. 409(p) is to deal with inappropriate tax deferral and/or avoidance and to limit ESOP tax benefits solely to those companies that provide meaningful benefits to rank-and-file employees.[11] In other words, the ESOP or its results cannot provide a disproportionate benefit to a select few, as defined by the legislation itself. The law prohibits any ESOP assets, or deemed assets, to be allocated to a "disqualified person" during a "nonallocation year."[12]

A disqualified person is defined as a person who owns 10% or more of all deemed-owned shares or is a member of a family collectively owning 20% or more of all deemed-owned shares.[13] For purposes of Sec. 409(p), "family" includes an individual's spouse, ancestors or lineal descendents of the individual or the spouse, siblings of the individual or the spouse, lineal descendents of these siblings, and the spouse of any person described in this sentence.[14]

Deemed-ownership calculations include allocated and unallocated ESOP shares and "synthetic equity" but not direct stock ownership.[15] Synthetic equity has been broadly defined to include common corporate benefit and retention arrangements such as split-dollar plans, stock options, stock appreciation rights, restricted stock, warrants, and nonqualified deferred compensation plans.[16]

A "nonallocation year" is a year in which all disqualified persons, in the aggregate, own at least 50% of deemed-owned stock and direct stock ownership in the S corporation.[17] No ESOP assets attributable to or relating to company stock may be allocated under any qualified plan, including the ESOP, for the benefit of any disqualified person during a nonallocation year.[18] If any disqualified person receives any ESOP assets attributable to company stock or any benefit also considered under the expanded definition, it would be a "prohibited allocation," and the company would be considered in violation of Sec. 409(p).[19] Additionally, shares of company stock, proceeds from the sale of such shares, and earnings on such shares that are held in the ESOP account of any disqualified person at any time during a nonallocation year are considered to be a prohibited allocation. Shares need not be added to an account during a nonallocation year in order to trigger a prohibited allocation.

Penalties for Violating Sec. 409(p)

The consequences for violating Sec. 409(p) are quite severe. Proper, proactive testing for this statute should be taken very seriously, as the ramifications of failure could be financially devastating, and the test must be passed every day of the plan year. The consequences of violation of Sec. 409(p) are as follows:[20]

- The plan would no longer be deemed an ESOP, would lose the prohibited transaction exemption related to the ESOP, and would be subject to the unrelated business income tax (UBIT).
- In a nonallocation year, the company would be subject to a 50% excise tax on the fair market value of any prohibited allocation, which includes ESOP shares already in disqualified persons' accounts at the beginning of the plan year.
- The company would also be subject to a 50% excise tax on the fair market value of synthetic equity held by disqualified persons in the nonallocation year.
- Each disqualified person would be taxed on the value of their ESOP account as if they had received a distribution of that account and, if the disqualified person is younger than age 59½, they generally would be subject to a 10% penalty tax.

Traditional Executive Benefits/Nonqualified Plans

Nonqualified plans may include executives' elective pretax income deferrals and/or corporate dollars. Depending upon the plan design, contributions may be made when the executive reaches predetermined goals and payable when the executive reaches retirement age or other benchmarks. By definition, nonqualified executive benefit plans are limited to a "select group of management or highly compensated executives" and are exempt from the vesting, reporting, and discrimination testing rules of ERISA.[21]

In addition, a nonqualified executive benefit plan can be tailored to each executive based on both the employer's and executive's needs. For example, the corporation may offer to set aside an additional 10% of Executive A's salary each year in which Executive A meets her sales objectives, until retirement. If Executive A remains with the company until retirement, she receives the cumulative benefit plus growth, if any. If Executive A leaves prior to retirement, the corporation retains the assets for other corporate uses. The potential forfeiture of accumulated benefits creates an effective incentive for Executive A to stay at the corporation (i.e. golden handcuffs). These plans are valuable recruiting and retention tools. In fact, the Clark Consulting survey of FORTUNE 1000® companies, "Executive Benefits—A Survey of Current Trends—2005 Results," indicates that 91% of the respondents have a nonqualified deferred-compensation plan in place.

Executive Benefit Planning Problems Facing ESOP S Corporations[22]

Post-Sec. 409(p), many ESOP S corporations face a major dilemma. Traditional executive benefits such as non-qualified deferred-compensation plans, stock options, split-dollar arrangements, and stock appreciation rights are now included in Sec. 409(p) testing under the broad definition of synthetic equity. However, these types of executive benefit programs are vital to recruiting and retaining the key managers who are necessary for the long-term viability of the corporation. The passage of Sec. 409(p) may have a huge impact on companies that have plans in place for the benefit of the selling shareholder, spouse, or any family members. Many of these plans may have been implemented to compensate for the prohibition of family members' ESOP participation due to the IRC Sec. 1042 election of a previous selling shareholder. In many instances, even in reasonable business arrangements, selling shareholders, family, and key management are prohibited from or significantly limited in receiving equity interests both inside and outside the ESOP. Many selling shareholders (potentially now considered disqualified persons) may have significant nonqualified deferred compensation arrangements that may be in jeopardy. Synthetic equity must be considered, not only for the executive and his or her family, but also in the overall calculations of whether the company is in compliance with the law.

Under Sec. 409(p) many S corporations will no longer be able to maintain both the ESOP and non-qualified executive benefit plans. This may create a significant shortfall in promised benefits to the selling shareholder, family members, and key executives. It is also a competitive recruiting and retention disadvantage for the ESOP S corporations that can no longer offer the benefit plans top executives expect. ESOP S corporations may have to seek alternative methods to recruit, retain, and reward key executives. Increased cash may be an option but has little golden handcuff retention value.

Solution

The executive bonus plan may be an alternative that meets the executive benefit objectives of a corporation yet remains out of the reach of both Secs. 409A and 409(p). An executive bonus plan utilizing life insurance is a plan based primarily on IRC Sec. 162 (it is often referred to as a "162 Bonus Plan"). This arrangement is not a new concept, but since the passage of recent legislation, it has become a more widely used executive benefit program for S corporations that sponsor ESOPs.

The mechanics of an executive bonus plan are simple. The corporation purchases and pays for a life insurance contract covering the life of the selected executive. The insured executive owns the policy cash value and death benefit. The policy premium is treated as a bonus to the executive. Sec. 162, further supported by Reg. 1.162-9 and Revenue Ruling 58-90, allows the corporation to deduct premium payments if three conditions are met:

1. The premium is included as compensation to the executive (the executive must claim the premium payments as income).

2. The total amount of compensation is considered "reasonable."

3. The corporation is not the owner or beneficiary of the policy.

Corporations could use any type of permanent life insurance contract that accumulates cash value for an executive bonus plan. Two popular types are flexible premium universal life and flexible premium variable universal life. These types of contracts allow the premium amount to vary and the payer may even skip a premium. However, the policyowner is responsible for maintaining enough cash value to cover the cost of monthly insurance charges and policy expenses. Premiums in excess of expenses accumulate in the policy's cash value account at a rate determined by either the carrier's general account portfolio or the separate accounts selected by the executive. Most quality flexible premium variable universal life policies offer a diverse mix of funding choices managed by well-known investment managers. To provide the maximum tax-advantaged retirement income stream possible planners can design the policy to efficiently minimize the amount of death benefit coverage and maximize cash value growth (within tax law limitations).

Specialty Executive Benefits Products

Several insurance carriers offer specialty flexible premium universal life and flexible premium variable universal life products designed for the institutional market and generally used for the informal financing of deferred compensation plans. Several carriers allow these specialty products to be used for executive bonus plans. These specialty executive benefit products are generally designed to take full advantage of tax benefits offered through life insurance and usually feature

- high early cash surrender values that are often 100% or more of the actual premium paid in the first year
- no surrender charges; the owner can surrender policies for the full cash value
- insurance charges that may be calculated based on a mortality pool of executives and unisex rates
- low or no interest charges on tax-deferred cash values borrowed from the policies

Roth IRA Tax Similarities

In general, the tax treatment of an executive bonus plan utilizing life insurance can be compared to the tax treatment of a Roth IRA. The executive's contributions to the account (the premium) are taxable (per IRC Sec. 61) in each year that the corporation pays and deducts the premium (per IRC Sec. 162). Often the corporation will "gross up" the executive's bonus amount to cover the tax due on the premium. The unique tax treatment of life insurance can enable its cash value to grow income tax free and makes it possible to design executive bonus plans so that the distributions are not taxed to the executive and provide income tax-free death benefits to the executive's heirs (per IRC Sec. 101(a)(1)). Additionally, the executive bonus plan may provide income at the owner's discretion without the early withdrawal penalties of qualified retirement plans and nonqualified annuities or minimum distribution requirements of qualified retirement plans other than Roth IRAs. The executive bonus plan is especially appropriate since the executives who often participate in the plan generally do not personally qualify for a Roth IRA.

Creditor Protection

The executive bonus plan can offer effective asset protection if properly arranged. Generally, corporate assets, including corporate-owned life insurance cash values, are subject to the claims of corporate creditors. However, life insurance policies owned by an individual, like interests in employer-sponsored qualified retirement plans, generally are not subject to the claims of corporate creditors. Additionally, many states afford some personal creditor protection to life insurance cash values and death benefits. Practitioners should consult legal counsel as to their own state's laws regarding bankruptcy and personal civil judgment provisions.

Case Study

Paul and Sally Widget, both age 53, are owners of Widget Company, an S corporation in Texas. Paul's and Sally's accounts in the Widget Company ESOP each hold 9% of the stock in the ESOP. The Widgets' participation in a traditional nonqualified plan (which is not a 162 executive bonus plan) pushes their deemed-owned percentage to 9.9%. Paul and Sally also each own 25% of the total outstanding stock of Widget Company, with the ESOP holding the remaining 50%.

Any ESOP shares allocated to the Widgets would cause them and the company to be subject to adverse tax consequences due to the violation of Sec. 409(p). Additional contributions to the nonqualified plan for the benefit of Paul and/or Sally would also render the Widgets and the company subject to penalties. An examination of the Widgets' situation will explain the impact of Sec. 409(p) on them and their company.

First, since the Widgets are each on the edge of owning 10% of all deemed-owned shares (which considers ESOP shares and synthetic equity due to the nonqualified plan) of an S corporation, the Widgets will be designated disqualified persons under Sec. 409(p) if they receive more ESOP shares or more under the nonqualified plan. Second, when their outright stock ownership is combined, the Widgets own 50% of all deemed-owned company stock. Therefore, any allocation of ESOP shares or contributions to the nonqualified plan (synthetic equity) for Paul and Sally would cause the company to violate the antiabuse provisions of Sec. 409(p) and subject them to the penalties outlined above.

To avoid violating Sec. 409(p), the Widgets decided to implement an executive bonus plan for themselves using a specialty executive benefit life insurance product. The amount of each executive bonus equals the sum of 1(the value of what each executive would have been granted in ESOP shares, 2(an amount equal to the amount that would have been contributed to the non-qualified plan on each individual's behalf, and 3(any desired additional contributions.

Paul's and Sally's contributions equaled $60,000 each, which purchased a minimum, non-MEC death benefit of $908,520 each. Assuming annual contributions continue until age 65, with the Widgets managing the investment options to achieve a tax-deferred 8% gross rate of return each year, each policy's cash value at age 65 is projected to equal $945,889[23] and would support a tax-free income stream of $78,668 per year for 20 years. Since the Widgets personally own the insurance, the cash value and death benefit are protected from corporate creditors. Because the state of Texas offers additional protection, the cash value and death benefit are also protected from Paul's personal creditors. Paul views the executive bonus plan as a Roth IRA look-alike strategy to the extent that the taxation is similar.

Summary

Due to the new stringent Secs. 409(p) and 409A provisions, S corporations with ESOPs could lose key executives to competitors that do not have ESOPs, and Sec. 409(p) also significantly limits family members' access to family-created wealth.

The executive bonus plan is an alternative that can meet many, if not all, of the S corporation's objectives and remain outside the scope of both Secs. 409A and 409(p).

The executive bonus plan provides significant tax advantages afforded only to life insurance. This Roth IRA look-alike provides an after-tax vehicle that potentially grows tax free, provides retirement income tax free, and ultimately pays a tax-free death benefit to heirs. The executive bonus plan is not subject to corporate creditors and, in many states, not subject to personal creditors.

In summary, the executive bonus plan can be an ideal solution for S corporations, either partially or wholly owned by an ESOP, that wish to recruit, reward, and retain family members and key executives *and*maintain the long-term viability of the ESOP.

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(1) H.R. 3448, Small Business Job Protection Act of 1996.

(2) Sec. 918 of House, 1309 of Senate, Public Law 105-34, August 5, 1997.

(3) Rev. Ruling 2003-6.

(4) Rev. Ruling 2004-4.

(5) P.L. 108-357 (H.R. 4520), American Jobs Creation Act.

(6) IRC §409A(a)(4)(ii).

(7) IRC §409A(a)(4)(iii).

(8) IRC §409A(a)(2)(A)(ii) and §409A(a)(2)(C).

(9) IRC §409A(a)(2).

(10) IRC §6051(a)(B).

(11) Rev. Ruling 2004-4.

(12) IRC §409(p)(1).

(13) IRC §409(p)(4)(A).

(14) IRC §409(p)(4)(P).

(15) IRC §409(p)(4)(C).

(16) IRC §409(p)(6)(C).

(17) IRC §409(p)(B)(A)(ii).

(18) IRC §409(p)(1).

(19) IRC §409(p)(2).

(20) IRC §4979A, IRC §72(t).

(21) 29 U.S.C. §§1051, 1061, 1081, and 1101.

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