

Ten tax-smart ways to compensate key employees

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I'm sure you're well aware of the importance of retaining and rewarding key people in your firm. Market salaries and profit-sharing bonuses are a great start, but as tax rates creep higher, there are other tax

efficient ways to reward your executives.

Qualified plans. Qualified plans allow participants tax-favored compensation. These plans normally benefit all employees without discrimination, and are subject to detailed rules and regulations.

Examples include:

Pension and profit-sharing plans. Contributions are tax deductible for the employer. As an added bonus, except in the case of employee elective salary deferrals, contributions are not subject to payroll taxes. Employees are not taxed on contributions made on their behalf until they start receiving benefits. The contributions, as well as the related subsequent earnings, are not subject to current taxation. Employees are taxed when they receive distributions from the plan. Some plans allow employees to contribute a portion of their salaries, and avoid taxes on that deferral.

Stock ownership plans (ESOP). Owners can sell their stock at its appraised value to

an ESOP and, when properly structured, the gain is tax-free. The ESOP purchases the stock by using tax-deductible contributions and tax-deductible dividends paid to the plan by your business. Although complicated, the tax benefits and investment diversification can make an ESOP worthwhile.

Non-qualified plans. Non-qualified plans are less restrictive than qualified plans in terms of contributions and in determining employee participation. However, they offer less favorable tax aspects.

Examples include:

Deferred compensation plans. Employees accumulate future benefits based on pre-established criteria such as a percentage of salary or corporate profits. These types of plans encourage key employees to remain loyal to your company. The tax advantages generally depend upon whether the plan is funded or unfunded. If the plan is funded, the employer sets aside designated amounts to pay for the accrued liability and the employee is taxed on the compensation when it is earned. If the plan is not funded, the employee is not taxed until the payments are received or the plan is funded. There is a risk that businesses may not have money available to pay their deferred benefits when they become due.

Stock plans. These plans allow employees to own minority interests in your company. A participant can acquire company stock at some future date at a predetermined price. Options generally work better with publicly owned companies than privately owned companies, unless the sale of a privately owned company is a realistic

possibility.

Phantom stock plans. Your employees accumulate non-equity units that mirror the value of your company's stock. If a liquidity event occurs, the unit holders are compensated based upon the relative number of units held. Employees are taxed on the additional compensation when paid in cash or other marketable property.

Stock appreciation right plans (SAR). These are similar to phantom stock plans except that the potential benefit is tied solely to the appreciation of your company's value over a period of time. When businesses place a ceiling on the potential appreciation, taxable income may result when the ceiling is reached. SAR plans work best with publicly traded companies and privately held companies that have easily ascertainable values.

Restricted stock plans. If your company has strong growth potential but limited cash for salaries, you can motivate key employees by issuing restricted stock. In the future, when your employees dispose of their restricted stock, the gain will be taxed at lower capital gain rates.

Fringe benefit plans. These are very popular with employees but in some cases may result in taxable income.

Examples include:

Employer-provided vehicles. Vehicles must be used for ordinary and necessary business purposes. Business use must be contemporaneously documented, and the employee will be taxed on personal use.

Insurance benefits. Up to \$50,000 of group term insurance can be provided if it is done on a non-discriminatory basis and

meets other specific criteria. Higher amounts of coverage can be provided with less tax advantages. Employer payments made for disability insurance payments are not taxable to the employee as compensation. However, the proceeds are taxable to the employee upon receipt. It may make sense for the employee to pay for the coverage with after-tax dollars and keep the proceeds exempt from taxation.

Travel and expense allowances. These are taxable to an employee unless the employee is required to account for their expenses and return to the company any amounts that are not properly documented.

As you can see, there are a variety of compensation options to consider. The key to understanding and using them effectively is to choose qualified financial, tax and legal experts who can guide you through each option with a good understanding of your needs.

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