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ADVANCED MARKETS INSIGHT

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M Financial Group continues to lead the industry in insurance due care and client advocacy, providing valuable insight and analysis that delivers significant value to clients.

Nonqualified Deferred Compensation: Demystifying the Phantom Stock Plan

Overview of Nonqualified Deferred Compensation Plans

Nonqualified plans can provide tax deferral for the employee, while helping to meet employer and employee compensation objectives.

A deferred compensation plan that is "nonqualified" largely falls outside the provisions and purview of the Employee Retirement Income Security Act (ERISA) but is subject to all Internal Revenue Code Section 409A (IRC Section 409A) rules and regulations. Nonqualified plans do not receive some of the tax benefits and creditor-protection rights associated with ERISA-conforming "qualified" plans.

Key differences between a qualified and a nonqualified plan are:

- Nonqualified plans do not generate an income tax deduction for the employer during the employee's working years. Instead, the employer must wait until the year in which the deferred compensation is distributed to its employee to take the deduction.
- The employer is free to choose which employees will be participants in a nonqualified plan without violating anti-discrimination requirements, as long as the plan is limited to management and highly compensated employees.

What is a Phantom Stock Plan?

Phantom stock is a popular and effective compensation program used to tie pay to performance. Typically structured as a nonqualified deferred compensation (NQDC) plan, phantom stock is used by employers to share value with selected key employees without relinquishing business control and decision-making powers associated with ownership or diluting current shareholder interests.

To promote key employee performance and activity, the business grants the participant phantom stock units, which fluctuate in value based on the growth of the business. Participants can be awarded periodic grants of units as part of their regular compensation program. Units may then be "cashed out," resulting in cash payments under certain event—such as retirement, change-in-control, death, disability—or even while still employed. As a result, the employee has the ability to share in the success of the company without capital investment or shareholder liability.

Any type of business form, including sole proprietorships, partnerships, limited liability companies, subchapter S corporations, and subchapter C corporations can set up and implement a phantom stock plan. Care must be taken with a subchapter S corporation to ensure a second class of stock is not being created. If created, the corporation can lose its S status and significant tax consequences may result.

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How Does a Phantom Stock Plan Work?

To implement a phantom stock plan, the employer selects a group of key employees who will be participants in the plan. Once selected, the business and participants enter into a written agreement, giving each participant a number of phantom stock "units" to be tracked. Units may be rewarded in one of two forms:

1. Full value units, which are similar to "restricted stock" awards (i.e., they retain the full starting value of the shares plus any change in value).

2. Appreciation units, which are similar to "stock options" (i.e., unit value is equal to the appreciation above the starting value only).

Unit values may be based on the actual value of company shares or they may be based on a formula value established by the plan sponsor. When payout dates or events occur, the value of the appropriate units is paid to the participant and is taxable as ordinary income. The employer may also obtain a tax deduction for benefits paid.[1]

Informally Funding the Phantom Stock Plan

Establishing a Phantom Stock plan creates a future liability for the employer. While the employer may plan to pay this obligation out of cash flow, it may instead opt to create a reserve using financial assets as a way of informally funding the plan liability.[2] They may use any type of investment or cash account to do so. Corporate owned life insurance (COLI) with cash value build-up is often selected as the informal financial vehicle used for matching plan liabilities. Life insurance can offer a number of advantages to the employer.

Cash value build-up in life insurance:

- Accumulates tax-deferred
- Can be considered a corporate asset, offsetting the benefit plan liability
- May be accessed to meet the deferred compensation liability by way of tax-free policy loans and withdrawals[3]
- Is available for employer use at all times

Death benefit proceeds of the life insurance can be used to:

- Provide a survivorship benefit to an employee's heir(s) should the employee die prior to receiving all of his/her deferred compensation
- Reimburse the employer for premiums paid
- Provide money to fund plan benefits for other executives

As the name implies, COLI is purchased and owned by the employer and insures the lives of its key employees. Each employee must consent to the purchase of the insurance policy.[4]

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1 IRC Sections 162 and 83

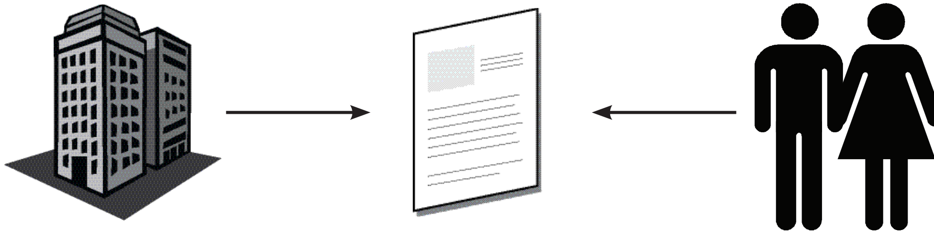
2 For ERISA purposes, a plan that is informally funded is not subject to ERISA's vesting and funding requirements.

3 Subject to the rules and regulations of IRC Section 7702; policy withdrawals, loans, and loan interest will reduce policy values. This assumes the policy qualifies as life insurance and does not lapse.

4 IRC Section 101(j)

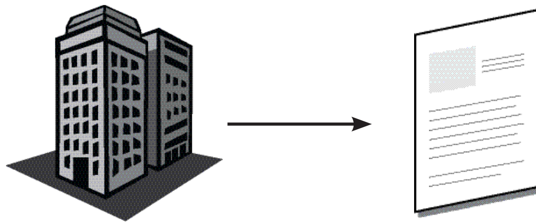
Phantom Stock Plan Informally Funded with Corporate Owned Life Insurance (COLI)

1. The employer and key employee enter into an agreement in which the employer agrees to pay future benefits based on phantom stock units.



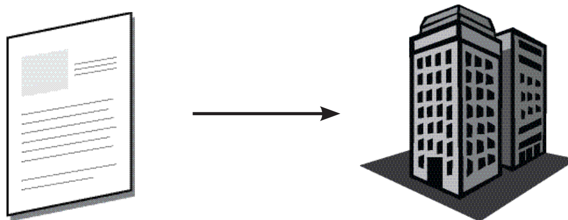
2. The employer establishes a bookkeeping account to track benefits as they accrue.

3. The employer obtains and informally funds a life insurance policy (COLI)—as owner and beneficiary—on the life of the key employee, with the employee's consent.



4. When the benefit payout is due, the employer withdraws or borrows insurance policy values to fund the income payments due to the employee. The employee pays income taxes due on benefits paid and the employer may deduct the payments.

5. At death, the employer will receive full or partial cost recovery via the death benefit of the policy on the employee.



For More Information

To learn more, please contact:

Greenberg, Wexler & Eig, LLC
7316 Wisconsin Avenue
Suite 230
Bethesda, MD 20814
301.656.0660
www.gwellc.com

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