BUTTERFIELD SCHECHTER LLP

ATTORNEYS & COUNSELORS

COUNSELING THE SMALL BUSINESS CLIENT IN CALIFORNIA

2017

I. OVERVIEW

Small businesses' considerations in Employee Benefits are varied, including factors not prevalent in large businesses. Factors include:

1. Tax benefits in general (for all employees)
2. Tax shelter and benefits for owners (to the exclusion, in many instances, of non-owners)
3. Hiring and retention factors (benefits may attract and retain better employees)
4. Insurance factors (health and death benefit protection)
5. Creditor Protection Issues

Factor number 2 is less prevalent in "Big" businesses.

II. "Big" Plan vs. "Small" Plan Mentality

Counseling small businesses requires identifying the motivation of the owner(s). Benefits goals range from:

A. "I want to be generous to employees."

B. "I want to match my competitor(s)' benefit plans but otherwise have no desire to benefit employees."

C. I want to pay the employees fringe benefits of "X" amount and pay, if possible, "Y" (a much larger amount) to "myself."

D. I want to give nothing, if possible to employees and keep all fringe benefits for myself.

Threshold of "Big" Plan mentality vs. "Small" Plan mentality varies but here is a chart we often use as guidepost:

Percentage of Benefits Going Irrevocably to Non-Owners

|---Small---|--Mid--|----------Big Plan----------|

0% 5% 10% 20% 30% 40% 50% 60% 70% 80% 90% 100%

Comment: It is a myth that a deduction saves taxes equal to the tax savings and that it is a wash to give the amount equal to tax savings to employees. Example – Pension Plan contribution of $20,000 at 28% federal bracket and 6% net state bracket. Savings? $6,800. Assume $6,800 goes to employees. $13,200 goes to owner. Owner later withdraws $13,200. Tax on it is $4,488. The cost is assumed to be $11,288. Owner ends up with $8,712 out of $20,000.

III. Entity Planning With Respect to Benefit Choices

Choice of entity makes a difference (as touched on earlier in outline). See the chart below.

Interaction of Benefit Choices and Entity Choice

	Sole Proprietor	Partnership/ LLP/LLC	C Corporation	S Corporation
Qualified Plans	Yes. Contribution limits identical for all entity choices (see below). No ESOPs. IRS § 4975	Contributions based on self-employment income. Deduction for owner taken on individual return.	Participant Loans (within limits) allowed for owners.	Contributions based solely on wages – not S corp dividends.
SEPs and SIMPLE	Same for all			
Nonqualified Deferred Compensation (NQDC)	Not applicable for owners.	Normally not applicable (see NQDC discussion).	An option, esp. if 15% tax rate applies. Normally not useful for owners.	Normally not applicable for owners.
Split Dollar Insurance Plan	Not applicable.	Normally not a factor (but is an option).	An option, esp. if 15% tax rate applies.	Normally not applicable for owners, but is possible.
Group Health Insurance Plan	100% deduction for s.p.	100% deduction limit applies to self-employed.	100% deduction for owner benefits if not based solely on share ownership	100% deduction limit applies to 2% plus owners.
Medical Diagnostic Reimbursement Plan	Not applicable (available for employees).	Not applicable for partners (available for employees).	Available (see discussion).	Available for employees, but not 2% plus owners.
Medical Expense Reimbursement Plan	Not applicable (available for employees). Subject to ACA restrictions.	Not applicable for partners (available for employees). Subject to ACA restrictions.	Available but subject to ACA restrictions (see discussion).	Available but subject to restrictions for employees, but not 2% plus owners.
Cafeteria (Flexible Benefit Plan)	Not applicable (available for employees).	Not applicable for partners (except perhaps for stand-alone child care flex plans (see IRC § 129(e)(3)); available for employees.	Available but subject to ACA restrictions on medical expenses (see discussion).	Available but subject to ACA restrictions on medical expenses for employees, but 2% plus owners tax free benefit limited to what partners could get.
Dependent Care Assistance Plan	Available (subject to limits – see discussion).	Available (subject to limits).	Available (subject to limits).	Available (subject to limits).

III. Entity Planning With Respect to Benefit Choices

Group Term Life Insurance	Not applicable for owners.	Not applicable for owners.	Available.	Available for employees other than 2% plus owners.
Stock Options	Not applicable.	Not applicable.	Available. Subject to IRC § 409A.	Generally not available.
Wage Continuation (Disability Insurance)	Not applicable.	Not applicable.	Available (see discussion).	Available for employees other than 2% plus owners.
VEBAs	Generally not applicable for owners.	Generally not applicable for owners.	Available (subject to limits).	Available (subject to taxation on benefits [under rules applying to the underlying benefits] for 2% plus owners).
Phantom Stock Plan	Not applicable.	Not applicable. Subject to IRC § 409A.	Available. Subject to IRC § 409A.	Available. Subject to IRC § 409A.

Comment: Revenue Ruling 91-26 describes the tax treatment of accident and health insurance premiums paid by a partnership or S corporation on behalf of a partner or 2% shareholder-employee. The deduction of 100% is taken at the individual level.

IV. Review of Qualified Plan Choices

A chart showing basic types of Qualified Plans allowed under IRC § 401(a) follows:

Tax Qualified Savings Plans By Category

Qualified Plans		Individual Retirement Accounts
Defined Contribution • Profit Sharing Plans • 401(k) Plans • Money Purchase Plans • Target Benefit Plans • Age Weighted (or Rate Group) Profit Sharing or Money Purchase Pension Plans • Employee Stock Ownership Plans (ESOPs) • Stock Bonus Plans	**Defined Benefit** • Fixed benefit with numerous benefit formula options **vs.** • Cash Balance	• Simplified Employee Plans (SEP) • Individual Retirement Accounts • SIMPLE

Brief overview of features of each type:

1. Profit Sharing Plan
Discretionary contribution. 0-25% of salary deductions limit (subject to $265,000 annual salary cap). Requires periodic contributions for qualification unless contributions formally discontinued. PSP can allow "second-to-die" life insurance and allow premiums to exceed 50% of contributions (25% for universal or variable life) if contributions "season" over 2 years.

Comment: Limit of $53,000 per participant (or if less 100% of compensation) applies to a Defined Contribution Plan for 2017.

2. Money Purchase Pension Plan
Fixed contribution percentage (percentage of salary). (Not recommended except in niche situations.) Plan amendment needed for a change (at least 15 days prior to year end of Plan Year – more if no year end employment requirement). Can (as can a PSP) be integrated with Social Security to give slightly more to higher compensated. 0-25% of salary range permitted for formula (individual participants can exceed 25% of salary but overall deductions is 25% of participant compensation).

3. 401(k) Plan
PSP variation allowing employee deferral. If elected by Employer, matching contributions by Employer. $18,000 annual deferral limit (subject to COLA). Catch up contributions ($6,000) allowed for those 50 or older. 100% of compensation limit applies to limit deferrals. Average Deferral Percent/Average Contribution Percentage Tests under IRC § 401(a) limit how much Highly Compensated Employees (IRC § 414(q)) can contribute in relation to others. "Safe Harbors" can eliminate ADP/ACP testing if the Employer makes specified minimum contributions.

Comment: Allows individual employee flexibility. Need not to be employer funded except to extent needed for top heavy rules of IRC § 416 (if "key" employees contributed).

4. Target Benefit Plans
A Money Purchase/Defined Benefit hybrid. Not used much now due to availability of Age Weighted Options. 25% of salary deduction limit applies, but formula is based on anticipated level of benefits (as a percentage of compensation or compensation based formula) at retirement age. Age weighted plan.

Comment: Ideal if older owners, younger employees and owner is satisfied with mandated contributions and 25% of salary deduction limit.

5. Age Weighted Plans
A Profit Sharing plan or Money Purchase Plan can use age weighted formulas or rate group formulas under IRC § 401(a)(4) regulations. 25% deduction limit applies.

Age Weighted – Each participant's contribution varies based on compensation and age.

Rate Group – Employees are grouped in nondiscriminatory (per Regs) classifications. Employees in same group get same contribution percentage.

Comment: Ideal for older owners and (on average) younger employees. Rate group can help eliminate age based disparities within groups.

6. Employee Stock Ownership Plans (ESOP)
A Profit Sharing type of Plan in which over 50% of Plan assets are intended to be invested in employer stock. Special ESOP exemptions from IRC § 4975 "Prohibited Transaction" rules allow employer or owner loans to an ESOP, or guarantees of such loans. ESOPs are also normally exempt from asset diversification rules (to the extent of employer stock).

Comment: Suitable for C corporations (and now S corporations with broad ownership (caution – there are strict rules) in limited instances) desiring to give employees indirect ownership of stock, or help finance shareholder buyouts with pre-tax (at least for the time being) dollars, voting rights issues, depending on type of corporate governance issue.

Pros – Include pre-tax contributions of funds to acquire corporate stock, potential tax deferred stock exchanges under IRC § 1042 (for C corporations) and potential employee motivation.

Cons – Include valuation costs, heightened fiduciary liability for loss in value, loss of flexibility in deal negotiations due to fiduciary obligations to ESOP, eventual repurchase liability to reacquire shares, potential the "owner(s)" are financing their own buyout.

7. Defined Benefit
Different type of Plan family from Defined Contribution. Specifies a monthly benefit at retirement age

and an actuary, under IRC § 404 and § 412 determines the annual contribution minimum and maximum.

Pros – No 25% of salary deduction limit, if owners are old enough. Allows investment losses to be recovered through tax deductible contributions.

Cons – More costly to establish and administer. Minimum funding rules can mandate re-funding losses. Employee costs (e.g., top heavy minimums) can be more than other approaches. Pension Benefit Guaranty Corporation premium and coverage involvement in all but owner only (or small professional practice entities). Can become fully funded and then no contributions to the Defined Benefit may be possible. Investment growth above assumed rate reduces contributions. Not ideal for multiple owners "sharing" same plan.

Comment: Defined Benefit Plans normally work best as "tax shelter" devices in small businesses without multiple owners and with older owners (late 40's or older) and younger employees.

8. SIMPLE

Form 5304/5305-SIMPLE incorporates the SIMPLE/IRA plan. The SIMPLE/IRA offers an option many employers of under 100 employees will desire.

SIMPLE/IRA allows deferrals up to $12,500 per calendar year.

Pros - $10,000 deferral limit applies without regard to percentage of salary limit ($3,000 more if age 50+). Example - $12,500 salary - $12,500 deferral contribution okay (subject to need to withhold FICA/Medicare). No business fiduciary exposure after contribution. No IRS 5500 forms. No ADP/ACP top heavy testing (SIMPLE contributions are required).

Cons – Requires either a 3% match (can go to 1% in 2 of 5 years) or 2% across board contribution. 25% penalty if withdrawn within 2 years of first contribution. Less creditor protection than qualified plan. No loans to participant. Calendar year requirement means deductions are not properly matched to fiscal year taxpayers. No other qualified plans can accrue or be funded in a year a SIMPLE plan is used.

9. SEPS (IRC § 408)

IRA arrangement similar to Profit Sharing Plan. 25% deduction limit (20% for sole proprietor, self-employed). Can be integrated with Social Security with proper Adoption Agreement. Can be set up on a fiscal year with proper Adoption Agreement.

Pros – Contribution flexibility. Employee withdrawal flexibility (subject to tax penalties). No IRS 5500 forms. No fiduciary exposure after contribution. Can allow channeling "bonuses" through SEP (based on percentage of pay) to allow owner(s) to "piggyback" on SEP/bonus. 3-year eligibility (comparable to 2-year eligibility in qualified plan as to how it works).

Cons – See attached chart for IRA features vs. qualified plans. Cannot use "year end employment" feature (even if IRC § 410(b) coverage test met) or 1,000 hours per year minimum for eligibility. No exclusion of categories of employees even if 410(b) can be met.

10. Comments on Eligibility

Qualified Plans eligibility rules are contained in IRC § 410, as modified by IRC § 401(a)(26) (see later discussion about 401(a)(26)).

IV. Review of Qualified Plan Choices

Plan choices are:

A. One-year eligibility and a vesting schedule (as long as 7 years if the Plan is not "top heavy" under IRC § 416). Top heavy status reduces vesting maximums to 6 years (20% per year beginning with the second year). A Plan is top heavy if over 60% of benefits (under all aggregated plans) accrued for "key employees." Most smaller businesses face the top heavy issue. 401(k) Plans must use 1-year or less eligibility. A Cash Balance Plan can use a vesting schedule no longer than 3 years.

B. Two-year eligibility and 100% vesting (not available for 401(k)).

Comment: One-year eligibility with 6-year graduated vesting is comparable mathematically in "cost" from an employee perspective to 2-year/100% vesting. This is not intuitive but here is a comparison:

	Benefit 1-year/6-year vesting	Benefit 2-year/100%
YEAR 1	0	0
YEAR 2	1000/200	0
YEAR 3	2000/800	1000
YEAR 4	3000/1800	2000
YEAR 5	4000/3200	3000
YEAR 6	5000/5000	4000

C. A 1000 hour minimum per year can be imposed on plan eligibility (qualified plans – not SEPS or SIMPLE). "Part-time" is not a permissible exclusion category for employees who work over 1000 hours per year.

D. Age 21 is the minimum age limit. There is no allowable maximum age restriction.

E. Completion of eligibility requirements requires actual entry to Plan within 6 months. Plans can use quarterly or semi-annual entry dates for compliance or (to stretch eligibility to the maximum) have an added 180-day wait or if earlier, beginning of next Plan Year, until plan entry (but no earlier than beginning of the next Plan Year).

F. IRC § 410(b) contains added complex rules on meeting coverage tests. Plans can provide specified exclusions for business reasons other than "part time," age, race, religion, etc. so as to help reduce employee cost and tailor the plan to the business. See 70% test of IRC § 410(b).

IV. Review of Qualified Plan Choices

Example –
Business has 4 employees other than owner who meet 1-year eligibility test of a qualified profit sharing plan. One is the full-time sales manager. Owner desires to exclude him/her. The PSP can be amended to specifically exclude him/her (assume there is no age discrimination issue). Covering 3/4ths of "nonhighly compensated employees" is 75% (over 70)%. Assume the PSP required employment at year end for a contribution. Assume one of the other 3 terminates during the year with over 501 hours of employment. The Plan will flunk 410(b) if it covers only 2/4ths of NHCEs. The PSP must be amended to include one of the two excluded people. IRC § 410(b) coverage tests can occupy an entire seminar.

Differences and Similarities After The Initial Contribution

	Qualified Plans	Individual Retirement Accounts (non Roth IRAs)
1. Tax Deferred Growth?	Yes (with exceptions: UBTI, margin accounts).	Yes (with similar exceptions).
2. Rollover Option To Participant Upon Distribution	Yes – to other Qualified Plans or IRAs with nonperiodic payments.	Yes – to other IRAs and Qualified Plans that accept transfers of IRA funds that did not originate from a Qualified Plan.
3. Any Capital Gains Treatment On Lump Sum?	Yes, only for funds attributable to pre-1974 participation.	No.
4. Subject To Estate Tax At Death?	Yes (subject to marital and/or charitable deductions and any available exemption).	Yes (subject to marital and/or charitable deduction and any available exemption).
5. Stepped Up Income Tax Basis At Death?	No.	No. Nondeductible contributions basis retained.
6. Pre-Age 59½ Penalty Taxes Apply?	Yes (subject to exceptions described later). Termination of employment needed for "annuity exception." Exception for terminating employment after age 54 applies.	Yes (subject to exceptions described later). No need to terminate employment for "annuity" option. No exception for terminating employment after age 54.
7. Potential Of Tax-Free Disability Benefits?	Yes, with special language, particularly Profit Sharing Plans.	No.
8.Post Age 70½ Minimum Apply?	Yes. If not 5% owner, deferral until retirement okay, depending on Plan language.	Yes. No exception for retiring after 70½.

IV. Review of Qualified Plan Choices

9. Mandatory Federal Tax Withholding Rules Apply?	Yes – except for post 70½ minimums.	No.
10. Individual Trustee OK?	Yes.	No.
11. Life Insurance A Permissible Investment?	Yes, if Plan allows.	No.
12. Investment In "Collectibles" Allowed Without Current Tax?	Yes, if not in an earmarked self-directed account.	No.
13. Loans To Participants Allowed?	Yes, within strict limits.	No.
14. Leveraged Real Estate Allowed As Tax Deferred Investment?	Yes, within limits.	No, with some exceptions.
15. Creditor Protection?	Significant potential protection in California, if incorporated, or nonowners are Plan participants.	Less potential protection under California law than Qualified Plans.
16. Prohibited Transaction Penalty?	15% tax penalty.	Entire account is taxed as ordinary income.

The outline does not contain a discussion of Roth IRAs, an option for certain eligible individuals. A Roth IRA is not a employer level benefit. A 401(k) Plan can include a "Roth" deferral feature. This feature is not discussed in detail in this Article.

V. Equity Based Compensation For Small Business

A. Introduction

Equity-based compensation is a separate and distinct form of compensation from qualified retirement plans, with the one overlap of Employee Stock Ownership Plans (ESOPs) (and Profit Sharing Plans holding employer securities). This outline does not devote significant attention to ESOPs. The discussion focuses on equity-based compensation outside the ESOP, qualified plan context. NOTE – There are restrictions on deferred compensation under IRC § 409A that apply to deferred compensation and many aspects of equity-based compensation. A detailed discussion is beyond the scope of this Article. Advice should be sought from an expert who knows the implications of IRC § 409A.

B. Why Use Equity-Based Compensation?

Reasons include (a) employee performance incentives for future performance, (b) attracting desired personnel, (c) rewarding past excellent performance, (d) selectivity in equity-based compensation and in substitution of "market" salary in cash starved "start-up" companies.

COMMENT: Equity-based compensation generally (with some exceptions) can be selective. IRC § 410 coverage rules do not apply (unless, of course, an ESOP or Profit Sharing Plan involved).

C. Unrestricted Stock Transfers

The simplest form of equity based compensation is to give an employee unrestricted stock. The corporation simply gives the employee unrestricted stock as compensation. This is often done under the mistaken understanding the transfer is not taxable. The fair market value of stock is taxable to the employee as ordinary income, subject to FICA and withholding. Fair-market value is subject to applicable minority, lack of marketability discounts. The employer is entitled to a corresponding deduction equal to the income recognized by the employee.

Good Questions – (1) What if the employer's principal shareholder gives stock to the employee as compensation? The IRS treats this as a contribution to the employer's capital, with the employer being deemed to transfer the shares thereafter. (2) Can the transfer ever be a nontaxable to gift (i.e., not taxable to the employee, nor deducted by the employer)?

Caution - Unrestricted stock can be just that, i.e., consideration should be given to conditioning the stock transfer on assent to a shareholders' agreement.

Securities Law Considerations

See the discussion under Restricted Stock.

D. Restricted Stock

General Considerations

Restricted Stock typically is provided by an issuer of common stock in connection with the performance of services. Restricted Stock, or units representing the stock, may be issued without cost or for a nominal price, and typically is subject to restrictions (i.e., the right to ownership will vest over a period of time and is nontransferable). Vesting rights also can be based on performance. The holder is viewed as the owner during the restricted period and is entitled to all rights as a shareholder for such stock.

Tax Consequences

When stock is transferred in connection with the performance of services, holders must include as ordinary income the excess of the fair market value of the stock over the amount paid for the stock. However if the stock is restricted (i.e., subject to substantial risk or forfeiture and nontransferable), the recognition of income is delayed until the restrictions lapse. Despite the restricted nature, holders may make a "Section 83(b)" election to include in ordinary income the excess of the fair market value of the stock over the purchase price at the date of grant; any subsequent gain would be taxed as capital gain.

Issuers are allowed a corresponding deduction equal to the amount included as ordinary income by the holder, provided the employer provides a timely W-2 or 1099, as appropriate (Reg. § 1.83-6(a)(2)). Employers are not required to deduct and withhold income tax as a condition of claiming the deduction (T.D. 8599, July 18, 1995).

Securities Law Considerations

The anti-fraud provisions of the federal and state securities laws will apply to the offer and sale of restricted stock. For federal purposes, the grant of restricted stock without cost typically is not considered to be a "sale" of or an "offer to sell" a security requiring registration; however, the sale of such stock for even a nominal cost may require registration or an exemption therefrom. In this regard, it is possible that a restricted stock plan may qualify for certain "private offering" exemptions. State blue sky laws may impose different qualification requirements or exemption standards (for example, California deems the grant of restricted stock without cost to be a "sale" requiring qualification or exemption).

E. Phantom Stock

General Considerations

Phantom stock typically is issued in the form of units which are equivalent to, but not actual shares of issuer's stock. The value of phantom stock equals the appreciation in the market value of the underlying stock between the date the unit is granted and its settlement date. Settlement usually occurs at retirement, termination of employment, or some other fixed date. The award may be payable in a lump sum or in installments in case stock or a combination of the two. A phantom stock plan often is used when it is not beneficial or possible to issue stock of the company to executives. Phantom stock plans typically differ from stock appreciation right (SAR) plans in that dividend equivalents usually are paid and phantom stock usually has a fixed settlement date.

Tax Consequences

No income is recognized at the time of grant, rather the units are taxed at the settlement date. Stock settlements are taxed at the stock's fair market value unless the stock is nontransferable and subject to a substantial risk of forfeiture. When the restrictions lapse, the difference between the fair market value of the stock and the holder's purchase price, if any, would be taxable. The holder must pay tax at ordinary income rates. Cash or stock awards are subject to withholding.

The employer is entitled to a deduction for phantom stock payments in the year the payments are made.

Securities Law Considerations
Similar to SAR treatment. Please refer to the section entitled "Securities Law Considerations" included with the summary outline on SARs.

Tandem Grants with NQSOs
By issuing tandem awards of phantom stock and non-qualified stock options (NSQOs), an employee can provide executives with both "stable" compensation in the form of phantom shares and "speculative" compensation in the form of at-the-money NQSOs. For example, to compensate an executive in the amount of $50,000, an employer can grant 2,000 shares of phantom stock (with "real" stock trading at $25) and NQSOs exercisable for 7,000 shares of stock at $25 per share (granted in tandem so that if one form of compensation is exercised, a pro rata amount of the other form is fortified). If the stock stays close to $25 per share, the executives can elect to receive compensation in the form of phantom shares. Alternatively, if the stock exceeds $35.00 per share, an exercise of the NQSOs would "leverage" the executive's compensation to a substantially higher level.

F. Non-Qualified Stock Options

General Considerations
Non-Qualified Stock Options ("NQSOs") entitle holders to purchase shares of an issuer's stock, or that of a parent or subsidiary, during a specified period of time and for a fixed price, thus providing performance-based compensation. Holders of NQSOs must recognize income upon exercises of NSQOs unless restricted stock is received upon such exercises. This treatment differs from the treatment attributable to an incentive stock option ("ISO") under which income may be deferred until a sale of the stock acquired.

The employer is entitled to a corresponding deduction equal to the income recognized by the holder of the NSQO (even where the employer's parent or subsidiary is the issuer). Based on the current federal income tax rates and the capital gain tax rate, it is generally preferable, from an overall economic standpoint, to use an NSQO as opposed to an ISO.

Unlike ISOs, NSQOs can be granted "in the money." "In the money" NSQOs, however, are now subject to the strict new rules applying to Nonqualified Deferred Compensation. NSQO holders are not subject to holding period requirements, NQSOs can be granted individually (rather than pursuant to a "plan"), and holders do not have to be employees (e.g., holders can be non-employee directors or consultants).

NQSO holders may effect a "cashless" exercise whereby proceeds from a sale of underlying stock being acquired, or shares previously acquired, are used to pay the exercise price. NQSOs also may include a "reload" feature pursuant to which the issuer immediately grants the holder a new NQSO if issuer shares are surrendered to exercise the NQSO.

Tax Consequences
The grant of an NQSO typically is not a taxable event to the holder unless the option has a "readily ascertainable fair market value" (e.g., an exchange-traded option). A holder generally recognizes ordinary income as compensation for services upon the exercise of an NQSO equal to the excess of the fair market value of the underlying stock over the exercise price; however, if the underlying stock remains restricted, the recognition of the ordinary income will be deferred until the lapse of the restriction. A holder's sale of the underlying common stock is taxable as capital gain or loss based upon the difference between the stock's sale price and the fair market

value at the time of exercise. NOTE - Please see the earlier caution about IRC § 409A.

When the NSQO holder recognizes income, the employer is entitled to a corresponding deduction (see Tax Consequences under Restricted Stock).

Securities Law Considerations

The anti-fraud provisions of the federal and state securities laws will apply to the offer and sale of NQSOs and underlying common stock. For federal purposes, the grant of an NQSO typically is not considered to be a "sale" of or an "offer to sell" a security requiring registration; however, the exercise of an NQSO for underlying stock is deemed to be a "sale" of a security requiring registration or an exemption therefrom. In this regard, it is possible that an NQSO Plan may qualify for certain "private offering" exemptions. State blue sky laws may impose different or additional qualification requirements or exemption standards (for example, California deems the grant of an NQSO to be a "sale" requiring qualification or an exemption while the subsequent exercise of an NQSO is a non-event).

G. Incentive Stock Options – IRC § 422

General Considerations

Incentive Stock Options ("ISOs") permit holders to purchase shares of an issuer's stock during a specified period of time and for a fixed price, thus providing performance-based compensation. Unlike other option plans (e.g., non-qualified stock option ("NQSO") plans), if statuary requirements are met, holders can defer recognition of income until the sale of the underlying stock; however, the issuer will not benefit from a corresponding tax deduction. The statutory requirements applicable to an ISO include (i) shareholder approval, (ii) a 10-year limit on exercisability (five years for 10% holders), (iii) exercise prices must equal or exceed fair market value of the underlying stock at the time of grant (110% of fair market value for 10% holders), (iv) transferability restrictions, (v) ISO holders must be employees of the issuer or a parent or subsidiary at the time of grant and until at least three months prior to exercise of ISO; and (vi) the aggregate fair market value determined at the time of grant for stock exercisable for the first time by an ISO holder during any calendar year cannot exceed $100,000.

Stock acquired upon exercise of an ISO may not be used to exercise another ISO (e.g., a "cashless" exercise) prior to the end of the two-year period after the date of grant of the ISO and one year after its exercise without terminating the ISO tax benefits.

Tax Consequences

Holders of ISOs recognize no taxable income on exercise of an ISO if the statutory requirements are met; however, the excess of the fair market value of the stock over the option exercise price is a preference item which must be included in computing the holder's alternative minimum taxable income for the exercise year. A holder's sale of the underlying common stock is taxable as capital gain or loss based upon the difference between the stock's sale price and the option exercise price. If the statutory requirements are not met, holders recognize ordinary income as compensation for services (either at the time of exercise (similar to NQSO) or upon a disqualifying disposition of the underlying stock).

The issuer normally has no income tax consequence. However, if a holder recognizes ordinary income due to the failure to meet the statutory requirements, the issuer is entitled to a corresponding deduction and must withhold.

Securities Law Considerations

Similar to NQSO treatment. Please refer to the section entitled "Securities Law Considerations" included with the summary outline on NQSOs.

H. Stock Appreciation Rights

General Considerations

Stock appreciation rights (SARs) are contractual rights granted to executives to receive income based on share appreciation, i.e., the excess of the market value at exercise date over a pre-established price. SARs may be payable either in cash, stock or a combination of cash and stock. The form of payment may be at the option of the employer or, subject to certain limitations, the employee. The plan may limit the amount of share appreciation for which an executive is eligible. Such plans may be combined with ISOs or NQSOs, and the executive may be given the opportunity of electing one or the other. SARs are rare in small businesses.

Tax Consequences

Upon the exercise of an SAR, the employee will include in gross income an amount equal to the cash and/or fair market value of the shares of stock received unless the shares are restricted. The employer is entitled to a corresponding deduction and must withhold.

Securities Law Considerations

The anti-fraud provisions of the federal and state securities laws will apply to the offer and sale of SARs although SARs in their own right typically do not constitute securities for which federal registration is required. Applicable state blue sky laws may have requirements which are distinct from federal securities law with respect to SARs (in California, for example, although the grant of an SAR which is exercisable for cash only is exempt from state qualification requirements, the grant of an SAR which may be settled for stock requires qualification or an exemption).

I. Employee Stock Purchase Plan ("ESPP")

General Considerations

An ESPP typically is established by larger businesses to permit a larger number of an issuer's employees to acquire employer stock. ESPPs usually are implemented through voluntary payroll withholding. This outline does not focus on ESPPs, as they are atypical in a small business.

VI. Non Qualified Deferred Compensation

A. Traditional Deferred Compensation

Involves deferring or reserving income at the (normally C) corporate level and paying it later to employees (new strict Internal Revenue Code Section 409A means a formal nonqualified deferred compensation plan for owners is not feasible). NOTE - Please see prior caveat about the IRC § 409A.

Income Tax Issues

Corporation does not deduct the deferral. NQDC use almost always limited to 15% corporate tax bracket (for non personal service corporations). Tax deduction at corporate level is when deferral is paid. IRC § 404(b).

Comment: Owners of small businesses normally do not use a formal deferred compensation plan or formal deferral of "declared" compensation. Often they have informal severance pay (generally limited to 2 years' pay) contracts continuing salary for a time after retirement, or a formula defining deferred compensation to be paid upon termination.

FICA Issues

IRS Regulations 31.3121(v) describes impact of Social Security Amendments Act of 1983. FICA implications are complex and a genuine consideration in NQDC. FICA normally applies when a "non-account" or "account" plan defines a legally binding ascertainable benefit to be paid at a future date. A full discussion of FICA implications is beyond the scope of this outline.

B. NonTraditional Informal NonQualified Deferred Compensation

Small C corporations often accumulate corporate retained earnings as an "informal" deferred compensation plan. This will be the only method that can be used for owners under the IRC § 409A rules.

Pros – 15% tax rate on first $50,000 of income for eligible C corporations. No current FICA implications. Possible deduction for compensation payout or other expense in later year. Possible eventual liquidation or corporation at capital gains rates. Possible gift of stock to children to shift gain to next generation. Death of owner (or spouse in community property context) step up basis up could allow tax free liquidation.

Cons – No assurance tax rate upon liquidation is favorable. If paid as compensation, resulting deduction may generate unusable net operating loss. Accumulated earnings tax (IRC § 532) implications for retained earnings over $250,000 ($150,000 for certain service corporations). Possible increased FICA in later year(s).

C. Rabbi Trust

(Not common in small businesses) – Assume the business establishes a deferred compensation plan for a non-owner – or a minority owner. He/she desires assurance the "funds will be there." A Rabbi Trust is an irrevocable trust in which assts are set aside for the exclusive use of satisfying an employer's contractual obligation to pay deferred compensation. It can be funded in any manner including cash or insurance products. Rabbi Trusts are subject to the claims of general creditors but are inaccessible to the business for discretionary use until benefit obligations are met. The earliest IRS blessing of this was a private letter ruling involving deferred compensation provided by a congregation to its rabbi. Therefore, the term "Rabbi Trust."

Comment: Rabbi Trusts are not typical with formal deferred compensation plans for owners. They are often funded with life insurance or "tax managed investments" to limit current taxable income to the corporation.

D. ERISA Implications

ERISA Sections 3 and 201 and their regulations describe exemptions from ERISA coverage.

CAUTION– Formal deferred compensation plans must be limited to select management employees or highly compensated employees (normally called "top hat" coverage) to avert ERISA coverage. Top hat plans are exempt from the participation, vesting, funding and fiduciary requirements of ERISA, but are subject to limited reporting and disclosure requirements. The business must file a brief one-time disclosure statement with the U.S. Department of Labor.

E. Split Dollar Insurance

Variations of Split Dollar abound. Split Dollar insurance benefit plans are far less common at this time because the IRS regulations require use of a reasonable interest rate on the "loaned" funds. A traditional one used by the author (and the only one discussed here) is the collateral assignment approach as follows

Owners of Policy	**Beneficiary of Policy**
Employee	Spouse, children, Trust
Employee(s) Spouse	(ties into estate planning)
Irrevocable Trust	

Premium paid part by company and part by employee or owner – hence "split" dollar. Employee typically pays the "economic cost" of policy under P.S. 58 (or the lowest published and available term rate) and the company pays the rest. The company's payment is an advance, subject to return in accordance with the Split Dollar Agreement, and with interest calculated in accordance with Internal Revenue regulations. A formal written collateral assignment is filed with the insurance company to secure the debt. The company can bonus the economic cost to the employee as taxable compensation.

Pros – Most of the premium is paid with 15% tax dollars (Split Dollar is not often used with S corporations or with C corporations not in the 15% federal bracket). Build up in value on funds is tax deferred within life insurance policy. Amount owed to the company must bear interest under IRS regulations.

Cons – "Economic cost" continues until Split Dollar Agreement terminates.

S Corporation Issue: IRS PLR9651017 ruling indicates a collateral assignment split dollar life arrangement did not create a second class of stock to cause the corporation to lose its S corporation status (the IRS also ruled the particular arrangement did not cause the proceeds to be in the insureds' estates). Lack of the 15% corporation tax rate (and flow through owners) makes split dollar highly unusual in the S corporation context.

Reverse Split Dollar: A nontraditional split dollar arrangement known as "reverse split dollar" (noncharitable) rents death benefits to the corporation. Discussion of reverse split dollar is beyond the scope of this outline.

F. Corporate Owned Life Insurance

Life insurance schemes to deduct interest (at high interest rates) on corporate owned life insurance on employees lives (used at times in context of deferred compensation and some split dollar plans were attacked in the Health Reform Act of 1996. Interest is allowed only for policies on certain key employees and then only at specific rates. See IRC § 264(d).

VII. Fringe Benefit Plan

An overview of fringe benefit plans follows:

A. Group Health Insurance Plans

IRC §§ 104, 105 and 106 allow company paid tax free (for employees or C corporation owners) health insurance coverage and benefits for employees. Sole proprietors, partners and 2% shareholder-employees of S corporations have deduction limits under IRC § 162(1). Health Reform Act of 1996 added language to allow such benefits "through an arrangement having the effect of accident or health insurance" (i.e., certain large self-insured welfare plans, etc.). Long term care insurance (with dollar limits on premiums) was also added as a qualifying benefit in the 1996 Health Reform Act (IRC § 213(d)).

ACA – Discussion of the Affordable Care Act's requirements is beyond the scope of this Article.

Note – Group insurance plans for employers of 20 or more employees (in prior calendar year) involve COBRA coverage (See IRC § 498B). This involves notices upon hire and upon termination of employment. Post employment termination coverage under a group health plan can be elected, at the employee's (or qualified beneficiary) expense (102% of the premium), for up to 18 months, 36 months for some qualifying events. Certain disabilities within the first 60 days of continuation coverage allow up to 11 months of coverage past the 18 months at 150% premium cost. California law extends COBRA-type coverage to employers with less than 20 employees.

Comment: COBRA, MSAs and Group Health Insurance are a full subject of their own. Work with your tax advisor and benefit consultant to get and stay in compliance! COBRA is fertile litigation ground.

B. Medical Diagnostic Reimbursement Plans

Not common. The "executive physical." For employees only (no dependents). See IRS Reg § 1.105-11(g). A C corporation can provide tax free reimbursements of an employee's uninsured diagnostic expenses. There are no discrimination rules. A written plan or policy is normally necessary.

C. Medical Expense Reimbursement Plan

See IRC § 105(h). A business can offer tax free (see chart at beginning of outline on limits in non C corporations for owners) medical expense (treatment) reimbursements but this is subject to strict ACA rules. A recent law that went into effect on January 1, 2017, allows use of medical reimbursement to pay for employee's (of small qualifying businesses) individual health insurance coverage, but only if the business has no group health insurance. A written plan is needed.

A discussion of medical reimbursement plans is beyond the scope of this Article.

Comment: Assume the 3 employees use 50% of the benefits of the Plan. The Plan's "tax shelter" for owners is offset by the cost. Nontax employee benefit considerations then apply.

D. Cafeteria Plan (Section 125/Flexible Benefit Plan)

A Cafeteria Plan under IRC § 125 eliminates constructive receipt of income issues when an employee has choices between taxable and nontaxable benefits. Commonly involves salary reduction to purchase from a limited "menu" of "cafeteria" choices such as: (1) health insurance for dependents; (2) child care; (3) uninsured medical costs; (4) group life; (5) vacation days (less common as a benefit and only in employer funded plans); (6) possible 401(k) deferrals (only in

employer funded plans). See Temp Reg § 1.125-2T. Long term care insurance may not be offered in a cafeteria plan. Nor may educational assistance under IRC § 127(b)(4) or deferred compensation under IRC § 125(d)(2).

Pros – Allows employees to convert after tax benefit choices to pre-tax. Employer and Employee save on FICA.

Cons – Discrimination tests apply. No more than 25% of tax free benefits may be used by key employees (IRC § 416(i)(1)). IRC § 125(g)(3) allows use of the Qualified Plan classification test under 410(b) and 3-year eligibility. Regulations require annual elections, for "use it or lose it" approach and, for noninsured medical benefits, "risk sharing" in which an employer could be liable for more than an employee's salary reductions. Child care plan tax benefits should be compared to child care tax credits. A Cafeteria Plan does not work for 2%+ owners of an S corporation.

The limit of health benefits (not including the employee's portion of the employer's ACA qualified group health insurance plan).

Comment: Cafeteria Plans can occupy an entire seminar.

E. Dependent Care Assistance Plan – IRC § 129(d)

Usually part of a Cafeteria Plan. Rarely, in a small business, a stand-alone plan due to employee cost.

Pro – Tax free child care.

Con – Benefit is an added employer cost. No more than 25% of benefits may go to more that 5% owners. Plan must also meet discrimination tests of IRC § 129(d), i.e. average benefits to nonhighly compensated employees is 55% of benefits to HCEs (excluding employees under $25,000, age 21 and one year of service).

F. Group Term Life Insurance – IRC § 79

Up to $50,000 of term insurance death benefit coverage is tax free (for C corporation owners only).

Pro – Premiums not taxable to employee.

Con – Plan must meet discrimination tests of IRC § 79(d). Tax benefit of tax free premium offset by employee cost.

G. Wage Continuation (Disability Insurance) – IRC § 105

Employer written plan to pay disability insurance premiums for benefit of employee.

Pros – Disability premium is tax free (for C corporation owner-employees only). Potentially allows more insurance to be purchased with pre-tax dollars. No discrimination rules. Can be for owners only (subject to dividend issue).

Cons – Benefits from insurance, if disabled, are taxable. A business owner will have serious hindsight concern if he/she elects tax free premiums for 2 years, gets disabled, and receives taxable income.

Comment: Schemes to have employee pay, but employer reimburse at year end if no disability, have failed in court tests. Also see IRS Reg § 1.105-1(d)(2) in which a 3-year lookback applies on the source of premium payments unless there is a binding election between "pre-tax" or "after-tax" prior to the beginning of the year.

H. VEBAs

Voluntary Employees Beneficiary Associations under IRC § 501(c)(9) are rare in small businesses. Tax Reform Act of 1984 added IRC §§ 419 and 419A to severely limit deductions. Exception in § 419A for "over 10 employer plans" is exploited (in author's opinion) in a number of tax shelter motivated severance pay etc. plans that often involve significant tax or economic risk. A 1997 Tax Court decision explains requirements for qualifying for the "over 10 employer plan" exception. Almost all VEBA arrangements marketed to small businesses will not qualify. A discussion of the implications is beyond the scope of this outline.

Pros – Possible tax deductions, if plan is properly structured. Possible use of Federal rules (other than California) relating to accrual of vacation pay in properly funded vacation pay VEBA.

Cons – Possible economic risk of loss if plan is properly structured to not involve "experience rating." Possible IRS attack on plan deductions. Employee cost if plan properly meets discrimination tests of IRC § 501(c)(9).

Comment I: There are a number of VEBA "deals" around – some of which involve tax exempt VEBAs and other involve taxable trusts (VEBA that do not qualify for tax exempt status). Be very cautious and see competent counsel before advising a company to sign up on a VEBA. Most proposals are overly insurance oriented and economically costly even if the tax deduction treatment is not challenged by the IRS.

Comment II: VEBAs can be useful for small business contractors who do government contracting and need a "Davis-Bacon" qualified welfare plan to deposit vacation and health insurance benefits mandated under David-Bacon contracts.

I. Comment on Multiple Entities

A series of rules under IRC §§ 414 and 1563 aggregate entities for coverage. Congress has attempted to plug numerous perceived loopholes exploited by taxpayers in entity structure who attempted to avoid covering employees. No discussion of employee benefits is complete without reference to the following tests:

A. Controlled Group of Corporations: IRC § 414(b) refers to IRC § 1563(a) to treat all members of a controlled group of corporations as treated as employed by a single employer for IRC §§ 125, 401, 408(k), 410, 411, 415, and 416. The tests of Section 1563(a) are beyond the scope of this outline but the principal threshold is the "80% common ownership test," and a companion 50% identical ownership test.

Example: A and B equally own Company X. A also owns 90% of company Y. B owns none of Y. X and Y are not in a controlled group (unless ownership options, family attribution rules, "substance over form" or some other aggregation rule applies).

B. Businesses Under Common Control - IRC § 414(c): Unincorporated and incorporated businesses are also aggregated under IRC § 414(c) under rules similar to Section 1563(a). See Reg § 1.414(c)-1, et al.

C. Affiliated Service Groups - IRC § 414(m): IRC § 414(m) was added in 1980 to plug the loophole under which corporations in service businesses (see IRC § 414(m)(3)) were creating partnerships of corporations – and the IRS was losing challenges it based on a 1968 Revenue Ruling claiming the partnership's non-owner employees were aggregated for benefit purposes with the owner-employees if the corporations.

Example: 4 lawyers each incorporate separate corporations and form a partnership of corporations. IRC § 414(b) and (c) does not aggregate them. IRC § 414(m) treats all entities as one group for benefit plan purposes.

D. Affiliated Management Businesses – IRC § 414(m)(5): A new form of loophole emerged after enactment of IRC § 414(m) – the incorporated executive. Executives with insufficient ownership percentages for aggregation under § 414(b) or (c) formed management entities to contract with the businesses they managed. IRC § 414(m)(5) was added, beginning in 1984. It aggregates an entity performing management functions for another entity on a regular basis (the "principal business" test) for benefit purposes.

Comment I: The interpretation of IRC § 414(m)(5) is in doubt due to the IRS withdrawal of Reg. § 1.414(m)(5) on April 27, 1993. The proposed regulations are viewed by some (not necessarily the IRS) to be overly expansive in defining "management" to include professional services whether they were management in nature. The IRS was concerned about the incorporated (or not) independent contractor doctor-lawyer, etc. to a group he/she owns none of being able to have his/her own pension/benefit plan.

Comment II: Withdrawal of the proposed regulations does not mean IRC § 414(m)(5) is dead. Managers who incorporate (a corporation is not required to invoke § 414(m)(5)) and "attach" themselves to one company will likely fall within § 414(m)(5). Another line of attack used by the IRS in both management and nonmanagement situations is to claim the executive is a common law employee of the business that he/she provides service to. This blows up the entire agreement, with significant tax/employee benefit issues for both sides. Reclassification of independent contractors as common law employees creates a ripple effect on FICA, benefit coverage and other issues. Benefit plans set up by the contractors, if any, also face disqualification (as they would be treated as employees rather than self-employed businesspersons).

E. Independent Contractor vs. Employee Issues: Proper classification of employees and independent contractors who are later reclassified can be vital to qualification of benefit plans, as well as to reduce exposure from independent contractors (or the IRS/Franchise Tax Board) claiming as employees, they should have been covered under Pension Plans, group insurance plans, workers compensation plans, etc. A full discussion of independent contractor vs. employee issues is beyond the scope of the program.

F. Leased Employees – IRC § 414(n): Employees of a "leasing company" who provide services to a recipient company are aggregated for virtually all benefit plan purposes. IRC § 414(n). A "safe harbor" to exempt coverage is very limited in scope and applies only if leased employees are less than 20% of the nonhighly compensated workforce, and a 10% fully vested immediate eligibility money purchase plan is maintained by the leasing company.

Comment: The Small Business Job Protection Act of 1996 amended Section 414(n) to change the applicable test to a "primary direction and control by the recipient test." The change is designed to make aggregation easier, especially in circumstances where the prior "historically performed" test made longstanding employee leasing arrangements difficult to attack (particularly in some health organizations).

VIII. Selected Issues

A. Comments on SIMPLE Plans or IRAs:

The outline previously referred to SIMPLE/IRAs.

Query: Which type of company will use SIMPLE?

Observations:

1. How often will the cost of the SIMPLE mandatory contribution be more than the tax savings of the owner(s) own deferral (and contribution)? Small company's owners may benefit, but those with over 4-10 eligible employees are not likely to.

2. Will 100% vested contributions to SIMPLE really be less costly than a 6- or 7-year vesting schedule on traditional 401(k) contributions?

3. Is $10,000 contribution level for owners worth it – when IRA rules potentially will allow owner and spouse to put $5,500 ($6,500 if 50+) each to IRAs?

4. Always consider creditor protection issues when choosing between SIMPLE IRA vs. SIMPLE 401(k).

B. S Corporations with ESOPs?

Internal Revenue Code Section 1361(c)(7)(A) allows an ESOP to own stock in an S corporation. Good news?

Basics of rule:

1. Plan counts as one shareholder for number of shareholders rule.

2. Income on K-1 to an ESOP Plan is NOT UBTI, but the Internal Revenue Code has significant penalties for small ESOPs benefiting key owners. An excise tax and income pass through applies.

Special ESOP Rules

1. IRC Section 404(a)(9)'s increased ESOP deduction limits do not apply to S corporation. Dividends are nondeductible too – no big surprise as an S corporation is basically a "pass-thru" tax entity anyway.

2. IRC Section 1042 tax free rollover treatment does not apply to sales of S corporation stock to an ESOP. Question – Can you sell C corporation shares under 1042 and later convert to an S corporation without affecting the sale rollover? Seems so.

3. A rollover by a participant of ESOP employer securities to an IRA causes disqualification of S corporation status. IRC § 409 has provisions designed to help avert this.

Comment II: No pension advisor should counsel a C corporation to convert to an S corporation or vice versa for some perceived pension reason without involving tax advisors to consider the overall pros and cons of the S vs. C choice. There are significant pension and nonpension tax issues to consider.

C. Defined Contribution Plans Coverage Testing

Plan coverage under DC Plan is limited to tests of §§ 410(a) and 410(b)! Example:

ABC Company has 50 employees who meet 1-year – age 21, etc. requirement. 4 are HCEs. 46 NHCEs. ABC Company desires a Plan covering 10 people. 1 HCE and 9 NHCEs.

Plan meets 410(b) –

25% HCE ratio
19.56% NHCE Ratio
25% x 70% = 17.5%

Comment I: 410(a) and 410(b) are the major tests. "Grouping" combinations of HCEs and NHCEs in separate distinct plans is feasible.

Comment II: Minor change to Defined Benefit IRC 401(a)(26)

Joe Blow, M.D. and John Smith, M.D. Inc. have a DB Plan and Money Purchase Plan. Joe Blow, M.D. is in DB. John Smith, M.D. has a Money Purchase Plan. Both are HCEs (assume no NHCEs meet 2-year eligibility standard).

401(a)(26) Test NOT okay.

DB Plan needs at least 2 people to qualify.

FOR MORE INFORMATION

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