Nonqualified Plans and How They Affect Business Owners

ADVANCED MARKETS

BUSINESS OWNER STRATEGIES

An owner or member of a pass-through business is not a good candidate to participate in a nonqualified retirement plan. Most U.S. businesses are taxed as pass-throughs, including S-Corps, LLCs, Partnerships and sole proprietorships. A pass-through business is defined as a business where the profits of the business flow through to the owner's or member's individual income tax return. It is common for financial advisors to be asked about nonqualified retirement arrangements for the owner or member and possibly for a few of the key employees.

For example, a nonqualified deferred compensation plan will allow a key employee to defer income taxation of his or her income. For the owner, though, any salary or bonus deferral into a nonqualified deferred compensation plan will not defer income taxation. The deferral simply increases the taxable revenue of the company and the owner still pays income tax on that deferral in the form of taxable revenue. In other words, the owner would be using after-tax dollars to fund any type of plan.

> The tax consequences of any nonqualified plan are very different for the owner as compared to key employees.

WHAT CAN BE DONE WHEN PRESENTED WITH THIS TYPE OF OPPORTUNITY?

- Treat the owner separately from the nonowner key employees.
- Discuss with the owner that each group should be viewed separately. Explain that the tax consequences for the owner are different from that of a key employee.
- Options for the owner to consider:
  - o **Qualified Plans -** Assess the current qualified plan in place for the business or implement a plan if none exists. A qualified plan will assist both the owner and nonowner key employees in a similar manner. The business receives a current income-tax deduction for the plan, and the owner does not include that contribution in current income or taxable net revenue. For some small businesses, a combination of a defined benefit and defined contribution plan can provide both significant tax deductions and contributions directed toward the owner's qualified retirement plan.
  - o **Nonqualified Plans –** Consider implementing a nonqualified plan if the business owner has key nonowner employees that he/she would like to retain. Nonqualified plans are effective tools to handcuff the best employees to the business. There are many options available including: deferred compensation and SERP plans, executive bonus plans and split-dollar plans.
  - o **Owner Personal Planning -** The next best thing for the owner personally is to contribute after-tax dollars to a tax-deferred instrument, such as life insurance. If properly accessed, life insurance can also provide tax-free income. The tax deferral and tax-preferred access are both tax advantages. It can and should be structured in a way to operate much like a Roth IRA.

KEY TAKE-AWAY

When a pass-through business owner asks about nonqualified retirement plans for the owner and nonowner key employees, it's usually best to treat the groups separately. Explain to the owner why this is the case. Use the approach described above to determine the best course of action.

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