THE VELD GROUP VELD MERGERS & ACQUISITIONS

Owner Deferred Compensation

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In an ideal world, every seller of a privately-held company would leave the closing table with enough cash to enjoy the "golden years." But we live in the real world and unless your company is worth well in excess of $10 million and you find a buyer who is willing and able to pay all cash, you may receive part of the consideration for your company in a form other than cash. If you transfer your company to an insider (co-owner, employee or child active in the company) the non-cash portion of your compensation may be quite large.

With the majority of your compensation at stake then, you must consider (well in advance of any transfer) which form of non-cash compensation—consulting fees, salary or deferred compensation—is the most advantageous to you from a tax standpoint.

As you may have guessed, all three types of compensation mentioned above are treated as ordinary income. But not all three are subject to Social Security Taxes. (More about that in a moment.)

You must also consider what you will actually have to do to receive your compensation. If, for example, you receive a consulting fee after you leave the business, you actually must consult. Similarly, if you continue to receive a salary, you actually have to work. Who imposes these rules? Who else? The IRS.

As the basis for your consulting fee or salary, many former buyers (now owners) insist that the former owner perform under terms contained in a consulting or employment agreement. Living up to these terms may not be exactly how you imagined your retirement on the golf course!

In 2004, the Federal Government imposes a Social Security (or FICA) tax of 12.4 percent on the first $87,900 of salary or consulting fees (the taxable wage base). One half of the tax (6.2 percent) is paid by the employer and the other half by the employee. In addition, there is a Medicare tax of 2.9 percent (for which there is no taxable wage base) on all income, salary, consulting fees and deferred compensation.1

From a tax perspective, deferred compensation is not treated like other forms of compensation if the deferred compensation vests in a year in which your earnings exceed the taxable wage base. When you do

ultimately receive the deferred compensation, it is considered to be above the taxable wage base and is therefore not subject to FICA taxes.

How then can you design your exit so that proceeds from the sale of your company are paid to you in the form of deferred compensation?

First, you must document the terms of your deferred compensation in a written plan. Ask your attorney or CPA to help you to design a plan that meets your particular needs.

Second, you will need to accrue an amount of deferred compensation (probably over several years) in order to reach the total dollar amount you want after you leave your company. Keep in mind that during each year you are accruing compensation, the total amount of compensation (both actual and deferred) must be "reasonable" in the eyes of the IRS.

Third, during each year that the deferral compensation vests (probably the same years as the years of accrual) you need to be certain the taxable wage base is first exceeded to avoid FICA taxes. You cannot avoid the Medicare tax because there is no taxable wage base limit. Assuming that you defer compensation for seven years prior to your departure, the FICA savings will be on the order of $85,000 (this amount is based upon the excess of the FICA taxable wage base over a seven year time period), and probably more.

Deferred compensation can be a powerful tool that savvy owners use to leave their companies in style. Your advisors can help you to put together a deferred compensation plan that is designed to meet your financial exit objectives. Remember, however, that this exit planning technique, like most others, requires time to develop and to implement. If you haven’t already done so, I encourage you to begin planning for your successful exit.