

# STRATEGIC

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Strategic Integrated Planning

## Compensating Key Employees

Clearly, one of the most important factors in attracting and holding key employees is your company's program for compensating executives. Naturally, the basic salary is of great importance, but equally important may be special plans of incentive compensation; plans for allowing executives to participate in the ownership of the company through stock options, stock bonuses and other stock-acquiring arrangements; and special plans for deferring compensation. For this reason, many special devices have been developed to compensate the executive.

There are four basic types of benefits currently in use for compensating the executive. These are direct compensation, "perks" or non-cash fringe benefits, deferred compensation, and retirement plans. There are basic differences among these four major types of executive compensation, including their respective tax implications for you, as the employer, and the employee.

*Direct compensation.* As its name implies, direct compensation is comprised of immediate pay to executives in the form of salary, cash bonuses and qualified stock bonus plans. Direct compensation differs from fringe benefits in that it typically involves cash payments or other evidences of indebtedness to the executive that can be readily negotiated or sold for cash. Direct compensation also differs from deferred compensation and retirement plans in that its impact is immediate (or within a year's time) rather than delayed until some future date. Generally, executives must recognize income in the year they receive direct compensation, and employers can deduct corresponding amounts in the year they pay direct compensation.

*"Perks" or non-cash fringe benefits.* Perks are those benefits that most employees think of as being fringe benefits. Thus, the perks that an employer may provide its employees consist of such non-cash benefits as company cars, exercise facilities and employee cafeterias. In the context of executive compensation, however, directors, officers, and managers have come to expect perks "above-and-beyond" those available to the average employee. Therefore, many companies have developed executive perks that consist of such "extra" benefits as chauffeured limousine services, use of corporate stadium skyboxes, and expenses-paid attendance at trade or professional conventions.

Perks tend to differ from direct compensation in that they typically involve the use of employer-provided facilities or reimbursement of employer-induced expenses rather than the payment of cash or its equivalent. Like direct compensation and unlike deferred compensation and retirement benefits, perks provide an immediate economic and financial benefit to participating employees.

Of the four types of executive compensation, perks have been most severely affected by changes in the tax law. Basically, the Internal Revenue Code now provides that all perks are taxable as wages to participating employees unless the perk is specifically exempted from taxation.

*Deferred compensation.* Deferred compensation refers to what would otherwise be direct compensation or a perk (i.e., fringe benefit); except that it is so structured as to postpone receipt of a portion of an executive's taxable compensation until sometime after it has been earned by the executive. Conceptually, deferred compensation plans are a type of benefit located midway between the immediate benefits bestowed on an executive by perks and the long-range benefits bestowed under a retirement plan.

A common aim of a deferred compensation plan is to shift otherwise taxable compensation into a future year and, thus, defer, if not reduce, the income tax that would otherwise be paid to the IRS. For example, the deferral of income may be for a fixed period of time or until the executive has satisfied obligations to the company. Deferral of taxable gain will depend, however, on whether a specific provision in the tax code permits such deferral relative to a given form of deferred compensation and upon what conditions. Types of deferred compensation include deferred bonuses, stock options, and the so-called golden parachute payments.

*Retirement plans.* The term "retirement plan" refers to deferred compensation that takes the form of an employer-sponsored plan or program the purpose of which is to accumulate funds that will be paid to participating employees at some future date (e.g., at retirement or separation from the employer's service). Retirement plans take many forms (e.g., pension plans, profit-sharing plans and simplified employee pension plans), and there is some latitude permitted as to the benefits that a retirement plan may provide to participating employees. Other than direct compensation, retirement plans are the most costly for employers to establish, maintain and fund. Retirement plans may also be the most important benefit that employers can provide to their employees due to their long-range economic and financial effect on the well-being of the employees. However, retirement plans lose favorable tax treatment if they do not meet nondiscrimination rules. Therefore, few, if any, such plans are designed to provide executives with special treatment or benefits.

Considering the importance of a quality compensation plan to retaining key employees, it is essential that a plan be well thought out. We can assist you in developing a plan that will meet your needs and reduce your tax burden.

Please call our office at your convenience to arrange an appointment. 1-866-657-0246 or [jwaage@strategiclawgroup.com](mailto:jwaage@strategiclawgroup.com)