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Tax & Business Alert

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THE PROS AND CONS OF NQDC PLANS

Nonqualified deferred compensation (NQDC) plans allow participants to set aside large amounts of tax-deferred compensation while enjoying the flexibility to schedule distributions to align with their financial goals. However, the plans also pose substantial risks. If your (or a prospective) employer offers an NQDC plan, or you're considering one for your business, weigh the pros and cons carefully.

WHAT'S THE DIFFERENCE?

NQDC plans differ significantly from qualified defined contribution plans. The latter allows employers to contribute on their employees' behalf and employees to direct a portion of their salaries into segregated accounts held in trust.

Qualified defined contribution plans also generally allow participants to direct the investment of their account balances among the plan's investment options. The plans are subject to the applicable requirements of the Employee Retirement Income Security Act (ERISA) and the Internal Revenue Code, including annual contribution limits, penalties for early withdrawals, required minimum distributions and nondiscrimination rules.

By contrast, an NQDC plan is simply an agreement with your employer to defer a portion of your compensation to a future date or dates. Many NQDC plans provide for matching or other employer contributions, while some permit only employer contributions. Employer contributions may be subject to a vesting schedule based on years of service, performance or the occurrence of an event (an IPO or sale, for example).

To avoid current taxation, NQDC plans may not be "funded," and they can't escape your employer's creditors. The plan is secured only by your employer's promise to pay. It's possible to set aside funds in a special type of trust to ensure that your employer doesn't use them for other purposes, but they remain subject to creditors' claims.

WHAT ARE THE PROS?

Like qualified plans, NQDC plans allow you to defer income taxes on compensation until you receive it — although you may have to pay FICA taxes in the year the compensation is earned. NQDC plans also offer significant advantages over qualified plans. Depending on the specific plan's limits and distribution rules, you may have no contribution limits, allowing you to set aside substantial amounts of wealth. Participants may also enjoy greater flexibility to schedule distributions to fund retirement, college expenses or other financial goals without penalty for distributions before age 59½ or required distributions at a certain age.

From an employer's perspective, NQDC plans are attractive because they can be limited to highly compensated employees and they avoid the cost of compliance with ERISA's reporting and administrative requirements. However, unlike contributions to qualified plans, deferred compensation isn't deductible by the employer until it's paid.

AND THE CONS?

The biggest disadvantage of NQDC plans for participants is that deferred compensation is subject to the claims of the employer's creditors and could be lost in the event of bankruptcy or insolvency. Also, you may not be able to take loans from the plan and can't roll over distributions into an IRA, qualified plan or other retirement account. What's more, there are limitations on the timing of deferral elections.

IS IT RIGHT FOR YOU?

An NQDC plan offers attractive benefits, but it can be risky. Contact our firm to discuss how such a plan might affect your financial situation or whether it's right for your company. ■

BEWARE OF "WASH SALES" WHEN SELLING SECURITIES

If you're planning to sell capital assets at a loss to offset gains that have been realized during the year, it's important to beware of the "wash sale" rule. Under this tax rule, if you sell stock or securities for a loss and buy substantially identical stock shares or securities back within the 30-day period before or after the sale date, the loss can't be claimed for tax purposes.

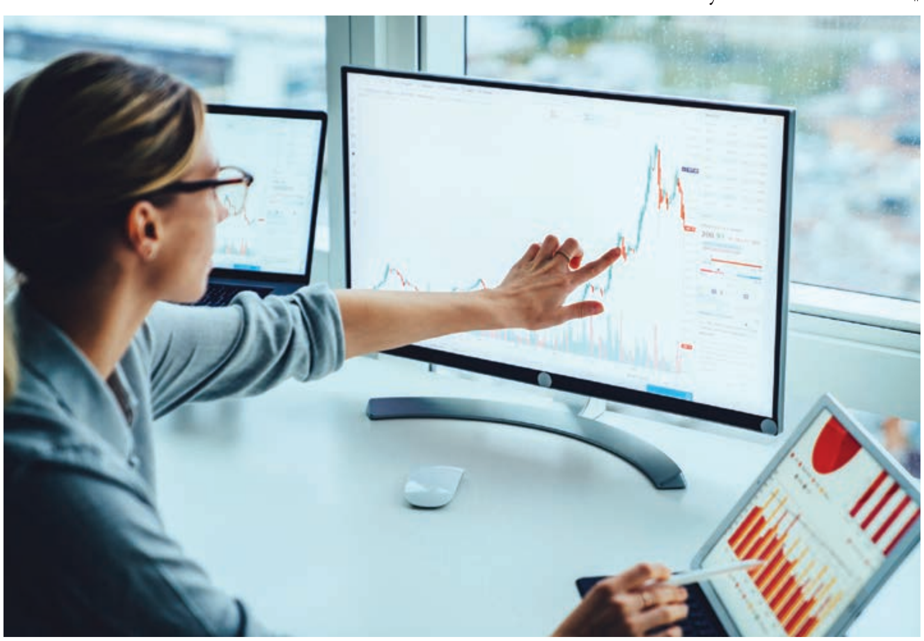
THE RULE

The wash sale rule is designed to prevent taxpayers from benefiting from a loss without parting with ownership in any significant way. Note that the rule applies to a 30-day period before or after the sale date to prevent "buying the stock back" before it's even sold. (If you participate in any dividend reinvestment plans, the wash sale rule may be inadvertently triggered when dividends are reinvested under the plan, if you've separately sold some of the same stock at a loss within the 30-day period.)

Although the loss can't be claimed on a wash sale, the disallowed amount is added to the cost of the new stock. So, the disallowed amount can be claimed when the new stock is finally disposed of (other than in a wash sale).

AN EXAMPLE

Assume you buy 500 shares of XYZ Inc. for $10,000 and sell them on November 5 for $3,000. On November 29, you buy 500 shares of XYZ again for $3,200. Since the shares were "bought back" within 30 days of the sale, the wash sale rule applies. Therefore, you can't claim a $7,000 loss. Your basis in the new 500 shares is $10,200: the actual cost plus the $7,000 disallowed loss.



If only a portion of the stock sold is bought back, only that portion of the loss is disallowed. So, in the above example, if you'd only bought back 300 of the 500 shares (60%), you would be able to claim 40% of the loss on the sale ($2,800). The remaining $4,200 loss that is disallowed under the wash sale rule would be added to your cost of the 300 shares.

NO SURPRISES

The wash sale rule can come as a nasty surprise at tax time. Contact us for assistance. ■

IS IT TIME FOR A COST SEGREGATION STUDY?

Because of the economic impact of the COVID-19 crisis, many companies may want to conserve cash and not buy much equipment this year. As a result, you may not be able to claim as many depreciation tax deductions as in the past. However, if your company owns real property, there's another approach to depreciation to consider: a cost segregation study.

DEPRECIATION BASICS

Business buildings generally have a 39-year depreciation period (27.5 years for residential rental properties). Typically, companies depreciate a building's structural components — including walls, windows, HVAC systems, plumbing and wiring — along with the building. Personal property (such as equipment, machinery, furniture and fixtures) is eligible for accelerated depreciation, usually over five or seven years. And land improvements, such as fences, outdoor lighting and parking lots, are depreciable over 15 years.

Often, businesses allocate all or most of their buildings' acquisition or construction costs to real property, overlooking opportunities to allocate costs to shorter-lived personal property or land improvements. Items that appear to be "part of a building" may in fact be personal property. Examples include removable wall and floor coverings, removable partitions, awnings and canopies, window treatments, signs and decorative lighting.

PINPOINTING COSTS

A cost segregation study combines accounting and engineering techniques to identify building costs that are properly allocable to tangible personal property rather than real property. Although the relative costs and benefits of a cost segregation study will depend on your particular facts and circumstances, it can be a valuable investment.

It may allow you to accelerate depreciation deductions on certain items, thereby reducing taxes and boosting cash flow. And, thanks to the Tax Cuts and Jobs Act, the potential benefits of a cost segregation study are now even greater than they were a few years ago because of enhancements to certain depreciation-related tax breaks.

WORTH A LOOK

Cost segregation studies have costs all their own, but the potential long-term tax benefits may make it worth your while to undertake the process. Contact our firm for further details. ■

TAX CALENDAR

October 15

Personal federal income tax returns for 2019 that received an automatic extension must be filed today and any tax, interest, and penalties due must be paid.

- The Financial Crimes Enforcement Network (FinCEN) Report 114, "Report of Foreign Bank and Financial Accounts" (FBAR), must be filed by today, if not filed already, for offshore bank account reporting. (This report received an automatic extension to today if not filed by the original due date of July 15.)
- If an extension was obtained, calendar-year C corporations should file their 2019 Form 1120 by this date.
- If the monthly deposit rule applies, employers must deposit the tax for payments in September for Social Security, Medicare, withheld income tax and nonpayroll withholding.

November 2

The third quarter Form 941 ("Employer's Quarterly Federal Tax Return") is due today and any undeposited tax must be deposited. (If your tax liability is less than $2,500, you can pay it in full with a timely filed return.) If you deposited the tax for the quarter in full and on time, you have until November 10 to file the return.

- If you have employees, a federal unemployment tax (FUTA) deposit is due if the FUTA liability through September exceeds $500.

November 16

If the monthly deposit rule applies, employers must deposit the tax for payments in October for Social Security, Medicare, withheld income tax and nonpayroll withholding.

December 15

Calendar-year corporations must deposit the fourth installment of estimated income tax for 2020.

- If the monthly deposit rule applies, employers must deposit the tax for payments in November for Social Security, Medicare, withheld income tax, and nonpayroll withholding.

TALKING ABOUT THE SANDWICH GENERATION

The term "sandwich generation" was originally coined to describe Baby Boomers caught between caring for their aging parents and their children. Now the term applies to whichever generation happens to be grappling with the problem. If you're in the middle part of the sandwich, one thing that can help is having one or more honest discussions about the situation.

When preparing for such a discussion, start with the "bottom" part of the sandwich: your children. Assuming they're still in their formative years, make them your top priority. At this stage, you'll still have most of the control over the decisions affecting their lives. These involve personal choices that are different for every family.

The "upper" half of the sandwich can be more problematic. Depending on their health status and other factors, including finances, your parents may resist your efforts to assist them. They may be oblivious to changes or dismissive of your concerns. And their attitude might range from being cooperative to highly resistant.

To initiate a family meeting, invite all the key players — your parents, siblings and, as appropriate, their spouses, at the least. In the "old normal," the gathering would have best been held face-to-face. In light of the COVID-19 pandemic, however, you may want to consider an online video chat instead.

What should you discuss? Cover the entire tax and financial planning gamut. The dialogue should be frank and honest. Many issues can be sensitive, and emotions can run high, so be prepared for some handwringing or pushback.

You probably won't be able to accomplish all your objectives in a single session. Consider meeting again with as many of the other parties as possible. In fact, you might broaden the circle to include your CPA or attorney. ■