ADVISORSERVE®

THREE GOOD APPROACHES TO NON-QUALIFIED PLANS FOR YOUR CLIENTS

Your high-income clients have a problem when it comes to retirement planning. You already know what I am going to say: tax qualified retirement plans limit contributions to amounts far below what these high-income clients want to put away. With Washington showing no interest in helping those with higher incomes, the qualified plan approaches like 401(k)'s, IRA's and even pension plans are bound to fall short for the foreseeable future.

Fortunately, good tax planners will always come up with great alternatives. Washington never seems to understand that raising taxes on any basis is bound to drive changes in behavior which will avoid those new taxes whenever possible. We are happy to report that the arsenal of good strategies continues to grow. Let's take a look at nonqualified plans.

"The best advisors pull out all the stops when working for their high-income clients. Consideration of non-qualified plans will make your firm different and exceptional."

In the broadest sense, a nonqualified plan forgoes an immediate tax deduction in exchange for much more flexibility to build an approach, virtually unlimited ability to select who will participate, and ultimate deductibility later. It almost makes me think of a Roth, where I give up the immediate tax deduction in exchange for a very favorable future outcome. Often, that lost tax deduction will come back later, with an even greater amount to employers.

AdvisorServe is very involved in non-qualified plans because the funding of these plans will often involve the use of specially designed life insurance policies. Why use life insurance? Due to its unique tax features, life insurance can protect the owner from paying any taxes while funds are accumulating and it can also be instrumental in avoiding taxes when funds are taken out of a policy, both on a living basis and ultimately in the death benefit. To you advisors who think that term insurance is the only way to go, stick with me. I agree that term insurance is the best way to acquire shorter term death benefits (most of the policies we place are term insurance), but the tax rules can make the cash value policies work wonders in the funding of nonqualified plans.

Let's take a look at three good approaches to nonqualified planning. Even more approaches may spin off from these three, but we selected these very different arrangements to demonstrate the many ways you can help your high-income clients enhance their retirement planning.

Deferred Compensation Plans

For a few decades, we have been firm believers in the use of deferred compensation plans for highly paid executives. These plans take several forms with a wide range of options to suit the employer and the executive (who can be the same person). Plans can use all employer money or all employee money or a combination of both. They can be defined benefit or defined contribution, and they can be fully discriminatory since they are non-qualified. As already noted, that non-qualified status also means that employer funds are not deductible going into the plan, but the benefits are usually fully tax deductible when later paid to the executive.

Deferred compensation plans are excellent ways to help executives who have reached the maximum amounts that can be placed into qualified plans. At the executive level, contributions are essentially tax deductible, not because the deposits are deductible payments, but because the deposits represent salary not taken, giving such deferrals the same effective tax result. And historically, we always believed that tax rates for an employee should be lower during the retirement years, when the benefits were paid out to them.

Two more aspects should be mentioned. First, deferred compensation plans give employers a set of "golden handcuffs" around their employees to the extent there are vesting requirements or other restrictions on access to the accumulated compensation plans have a way to attract and retain key talent. The other key point to note is that since the accumulated funding is exposed to creditors of the company, many firms have established "Rabbi Trusts" to hold the funds. These trusts restrict access to the funds by limiting such access to only creditors who have obtained judgments against the employer. Other employer uses of the funds are generally prohibited.

Ultimately, the employer has tremendous flexibility to invest accumulated funds in any way that benefits the company. That's because the executive does not have "constructive receipt" of the funds set aside, or else the executive would be taxed on the identified funds. This is where the term "unfunded" plan arises. Funds may be set aside, but they remain the company's funds. All the executive really has is a written promise from the employer to pay a future benefit. We have even seen plans where there was nothing set aside to back up an employer's promise.

> *"But we have learned several things about deferred compensation plans which open the door to taking alternative approaches."*

This is the other side to this story and why we are also suggesting that advisors look at other approaches. As good as a deferred compensation plan can be, here are a few of the objections we have heard:

1. When employers are pass-through entities, the avoided taxes on the deferred salaries and bonuses can end up on the tax returns of the owners.
2. No matter how tightly a rabbi trust is written, we have seen rabbi trusts invaded by a company, especially when the officers cannot object or face losing their jobs if they do.
3. Failed companies have judgment creditors and funds in the rabbi trust can be lost.
4. Internal Revenue Code Section 409A has taken much of the flexibility away, requiring set patterns and timing of distributions, whether their personal situations change or not.
5. The threat of higher taxes on income in the future makes future tax free income of greater interest to executives.
6. Deferred compensation plans can have complex and costly administration needs.
7. Employers may want deductibility earlier than when benefits are paid out.
8. Employers may want ways to recover all their costs, including the interest on such amounts.
9. Executives may want more choices in how their funds are invested.
10. Executives may want emergency access to their retirement funding without the need to treat such payouts as taxable income.

These issues do not necessarily demand that a deferred compensation plan be terminated or avoided. Some of them are just the result of a poorly designed plan.

However, these issues can drive planners to take other directions when designing or maintaining nonqualified benefits for highly paid executives. So here are the next two candidates for you to consider: Section 162 Bonus Plans and Loan Regime Split Dollar. Each of these approaches require more thorough discussion by themselves. We will summarize their features below and encourage our readers to contact us if you have clients who would benefit from a review of their existing deferred compensation plan or would like to consider one of the two alternatives discussed here.

Section 162 Bonus Plans

If an employer wants an immediate tax deduction for contributions, a bonus plan may fit best. In a typical arrangement, the employer places any combination of employer or employee funds into a life insurance policy on the life of the executive (or spouse if the executive is uninsurable). The policy is owned by the executive. Creditors of the employer have no access and the restrictive rules imposed by Section 409A do not apply. The employer has an immediate tax deduction. The executive must show that same amount as ordinary income, but the employer can reimburse the executive on either a single bonus basis or a double bonus basis, also deductible to the employer. The employer can also loan the executive the funds needed to pay his taxes, recovering such loans in the future out of the cash values (typically at retirement), or forgiving the loans upon retirement or other benchmark.

The employer can retain an element of golden handcuffs by restricting the employee's access to the cash values until sometime in the future, typically retirement date. Under this restriction, the employee cannot touch the cash value without the employer's permission, which still allows the parties full flexibility to respond to emergencies or unexpected needs.

The absence of Section 409A restrictions or minimum required distributions gives the executive a full ability to time his or her future income to suit any and all personal circumstances. Maybe the executive has failing health and needs the funds over a shorter period of time. Maybe the executive wants to allow funds to continue to accumulate until much later in the retirement years, or possibly even pass everything tax free to his or her beneficiaries. Either way, or in virtually all other situations, the magnitude of employee use of the accumulated funds is limited only by the usual economics of the policy and its investment results.

> *"Tax free distributions from a bonus plan cannot be overvalued."*

We don't know whether the mounting national debt is going to force income tax rates to rise but having a source of tax free income is a huge benefit with these plans. In its RICP curriculum, the American College states that the availability of tax-free income allows significant flexibility to better manage taxes and possibly extend the life of a retirement portfolio by as much as 3 or more years. For example, if the only source of emergency funds is a qualified plan or other taxable income generator, drawing out a large lump sum can force someone into a high tax bracket, requiring them to draw out even more funds to cover a specific need. It is the highly paid executives who are most in need of tax-free sources of funds.

Overall, one of the questions that illustrates the difference between deferred compensation plans and bonus plans is this: do you want to pay taxes on the seed or on the harvest? Do you want to pay taxes at the beginning or the end? People who like Roth accounts have an answer.

Loan Regime Split Dollar Plans

Our third candidate, which has an even greater advantage in the non-profit sector, is the use of a split dollar plan to create retirement income. Split dollar arrangements are methods that have two parties owning different pieces of a life insurance policy and deciding who pays premium, who owns the cash value, and who receives the death benefit. Plan designers will blend these aspects in different ways. In an arrangement with which we are quite familiar, the executive owns an insurance policy on his or her life. The employer loans the premiums to the executive using very favorable interest rates that apply to corporate transactions such as this. Ultimately, the employer will forgive the loan or be paid back later, even as late as whenever the executive dies. If the executive is living at the point of payback, his costs can come out of the cash value. Alternatively, if payback is due upon death, the amount being returned to the employer comes out of the tax-free death benefit.

Overall, this arrangement is not initially deductible by the employer. Instead, there is either a later deduction upon loan forgiveness or there is a potentially full and tax free recovery of all funds loaned with interest. The executive has much of the same benefit of the bonus plan, but he or she may need to pay interest to the employer or tax on the interest that should have been paid, both of which can be fully funded out of the large cash values that are developed under these arrangements.

Also like a bonus plan, the employer can restrict access to the cash value until a date in the future, much like a vesting schedule. And employers will always have an ability to recover their full cost if an employee were to pass away earlier than expected as well as when expected.

"Remember, by using life insurance in either a bonus plan or a split dollar plan, there is a valuable death benefit for the executive's beneficiaries at all times."

Finally, where non-profits are involved, this can be a great solution to the taxation of retirement benefits unique to Section

457(f). You probably know that when an executive of a nonprofit retires and the risk of forfeiture falls away, the executive is liable for the income tax on the full present value of all future retirement income! For example, a hospital president we knew retired with a $100,000 annual income benefit for the next 20 years under Section 457(f). Upon his loss of any risk of forfeiture on the date of retirement, he was taxed on the present value of this entire income stream, calculated to be approximately $1,000,000. The income taxes on a $1,000,000 bump in taxable income essentially wiped out his first years of retirement benefits. Yes, organizations may loan those taxes to the executive, but those funds still have to be paid back. With a loan regime split dollar plan, this is a non-issue. Problem solved.

Conclusion

Yes, we were a little tough on traditional deferred compensation approaches.
We fully support the use of deferred compensation plans in the right circumstances and expect to help design and fund those plans for years to come. However, in today's environment, advisors need to always consider the alternatives, not just when designing retirement income for their clients but also when evaluating what plans are currently in place. And, if the existing deferred compensation plan is no longer the best approach, there are even ways that some deferred compensation plans with large balances can still be converted to alternative plans. It is all based on the facts and objectives of the situation and objectives of the client.
AdvisorServe is ready to help you evaluate existing arrangements or design new plans. Here's another opportunity for you to serve your clients in a significant and unexpected way. This enhancement to the tools you use to build out a retirement plan can yield excellent results. It could also give you one more way to attract those very desirable companies you would like to make your next new clients.
Do you have a candidate for a non-qualified arrangement? Contact us for some good ideas to help your high-income clients.

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