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Wealth Wisdom

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Retaining key employees: New rules, challenges and opportunities

Attracting and retaining top talent is more difficult than ever. But providing retirement benefit flexibility through a deferred compensation plan is proving an effective incentive to continued employment.

A new tax law dealing with a popular deferred compensation concept can help employers design and install a plan that offers executives tax advantages and flexibility. The new tax rules apply to existing deferred compensation plans.

Abuse in executive benefits led Congress to enact Section 409A of the Internal Revenue Code (IRC) in late 2004. This section, which the IRS has further clarified with comprehensive regulations in 2007, brings certainty and predictability to deferred compensation plans for executives.

With this certainty, however, comes mandatory compliance by the end of this year — and Congress has created sizeable penalties for failure to abide by the rules. If employers have plans that aren't compliant with the new law, executives may be subject to taxes of 70 percent or more. Professional advisors generally agree that the certainty for penalties is warranted and leads to increased use of the deferred compensation technique.

Under these tax rules, employers choose who to cover, for how much, and when to vest and pay out the benefit. The law largely avoids regulating how companies back up or finance commitments they make to their executives. Companies can still use popular funding vehicles, like corporate-owned life insurance and mutual funds, to cover their liability to the employee.

The primary take-away of the new rules is that once the timing of it payout is established, it generally cannot be accelerated. In the event of death, disability, severance of employment or change of corporate control, the benefit must be paid on the agreed-upon date and schedule.

Consider for example, an executive who earns a $100,000 base salary plus a target bonus of $70,000. His or her long-term financial goals include paying for a child's college, building a lake home and preparing

for a comfortable retirement. The new tax law allows sufficient flexibility that, under the deferred compensation plan, the executive could choose to defer 20 percent of his or her base pay and 50 percent of the bonus — creating an immediate and sizeable tax savings.

The executive can designate buckets to allocate the deferrals with varying payouts. In this example, the executive allocates 40 percent of the deferrals to a college fund, which begins payout in 2009 over four annual installments. Another 20 percent is allocated to a lake home account with a lump sum payout in 2015 and the remaining 40 percent is allocated to an account that would begin paying out at the normal retirement date. And because IRC 409A didn't take away the employer's opportunity and obligation to back its promises with appropriate funding, the employer can informally finance its commitment to the executive.

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Section 79 as a supplemental planning tool

As employer rules for providing non-qualified supplemental retirement benefits become more stringent, the need to look for non-traditional strategies increases. Recent changes in Internal Revenue Code (IRC) Section 409A regulations and closer scrutiny by the IRS have narrowed the planning possibilities for rewarding key employees and business owners.

Many employers use group term life insurance to provide insurance protection for their employees. Coverage amounts up to $50,000 are paid by the employer and are generally income tax-free to employees.

While group term life insurance provides a death benefit for employees during their employment, it doesn't provide portable life insurance protection. Coverage ceases upon retirement or termination of employment. Additionally, group term life insurance often doesn't meet the needs of owners and highly paid key employees. Limits on coverage amounts and the fact that the life insurance benefit is tied to employment may leave these key people without adequate protection.

Adding a permanent benefit to a group term life insurance program can help employers attract, retain and reward owners and key employees. IRC Section 79 allows a corporation to offer participating employees the ability to own a cash value life insurance policy — such as universal life insurance — as part of the group insurance plan. Including cash value life insurance in the plan allows the corporation to use excess pre-tax profits to potentially provide tax-advantaged benefits to participating employees.

Advantages to the employer:

- Contributions to the plan are 100 percent income tax deductible (to the extent compensation is reasonable under IRC Section 162).
- Requires minimal documentation and reporting requirements.
- No mandatory participation requirements.

Advantages to the employee:

- Income tax-free death benefit that is portable into retirement.
- Tax-deferred cash accumulation.
- Tax-free income in later years.*
- Only 60 percent to 65 percent of contribution is includable in taxable income.
- Numerous benefits and applications, including supplemental retirement income and tax planning, non-qualified deferred compensation plan replacement, executive benefits, and estate tax and liquidity planning.
- Uses the IRS' safe harbor valuation method to calculate the cost of permanent benefits.

Section 79 group permanent plans are primarily designed to benefit owner-employees and non-owner key employees. Any business can adopt a group permanent plan to benefit all employees, including non-owner employees. However, if an owner-employee participates in the plan, the business must be organized as a C corporation. Independent contractors, partners in a partnership, members of an LLC (unless it has elected to be taxed as a C corporation), sole proprietors and owners of more than 2 percent of the stock of a subchapter S corporation aren't permitted to receive any group life insurance benefits under Section 79.

Example:

Goal
- Provide deductions, supplemental retirement income and death benefit.

Facts
- Corporation has nine employees plus the owner.
- Corporation needs to remain an S corporation due to unreasonable compensation issues.
- Owner is responsible for the sales and marketing functions.

Solution
- Establish a new C corporation that provides sales and marketing services to the S corporation.
- Section 79 plan is set up in the new C corporation and includes employees from both corporation.
- Owner has $100,000 premium.
- Total cost for the other employees is $1,565.

As the example illustrates, the Section 79 plan can be designed with minimal costs for rank-and-file employees, while allowing key employees and business owners to develop a supplemental plan.

While Section 79 may not be the right solution for every business to attract, reward and retain key employees, it does offer an alternative to traditional non-qualified deferred compensation arrangements that you and your tax professional may want to review.

**Income tax free distributions from a life insurance policy are achieved by withdrawing to the cost basis (premiums paid) then using policy loans. Loans and withdrawals may generate an income tax liability, reduce available cash value and reduce the death benefit or cause the policy to lapse. This assumes the policy qualifies as life insurance is not a modified endowment contract.*

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Tax tips

Rebalancing your portfolio

Wanting to update your portfolio, but not sure which option to choose? Consider rebalancing.

Rebalancing involves restoring your original asset allocation by shifting funds among asset classes to regain the proportions you first designed.

For instance, let's say your original asset allocation calls for 60 percent in equities, 30 percent in fixed income and 10 percent in cash equivalents. The equity allocation is 20 percent in large cap equities, 20 percent in small cap and 20 percent in international. But after a period of time, your allocation has changed due to market fluctuations: The large cap equities now represent 25 percent; small cap is 30 percent and international remain at 20 percent. However, your fixed income securities are now only 15 percent.

In order to rebalance you would have you sell 5 percent of your large cap and 10 percent of your small cap and purchase more fixed income securities (buy low, sell high). *Note: This example is for illustrative purposes only and doesn't represent the actual returns of any investment or portfolio.*

In rebalancing, there may be transaction costs or tax consequences that need to be considered. Selling some large cap or small cap equities may trigger capital gains tax or possibly redemption fees (for some mutual funds). What can you do?

In many situations, like the above, it's quite likely that not all of the large cap or small cap equities are in gain positions. To minimize the effect of taxes, it may be possible to sell some positions with loss along with positions that are in gain – which offset each other. The offsetting of capital gains with capital losses can be accomplished with different types of investment vehicles (mutual funds, exchange-traded funds and individual shares of stock).

You'll need to know the adjusted tax basis of your investment holdings, sales price and how long you've owned the asset. Long-term capital gains and losses apply only when you have held the investment for more than a year. There are a number of other considerations, such as ordinary investment income, investment expenses, possibly passive income and losses, tax-exempt and tax deferred income that may impact the implementation of rebalancing. Therefore, consult with your financial advisor or tax professional first.

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In general, employers have until the end of 2007 to bring their plans into compliance with the new law. As mentioned, failure to do so results in the penalties being assessed to the executive — not the employer.

Referring back to the example, say at the time the company is audited, the executive has a $100,000 deferred compensation account. If the employer didn't amend its plan to reflect the new IRC 409A rules, the executive could be subjected to immediate income taxation on the plan plus an interest penalty and a 20 percent penalty tax — even though the executive had no part in setting up or administering the company's deferred compensation plan. These cumulative taxes and penalties can quickly exceed 70 percent of the account.

Despite this, deferred compensation as an executive benefit is still highly effective. The new law allows more flexibility and higher limits than traditional qualified plans and these deferred plans often have advantages over other executive benefits, such as stock options and restricted stock. The key for an employer is to review any existing deferred compensation plans for compliance this year. Then focus on creating a flexible — yet manageable — plan design, securing appropriate informal funding for the benefit, and establishing effective administration and ongoing plan monitoring.

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