Bloomberg Tax

Daily Tax Report ®

Supplementing Retirement Income for the Executive or Business Owner

By Henry Montag

Jan. 8, 2021, 3:01 AM

Henry Montag of The TOLI Center East explains how to structure a supplemental retirement plan for executives and small business owners with tax deferred accumulations and tax-free distributions using life insurance.

Employers and employees alike are interested in supplementing their retirement income. Doing so on a tax advantaged basis is always a plus. While life insurance is usually thought of as providing a death benefit to an insured's beneficiaries and estate, it can also be used to provide a significant living benefit to the Insured.

There are two funding methods primarily used to supplement one's retirement, stocks and bonds or a life insurance policy. For purposes of this article we'll be discussing a life insurance policy. Specifically, one that builds up a significant amount of cash value and contains the minimum amount of death benefit coverage while still retaining the favorable tax treatment afforded to a non-modified endowment contract (MEC) life insurance policy. Doing so will maximize the supplemental distributions one can gain from a deferred compensation plan (DCP), as an employee or a, supplemental owner retirement plan (SORP) for the business owner.

If your small business owner client wishes to reward employees for their loyal service after a five-,10- or 20-year period, a DCP can work well as a "golden handcuff. it gives an employer an opportunity to do something special to reward a particular employee or group of employees for their past or future service on a discretionary basis. In addition, it's only available if the employee meets certain pre-set conditions related to the completion of an employers' employment requirement.

This can be done in several ways by allowing that specially selected employee to defer a portion of their current income to supplement their retirement income. If the employee doesn't have the financial ability to defer any part of their current income, the employer can lend the employee the money. If the employer chooses, the amount can match a particular employee's deposits. Compared to a typical qualified plan there are relatively few o governmental approvals, administrative costs, or regulatory requirements necessary to initiate or maintain such a plan.

A DCP is a contractual agreement between a corporation or other employer, and one or more of its key executives under which the corporation promises to pay benefits in the event of death, disability, or retirement, provided that the executive or business owner is employed by the corporation at the time the benefit becomes payable.

The typical DCP is drawn up in a written agreement between the two parties and should contain the benefits to be provided by the employer and what the executive must achieve before he can receive these benefits. While there are two types of plans, qualified and non-qualified, I'll be focusing on non-qualified plans. Unlike qualified retirement plans, non-qualified DCPs can discriminate and only choose highly paid executives/employees.

Non-qualified plans are mere unsecured promises by the employer to the employee and aren't protected against a financial failure of the company. When the policy is owned by the employer, the employee is a mere creditor of the corporation.

A similar plan can also be used to provide a very attractive benefit to your business owner clients themselves. This too can be done on a purely discretionary basis. One of the most significant benefits of a SORP is that it utilizes a life insurance product specifically designed to minimize the life insurance protection aspect and maximize the tax deferred accumulation benefits inherent in a permanent life insurance contract. However, the most significant benefit of a SORP is that it allows the owner of the policy to distribute the tax deferred accumulations tax-free. It does so through a series of loans and surrenders, which allow the normally distributed taxable gains to be distributed 100% tax free and never be repaid **as long as the policy survives the insured.**

Keep in mind that many of the existing underlying non-guaranteed life insurance policies funding DCPs, SORPs or SERPs of many of your clients must be managed on an ongoing basis to make certain that the death benefit **does** survive the insured,. This must occur in order to maintain the various tax advantages normally afforded a life Insurance policy and this strategy. Many of these non-guaranteed policies are currently expiring prematurely as a result of years of reduced and sustained interest rates, coupled with neglect on the part of the owners of these policies……owners that weren't aware that the premiums should have been increased over the years to make certain that their policy did not expire prematurely.

Just as the objective in a closely held business is to always attempt to use corporate assets to gain personal benefit, a similar objective in designing a DCP should always be to use the lowest available tax bracket, corporate or personal. A strategically designed DCP often creates such alternate beneficial options when it comes to choosing between the employer's corporate lower tax bracket and the business owner/employee's higher personal tax bracket.

The deferral to supplement an employee's future retirement income can also provide some current benefits, including payroll tax savings and the 3.8% Medicare tax savings for both the employer and the employee.

The Newport Group, an organization that offers group benefits, recently surveyed members of Fortune 500 companies and found that 92% of them offer a deferred compensation plan to their employees. The top three reasons for doing so were to provide a competitive compensation program (83%), allow executives to accumulate assets to supplement retirement needs (72%), and retain valued executives (63%).

Although there are no surveys about implementing DCPs OR SORP'S in the closely held business marketplace, their use there is equally effective. They should be implemented if for no other reason than to provide tax relief for the owners of the business.

Let's look at a situation where an employee or employer might consider a traditional deferred compensation plan, or supplemental owner retirement plan to provide a supplemental retirement income. For example, a 45-year-old employee could choose to defer $25,000 of pre-tax income into a deferred compensation plan funded with a life insurance policy that will continue to grow its cash value on a tax-deferred basis until the employee reaches age 65. At that point, after 20 years the employee will have paid in $500,000. Then on the 25th year, at age 70, that employee could begin to draw out an annual income of approximately $139,000 income tax free for the next 15 years until age 85, all the while having been covered for approximately $1 million of life insurance coverage that could have been used to complete the plan had the executive or business owner died prematurely.

Employers can determine whether they select a traditional plan where employees pay for and own the policy themselves, or a non-traditional plan in which the employer will make a loan to

the employee and by using a split dollar arrangement, still allow the employee to take full advantage of the inherent tax benefits at distribution. For example, the employer could lend the $25,000 annual deposit to a selected employee. In that situation employees would only have to pay the tax on the $25,000 they didn't actually receive. If the employer chooses, they could also lend the employee the tax on the income, often referred to as a double bonus in a nontraditional DCP. In that case the death benefit is used to repay the corporation for any of its expenditures, with the balance going to the employee's family.

While only an employee of a C corporation is eligible to participate in a DCP, an employee of a Sub S, LLC or any other pass-through can enjoy the benefits of the tax law by establishing a non-qualified DCP or SORP/ For example, individuals who have maxed out their 401(k) contributions but would still like to defer some additional current income to supplement their retirement years could continue to make non-deductible deposits to a nonqualified DCP/SORP. In doing so, they could benefit from the additional life Insurance coverage for their beneficiaries, continue to take advantage of the tax-deferred accumulation aspects of a 401(k) plan, while also having the ability to take 100% tax-free distributions at any time, with no income restrictions, and no penalties for early withdrawals. It's kind of like a Roth IRA on steroids.

In summary, many in the corporate world have already taken advantage of the significant benefits of a strategically designed DCP. Statistics and practical observations as an experienced practitioner indicate that these popular corporate benefits are increasingly finding their way into the ranks of many smaller closely held businesses as a result of their advisors increasingly becoming familiar with the tax benefits, the ease of administration in setting up a plan, and the ability of the owner to determine who can participate.

This column does not necessarily reflect the opinion of The Bureau of National Affairs, Inc. or its owners.

Author Information

Henry Montag CFP, Managing Director of The TOLI Center East in practice since 1976 with offices in L.I N.Y, has authored articles and acted as a source for NYSBA , NYSSCPA, Bloomberg Tax Daily Tax Report, and Bloomberg Tax Estates Gifts & Trust Journal, Trusts & Estate Magazine, Accounting Today, and The Wall Street Journal.

Henry Montag CFP, CLTC, in practice since 1984, is the managing director of the TOLI Center East & provides CPE & CLE credits to organizations such as NYSBA, NYSSCPA, AICPA, ABA. He recently co-authored an ABA Flagship book titled "The Advisors' & Trustees' Guide to Managing Risk."

You can reach Henry:
by email – henry@thetolicentereast.com
by visiting his website
– www.thetolicentereast.com
by calling **516 695-4662**

© 2021 The Bureau of National Affairs, Inc. All Rights Reserved