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SMART STRATEGIES FOR RETIREMENT INCOME SPECIALISTS

Create A Saving Plan And Still Meet Non-Discrimination Requirements

By Jim Connolly and Joe Stenken

Financial advisors working with highly paid executives need to be aware of new regulations for both qualified and non-qualified deferred compensation plans, two types of plans that are the building blocks for retirement income planning, according to experts.

Non-qualified deferred compensation plans are one way that planners can help highly paid executives save more, they say.

Advisors need to make these clients aware that there are additional savings tools beyond the qualified plan that should be used, says George Middleton, a financial advisor with Limoges Investment Management, PC, Vancouver, Wash.

The non-qualified deferred comp programs are offered mostly by large companies and professional companies such as architectural or medical firms where the owners have control over what retirement plans are established, he says.

The "big mistake" and the "real danger," according to Middleton, is that an employee will save up to the rate that they are allowed under the restrictions and then not do anything beyond that, he says. If they save up to the limits allowed them under non-discrimination rules, then they might assume that they are saving enough when, in fact, they may not be putting enough away for sufficient retirement income, he continues.

Under current rules, companies must comply with certain requirements in order to avoid having the plans deemed discriminatory against non-highly compensated employees.

For instance, the top 20% of highly paid employees can put in only 1.25 times as much into a qualified plan as a non-highly compensated employee. So, for instance, if the non-highly compensated employees contribute an average of 3%, then the top 20% can only put in 3.75% maximum.

If the above test is not met, a plan will still meet the non-discrimination requirements if the actual deferral percentage for highly compensated employees does not exceed, by more than 2%, that of other eligible employees for the preceding year and if the actual percentage of highly compensated employees for the current year is not more than twice the deferral percentage for all other employees for the previous year.

An employer sponsoring a plan can, however, choose to contribute 3% of compensation across the board or a 100% match on the first 3% of elected contributions and 50% on the next 2% and satisfy regulatory guidelines.

A qualified plan is considered top heavy if the total account value of key employees exceeds 60% of all employees, says Josh Itzoe, Greenspring Wealth Management, Towson, Md.

But, under the Pension Protection Act of 2006, after December 31, 2007, plans may engage in automatic enrollment for employees in qualified plans, Itzoe adds,

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and in certain situations, automatic enrollment will exclude a plan from the top heavy rules.

Companies with qualified plans that meet certain requirements receive a safe harbor exemption from the actual deferral percentage and actual contribution percentage requirements, he says.

In addition to the benefit that it brings to employees who will be helped to save, this is an added inducement for companies to add this feature, Itzoe says.

For employees enrolled through automatic enrollment, each employee must be treated as if he or she elected to defer at least 3% in the first year; at least 4% in the second year; at least 5% in year 3; and 6% in any subsequent year, he says.

A higher percentage may be selected, but the selected percentage may not exceed 10%.

These requirements do not apply to employees who are already active participants, Itzoe explains.

There also has to be a match of 100% of the first 1% of pay plus 50% of the next 5% of pay, he continues. Or, according to Itzoe, at least 3% of non-elected contributions have to be provided, and there needs to be vesting of 100% no more than 2 years after an employee is enrolled.

Then a company is deemed to have met the top heavy requirement and the ADP/ACP requirements, Itzoe says.

“What I believe will happen going forward is that more and more companies will use the automatic enrollment feature, he continues.

Another “important point,” says Itzoe, is to note that the plan need to have a qualified default investment option that provides options for those participants who do not know how to allocate their accounts.

Jason Abosch, a financial advisor with Franklin Morris, Baltimore, Md., recently put together a non-deferred comp plan that provides additional executive compensation while complying with non-discrimination rules.

The current law, he says has 3 new requirements: a restriction on distribution, on accelerated payments, and on election distributions.

With regard to distribution restrictions, deferred comp cannot be distributed except for the following reasons:

- 1-separation of service;
- 2-disability;
- 3-death;
- 4-specified time in the agreement;
- 5-change in control of the corporation;
- 6-change in control of the corporation;
- 7-unforeseeable emergency which is defined as a severe financial hardship which results in illness or from an accident involving a spouse or dependent or a loss of property due to casualty or some other unforeseeable circumstance.

For companies trying to provide additional compensation for highly compensated employees, the plan that works best will depend on the business factors such as how much cash is set aside and a business' cash flow.

One good program, Abosch says, is a Supplemental Executive Retirement Program that is designed to retain key employees. The amount set aside is not taxable until the employee receives it, at which point the employer gets a deduction and the employee gets taxed. The tax treatment is at the ordinary income rate, Abosch continues. At retirement, the employee is usually in a lower income bracket, he notes.

Although there are new regulations, he says, the existing SERP plans are still viable. They may just need to be modified, Abosch continues.

Companies can still use split dollar programs but the new regulations could make these less popular. The new requirements, Abosch explains, were designed to minimize abuses. For instance, previously, in some plans, if there was a separation of service, then funds would be made available at a lower rate.

In addition to non-qualified deferred compensation programs, these financial advisors offered other ways for highly compensated employees to save beyond the limits imposed by discrimination requirements.

Limoges Investment's Middleton says that another option he likes is the tax-efficient exchange-traded funds.

There are times when an annuity could be used, he allows. But he says he doesn't think that this is the best option because with an annuity, the dollars paid upfront are usually after-tax and the dollars are then tax-deferred. With the ETF, however, the dollars are taxed at a capital gain rate of 15%, Middleton continues.

In addition to ETFs, another option would be tax-managed mutual funds, he adds.

Georgia Bruggeman, a financial advisor with Meridian Financial Advisors, Holliston, Mass., cites non-qualified deferred compensation plans as one option for highly compensated employees in top-heavy plans. But, she notes, there is always the alternative of buying index funds and letting them grow with after-tax money. The benefits, he says, are low turnover and low dividends taxed at 15% maximum.

This type of investing is better than investing in annuities, he says, because with annuities the person is taxed at ordinary rates on gains whereas with the index funds, the person is taxed at a maximum of a 15% capital gains rate.

"People get stuck on 'retirement plans' and think they are the only way to save for retirement. They forget that every dollar withdrawn from a 401k or IRA rollover will be taxed at ordinary rates rather than the low 15% max on long term gains and dividends," Bruggeman notes.

Joe Stenken, who contributed to this article, is an assistant editor with Tax Facts, a publication of National Underwriter Company, which is a division of Highline Media which also publishes Income Planning and its parent, National Underwriter Life & Health. Jim Connolly is feature writer for Income Planning and senior editor for National Underwriter L&H.

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