

FILLING THE RETIREMENT GAP

How can not-for-profit entities compete for top talent?

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Recent studies suggest that individuals will need 80% of their pre-retirement income to maintain their current lifestyle after retirement. Qualified retirement plans provide a tax-smart way to save for retirement, but qualified plans have limitations that prevent highly-compensated individuals from reaching their retirement income goals. Those limitations have traditionally been overcome through the use of nonqualified plans. However, not-for-profit organizations cannot offer many of the retirement benefits available to corporate America. These issues bring up two important questions for not-for-profit entities:

1. How can we compete with private practice groups and corporate America for top talent?
2. How can our key employees “fill their retirement gap” to reach their retirement income goals?

To answer these questions, we first have to review the three phases of retirement planning.

Three Phases of Your Retirement Planning:

#1 – Contribution Phase

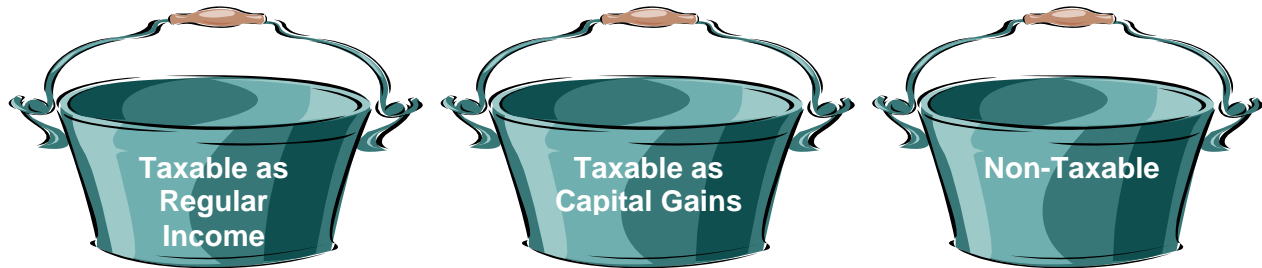
During the contribution phase an individual faces a number of decisions. Not only does an individual need to decide how much to contribute, he must decide whether these contributions should be made pre-tax, after-tax, or a combination of both. Qualified plans have limits further complicating the issue. Although pre-tax investments have always been touted as being better than after-tax, this is not always the case. At an early age one learns that, “a penny saved is a penny earned”, but how that penny is saved is probably just as important as the act of saving itself.

#2 – Accumulation Phase

An individual’s retirement lifestyle is directly impacted by the rate at which the money grows during the accumulation period. Modern Portfolio Theory subscribes to the importance of diversification. Diversification is why individuals invest in mutual funds. Since the wise adage is never to “put all our eggs in one basket”, this course of action makes perfect sense.

#3 – Distribution Phase

Funds available for distribution typically fall into one of three “buckets”:



Diversification in tax treatment during the distribution phase is just as important as diversification in the allocation of funds. Some portion of an individual’s investments should be inside a “non-taxable bucket” designed to provide a hedge against higher tax rates; so if tax rates increase, distributions can be taken from the bucket in which taxes have already been paid.

Since no one can accurately predict future tax rates, it is important that accumulated wealth should not be dependent on any single asset or assumption. Every time income tax rates increase, the value of taxable accounts decrease. An increase in the top tax rate from 35% to 52.5% reduces your distribution assumptions by roughly 50%. Retirement age is a terrible time to be forced to reduce distributions.

Conclusion:

What is understood from the phases of retirement money (above) is the need for:

- 1) Asset Diversity - How investments are allocated.
- 2) Tax Diversity - When investments are taxed.

With these diversification tools in mind, consider the alternatives for “filling the retirement gap”.

Not-for-Profit Vehicles for “Filling the Retirement Gap”

For many years, not-for-profit entities have found ways to compete with private practice groups and corporate America by offering benefits exclusively available to tax-exempt organizations (i.e., 457 plans) and additional benefits such as Split Dollar plans. However, recent regulations have retracted some advantages of both 457(f) plans and Split Dollar plans and not-for-profit entities are looking for any available alternatives.

#1 – 457(f) Plans

Not-for-profit entities have developed 457(f) plans to allow their key employees to defer their salaries and bonuses beyond the limits of 401(k)/403(b) plans. Contributions are made pre-tax and enjoy tax-deferred growth. A mandated, what the IRS labels “a substantial risk of forfeiture” requirement, whereby under certain circumstances the participant is at risk of losing his money, takes a little luster off this plan’s shine. Once this risk is gone (unrestricted access to funds), the entire balance is immediately subject to taxation.

Although the recent passage of 409A does not discredit this vehicle completely, it has reduced the desire to participate to the same extent as before passage. New guidelines limit the flexibility for participants to plan when they have full access to their money, thus limiting their ability for efficient tax planning. Vehicles such as “not to compete” clauses no longer satisfy “substantial risk of forfeiture” requirements, leaving the participant with limited viable options. The participant can:

- 1) Fail to meet 409A requirements and face severe penalties (income tax, plus 20% excise tax, plus interest on unpaid taxes back to deferral date).
- 2) Liquidate the 457(f) plan account and pay the taxes.
- 3) Defer the taxes by remaining “unvested” and leaving total amount deferred at risk.

#2 – Split Dollar Plans

In its most common form, a Split Dollar plan offers the participant a life insurance policy paid for by the employer. The employer pays premiums into the policy, which the participant owns and names his own beneficiary. In so doing, the employer provides an “interest-free loan” to the participant. The participant assigns the cash value in the policy to the corporation as collateral until the loan is repaid. At retirement, or the participant’s death, the employer receives the amount equal to premiums paid out of the policy values or death proceeds.

Under the old rules, the participant was required to recognize the value of the death benefit as income each year based on the Economic Benefit cost, which usually equaled the cost of 1-year Term insurance – a very low cost to the participant. Recent regulations have changed the tax treatment of split dollar plans by characterizing the employer-paid premiums as a loan, and taxing the employee on any foregone interest on that loan. A standard market interest rate is attached to the loan amount (total premiums paid) and the participant must pay taxes due each year based on the interest rate on the total loan balance. Therefore, each year the participant’s tax liability increases as the total premium amount increases.

The key employees of many not-for-profit organizations currently hold policies under a split dollar design. How are they to be treated? There are essentially two options:

- 1) Hold the policies - The employer can continue to maintain these split dollar contracts and participants can continue paying taxes on the stated interest on all premiums paid.
- 2) Terminate the policies - The employer can terminate and surrender the policies and release the cash surrender values in the policies to the participants. The participants would then pay taxes on all premiums paid from the origination of the plan.

#3 – The ISOP[®]

Many not-for-profits are exploring an alternative known as the ISOP[®] as a solution to the limited options available in 457(f) and split dollar plans.

What is the ISOP[®]?

The Insured Security Option Plan (ISOP[®]) is a proprietary product offered exclusively through Retirement Capital Group. The ISOP[®] is an alternative that provides the opportunity for individuals to supplement their retirement income. It provides the power of pre-tax savings and tax-deferred growth, without the limits imposed by qualified plans.

The ISOP[®]:

- Provides pre-tax saving power without contribution limits, age restrictions, or early withdrawal penalties imposed by qualified retirement savings plans.
- Provides benefit security by protecting investments from the risk of forfeiture through an after-tax trust.
- Provides protection against increasing tax rates, as an “after-tax” plan.
- Participants access 50+ investment alternatives, called “sub-accounts”, from fund managers like American Funds, Fidelity, Scudder, and more.
- Participants self-direct their accounts online, 24/7, at www.deferral.com.
- Administrative costs are minimal compared with other benefit programs
- Is a voluntary financial benefit plan that is not subject to the new regulations imposed under IRC 409A, or if plan sponsor so chooses, to ERISA.

In short, the ISOP[®] helps the highly-compensated work toward tax and asset diversification and financial independence.

How does the ISOP[®] work?

Using a unique, institutionally priced variable universal life insurance policy, the ISOP[®] provides a mechanism allowing the participant to create the power of pre-tax contributions.

Assume an individual would like to invest \$100,000 of annual earnings. After paying taxes (assume the individual's tax bracket requires 40%), \$60,000 remains to be invested. If the participant chooses, a unique policy rider may be accessed in the amount of \$40,000 to remain in the policy, bringing total premium back up to \$100,000.

The \$40,000 added by the carrier is a non-recourse "policy loan"^(a), however, assuming the policy is held until maturity, the participant does not pay it back until death^(b) – it is simply deducted from the policy's death benefit upon the participant's death. The policy loan's interest rate or carrying charge is just an indexed 90-day LIBOR + 1.5% (LIBOR – 5.5% on 7/24/06), which is roughly the Prime rate minus 1.5%.

Here is an example of a 45 year-old investing for 7 years, earning returns of 8%/year:

Summary at End-of-Year 7th Plan Year (Current Age 45)							
Gross Amount Contributed Annually	After-Tax Amount Contributed Annually	Annual Amount of Insurance Carrier Policy Loan	Interest Rate on Policy Loan	Gross Cash Value of The Policy	Gross Death Benefit	Net Death Benefit (After Policy Loan Re-Paid)*	Projected Non-Taxable Income Stream Starting at Retirement (Age 65)**
Assumed 8% Earnings Rate, Current Policy Mortality & Policy Charges							
\$100,000	\$60,000	\$40,000	LIBOR + 1.5%	\$870,605	\$2,081,604	\$1,733,225	\$142,927
x 7 Years	x 7 Years	\$280,000	(e.g. LIBOR - 5.50% on 7/24/06)	End-of-Year 7	End-of-Year 7	End-of-Year 7	Total Over 15 Years: \$2,143,905
Assumed 0% Earnings Rate, Guaranteed Policy Mortality & Policy Charges							
\$100,000	\$60,000	\$40,000	LIBOR + 1.5%	\$545,446	\$1,773,024	\$1,424,621	\$0
x 7 Years	x 7 Years	\$280,000	(e.g. LIBOR - 5.50% on 7/24/06)	End-of-Year 7	End-of-Year 7	End-of-Year 7	Policy Lapses at Age 66
Additional Options at Retirement							
<input type="checkbox"/> Lump Sum <input type="checkbox"/> Tax-Free Death Benefit <input type="checkbox"/> Any Combination							

*This is net of fees and expenses within the policy, including policy loan and interest on policy loan.

**Assumed retirement age 65. Withdrawals up to basis switching to policy loans. If withdrawals go over basis, they are subject to taxation.

Note: This hypothetical variable life insurance illustration is based on the assumptions presented and shows how the performance of underlying accounts could affect a policy's cash value and death benefits and should not be used to predict or project investment results. Loans, interest accruing on loans, and withdrawals reduce available cash value and reduce the death benefit or cause the policy to lapse. Actual returns may vary.

- (a) Initial amount limited to a maximum of 50% of total premium. Loan balance must maintain a loan-to-cash value of no greater than 65% or an automatic transfer from the separate accounts to the money market account will occur.
- (b) Loan amounts and unpaid interest are paid out-of-death proceeds balance to be paid to beneficiary.

In this illustration of the ISOP[®] we find the following:

- If a participant never contributed to the plan again after the 7th year...
- And the participant elected to receive the \$143,000/year beginning in year 20, and for 15 years...
- The participant would receive approximately \$2,100,000 in his lifetime, plus provide his named beneficiary with an additional \$1,700,000 upon his death (assumes death at age 82).
- All for an invested amount of \$420,000 over the first seven years.

Investors should consider the investment objectives, risks, charges, and expenses of Lincoln Corporate Variable 5 life insurance policy carefully before investing. This presentation must be accompanied by or preceded with a current prospectus. Please read the prospectus carefully before investing.

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