

Do You Have a Pre-Tax Cash Management Account for Your Key Executives?

David Stecher CPA, CFP, CLU, ChFC
 Executive Vice President
 Retirement Capital Group, Inc.

First of all, what is a Pre-Tax Cash Management Account (PTCMA)? A PTCMA is simply an IRC § 409A-compliant deferred compensation plan that has the attractiveness of widely used after-tax cash management accounts (ATCMA). Every highly compensated executive who earns more than they spend utilizes some form of ATCMA. Whether it is through their bank, brokerage house, financial planner or investment advisor, executives must put their money somewhere and usually it's in an ATCMA (hopefully not the mattress).

So why would highly compensated employees be interested in pre-tax savings? The reason is they are essentially using the tax dollars that would have gone to Uncle Sam to enhance the amount of after-tax assets that will be used to address unfunded personal liabilities in the future. In addition, a PTCMA is not subject to income tax on current earnings. Therefore, all of the annual gains and/or interest earned in the account are available to continuously compound. Pre-tax savings coupled with tax-deferred growth provides for substantially more dollars available to address needs like children's education, home purchases, childcare, and providing care to aging parents.

Typically the question asked is, "What happens if tax rates go up?" Table 1 illustrates how many years it would take for the advantages of pre-tax deferrals to be realized in an increasing tax environment.

Table 1

Year Until Breakeven for Deferred Compensation vs. Personal Investment Assuming Tax Rates Increase

Current Tax Rate: 40%

		Projected Tax Rate			
		45.00%	50.00%	55.00%	60.00%
Pre-Tax Yield	Number of Years to Breakeven				
3.00%	7.42	15.56	24.55	34.60	
4.00%	5.61	11.76	18.56	26.15	
5.00%	4.52	9.48	14.96	21.08	
6.00%	3.80	7.96	12.56	17.70	
7.00%	3.28	6.88	10.85	15.29	
8.00%	2.89	6.06	9.56	13.48	
9.00%	2.59	5.43	8.57	12.07	
10.00%	2.35	4.92	7.77	10.95	
11.00%	2.15	4.51	7.11	10.02	
12.00%	1.99	4.16	6.57	9.26	
13.00%	1.85	3.87	6.11	8.61	

In order for a company to develop a PTCMA, the following areas must be considered:

1. Plan Design
2. Investment Strategy
3. Corporate Funding of the Plan Liability
4. Education and Communication of Executives
5. Administration of the Plan

PLAN DESIGN

IRC § 409A provides the roadmap to available plan design and parameters. A great degree of flexibility is provided to plan sponsors within § 409A. In the eyes of the highly compensated employee, the lack of flexibility equals increased risk; conversely, increased plan flexibility decreases risk. The initial provision to consider is: "How does an executive get money out of the PTCMA?" The more flexible the distribution options, the less risky the plan. The dates of distribution must be determined when an executive initially elects to defer or contribute salary and bonus to their account.

The election to defer salary must be made prior to the year in which the salary is earned, usually in the months of November and December. Bonus deferral elections are treated separately and typically need to be made 6 months prior to the end of the bonus period; usually by June 30th.

Once an executive determines how much to contribute, the next step is to determine when to access the funds – see Table 2 for a typical deferral election.

Table 2

Example:

Participant: Age 40 - 2 Children, Ages 13 & 11

Base Salary: \$175,000	Salary Deferral: 12%	Deferral Amount: \$21,000
Bonus: \$100,000	Bonus Deferral: 20%	Deferral Amount: \$20,000
Total Deferral:		\$41,000

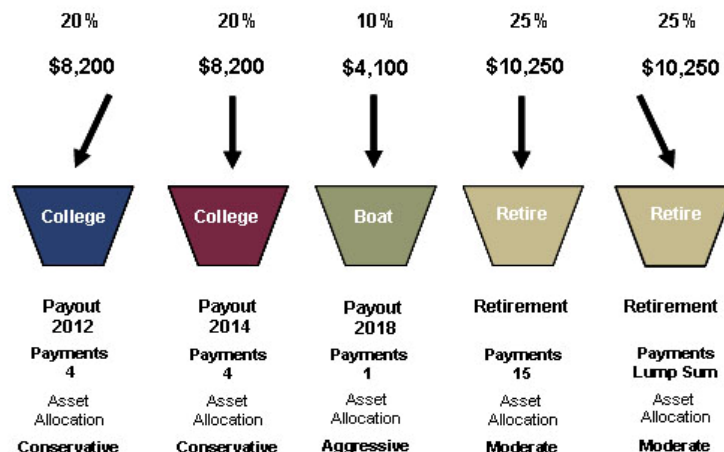


Table 2 illustrates a typical PTCMA deferral and distribution strategy. It is helpful to look at the situation from the perspective of the executive. When he or she goes through a financial planning exercise, the financial planner will assess the following:

1. Current income
2. Expenses
3. Future liabilities/goals
4. Appetite for Investment Risk

The difference between income and expenses dictates dollars available for savings (either pre-tax or after-tax). Quantifying the future unfunded liabilities determines when the employee will need to access the funds in the PTCMA. The assessment of investment risk will dictate the appropriate asset allocation for each sub-account, also commonly referred to as “buckets.”

When designing a PTCMA, the risk of losing the account must be considered. The fact that these accounts are non-qualified deferred compensation plans, and as such, must be subject to the claims of corporate creditors in the event of corporate insolvency must be remembered. A Rabbi Trust is recommended to limit other risk issues such as:

1. Change of future management
2. Change of heart of current management
3. Financial hardship short of insolvency
4. Change of control

A Rabbi Trust is practically worthless if it is not funded. Therefore, we recommend that the sponsoring company establish a corporate resolution to always maintain sufficient assets in the trust in order to pay all outstanding participant liabilities.

INVESTMENT STRATEGY

“What type of investments would attract your money?” When the highly compensated employee utilizes a financial planner, the planner initiates an investment strategy specifically for his or her client. We recommend a similar approach:

1. Construct a general investment menu utilizing a diverse array of asset classes.
2. Select mutual funds that have low costs, high-risk adjusted returns and consistent management.
3. Utilize an internal investment committee or third-party investment advisor to monitor the investment selection.
4. From the selected investments, construct “risk-based model portfolios” allowing participants to select from conservative to aggressive asset allocations for each distribution account. These accounts should be monitored and rebalanced monthly.
5. For the “do-it-yourself” investor, also offer monthly monitoring and re-balancing of the selected asset allocation.

CORPORATE FUNDING OF THE PLAN LIABILITY

Once the PTCMAs have been established, the sponsoring company must determine how to hedge these liabilities. If the company is a current taxpayer, Corporate Owned Life Insurance (COLI) is usually the most economic hedge. If not, institutional mutual funds provide a good solution. The cost of the mutual fund alternative would be the income taxes due on the mutual fund gains in the current period. The costs of owning COLI are the insurance and administrative charges within the policy. A simple comparison of the related costs will highlight the preferred solution.

EDUCATION AND COMMUNICATION

After taking the time to design and implement a PTCMA, it is equally important to ensure that it is adequately communicated and understood.

Designing and implementing a participant website is essential for proper communication and monitoring. The site should be available 24/7 and provide:

1. PTCMA access
2. Changes in asset allocation
3. Basic Plan Q&A
4. Fund information
5. Secured access for employees' advisors
6. Financial planning and asset allocation tools

Ideally, participants should also have access to a call center for basic questions, as well as access to investment advisors for asset allocation advice. Education can be provided economically through a multi-media approach using web casts, video conferencing and conference calls.

ADMINISTRATION

Since the PTCMA is a § 409A compliant deferred plan, it is essential to provide integrated plan design, investment monitoring, asset liability hedging and participant communication and education. A variety of administration platforms are available, depending on the size and complexity of the plan. When considering an administrator, examine the following needs within your company:

1. The need of human resources for daily participant information.
2. The need of payroll to upload participant deferral information and to administer participant distributors.
3. The need of finance and treasury to monitor assets and liabilities on a daily basis.
4. The need of accounting to properly record the income, expense, assets, and liabilities of the plan.

All of this entails a great deal of effort, but with the proper administrative system the majority of the work is outsourced.

CONCLUSION

Highly compensated executives are contributing billions of dollars per year to after-tax cash management accounts. Employers now have the tools to provide a low-cost benefit to these executives by allowing them to contribute to pre-tax cash management accounts.

Investors should discuss their own unique situation with their tax and financial professionals. RCG does not give legal or tax advice and the opinions presented in these materials should not be construed as such. All examples are hypothetical and not intended to represent any specific investment.

Investors should consider the investment objectives, risks and charges and expenses of the contract and underlying investment options, risks carefully before investing. The prospectus contains this and other information about the investment company and must precede or accompany this material. Please be sure to read it carefully.