

New Wrinkles in Executive Benefits

Maximizing Your Retirement Income for a Longer Life

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Previous newsletters introduced the Executive Roth/Professional Roth Plan program (hereinafter referred to as “ERP”) from Retirement Capital Group Inc. (RCG). This article discusses methods for incorporating the ERP into a dynamic, long-term personal financial plan.

First, a brief review of ERP:

The ERP is flexible and self-directed. Company-sponsored, it provides tax-advantaged wealth accumulation and retirement savings. The ERP is specifically designed for the highly compensated professionals and executives who are confronted with discriminatory retirement funding hurdles and the other legislative limits of traditional retirement and 401(k) plans. The ERP can fill the gap where these plans fall short in providing adequate resources for retirement. Not subject to regulatory restrictions of traditional plans, the ERP also provides these additional features:

- Tax-deferred investment growth and non-taxable withdrawals of an individual’s after-tax contributions
- No contribution limits, age restrictions, or early withdrawal penalties
- Funded through payroll deductions
- Income tax-free, lump sum death benefit
- Unlike IRAs and 401(k) plans, distributions made prior to age 59½ are not subject to tax penalty
- No requirement to begin income distributions by a preset or arbitrary age
- Flexibility to modify contributions and distributions; there is a wide range of competitive investment choices from top asset managers that include American Funds, Fidelity, Franklin Templeton, Vanguard, and others
- A proprietary “tax replacement feature” is available to restore taxes on after-tax contributions which effectively allows earnings to be credited on the full pre-tax amount deposited, comparable to nonqualified deferred compensation or 401(k) plan
- Fully portable and protected from the claims of the employer’s creditors

- For the employer, the ERP is very simple and straightforward administratively. Furthermore, it is not subject to the new IRC § 409A regulations. There is no P&L expense or balance sheet liability. Because the contribution comes from the employee's after-tax income, the contributions remain tax-deductible to the employer.

The structure, or chassis, supporting the ERP is a variable universal life (VUL) insurance policy issued by The Lincoln National Life Insurance Company, which is available only through an employer-sponsored executive benefits program.

Key features of the policy include:

- Institutional pricing not typically available to individuals and "guaranteed issue" underwriting
- Executive mortality charges (not retail pricing) and no surrender charges
- Reduced administrative charges
- Superior performance including 100%+ cash value at the end of year 1
- A dedicated policy administration system that manages on-going policy adjustments to minimize mortality and other monthly charges
- A unique policy "tax replacement" arrangement that allows a participant to leverage their after-tax contributions

Retirement planning highlights the importance of investment portfolio diversification, whether to minimize risk or to spread the sources of income between that taxed as ordinary income (e.g., 401(k) assets), capital gains (e.g., equities), or non-taxable income (e.g., ERP).

Specifically, the importance of planning for safer post-retirement income tax treatment is illustrated by the following fact: An increase in the top tax rate from 35% to 50% could reduce retirement income distribution from a taxable account by roughly 25% per year. Maintaining at least a portion of retirement investments in an account that is insulated from creditors and offers income tax-free distributions will provide a hedge against higher tax rates in the future.

This strategy also offers flexibility for future distributions should future tax law result in the unlikely scenario of a lower post-retirement tax rate, in which case an executive can pull most or all needed income from a "taxable as regular income" bucket while still having the non-taxable bucket available. In any event, with life expectancies increasing, having a diversified distribution strategy will provide the flexibility needed by tomorrow's retirees.

Of the three sources of income, the ERP may be the vehicle with the most flexibility, offering options to provide a reliable and steady source of cash to

fund certain future expenses that are often overlooked, especially long-term healthcare.

Why Should You Plan?

Retirees need a customized plan to provide the resources that will allow them to negotiate the twists and turns of life and market fluctuations. Their plan must be durable enough to withstand the many unknowns, including the rate at which taxes and inflation will force increased withdrawal amounts and extraordinary capital market turmoil.

Furthermore, the traditional notion of a 20-year retirement has become obsolete based on the following statistics: As of 2000, men reaching the age of 65 had a 50% chance of living past their 85th birthday and a 25% chance of living beyond 92. Women reaching age 65 have a 50% chance of living beyond 88 and a 25% chance of living beyond 94.

Retirement is a life-changing event. The primary emotion is apprehension as people wonder if they will be able to live out their remaining years comfortably without earned income. Even the wealthy are not exempt from this anxiety. In a recent study, roughly 60% of the respondents with \$5 million or more in investable assets admitted concerns about meeting needs in retirement.

Why? Social Security is facing a huge potential deficit and the once-stalwart defined-benefit pension plan has become obsolete, replaced by plans that have shifted the responsibility for providing adequate retirement income to the employee. Meanwhile, longevity keeps increasing, placing more pressure on retirement portfolios to perform.

Finally, there is the dreaded cost of healthcare. According to the U.S. Department of Health and Human Services (HHS), at least 60 percent of people over 65 will require some long-term care services at some point in their lives. And, contrary to what many people believe, Medicare and private health insurance do not pay for the majority of needed long-term care services.

This point emphasizes the essential need for adequate planning. Long-term care is expensive. Based on the 2007 national average, one year in a nursing home costs over \$66,000 for a semi-private room.

A brief examination of who needs LTC insurance may be appropriate.

Case Study A

John Q. Executive is age 50, married, and has three children ages 17, 14, and 11. He enjoys a salary of \$200,000, and a yearly bonus of \$50,000. He participates in the company 401(k) and has a balance of \$125,000; he also has an IRA from a prior employer that has a balance of \$75,000. There is no company-defined benefit pension plan; however, he does have stock options worth \$150,000. The company has converted John's former nonqualified deferred compensation plan into an Executive Roth and transferred \$50,000 of balances into the new plan. John contributes \$25,000 annually to the ERP after-tax. His personal assets in mutual funds and individual stocks have a current value of \$120,000.

- The company has introduced a new voluntary Long-Term Care Plan insurance plan for executives and their spouses. Because the plan is sponsored by the company, the policy is issued on a guaranteed basis, meaning no medical underwriting requirements are needed. John elects to participate and include his spouse. The annual premium for both policies is \$12,000 and is paid through payroll deduction. The policy is paid-up in 20 years.
 - The plan provides benefits for life, and the monthly benefit is \$6,000 for both John and his spouse.
 - The plan also provides for a 5% inflation factor.
- John's objective is to retire at age 60 and pay premiums for the long-term care policies with distributions made from his Executive Roth until premiums are paid up at age 70. After he retires, he also intends to teach at the local university until age 70.
- John's projected assets at age 60 from his plans are as follows:
 - 401(k)/\$500,000
 - IRA/\$200,000
 - Personal Assets/\$300,000
 - Stock Option Value/\$300,000
 - Executive Roth Plan/\$300,000
 - Total assets/\$1,600,000
- Withdrawals from ERP will fund the premium for the Long-Term Care insurance and the income shortfall while teaching. Other assets are projected to increase to over \$2,000,000 by age 70, at which time the premiums for their Long-Term Care policies will be fully paid. John's income from Social Security and his investment accounts will yield approximately \$180,000 a year without invading principal. In the

event either or both John and his spouse require long-term care assistance, their assets will be protected.

Case Study B

George is a 60-year-old senior manager with a major industrial company that has seen major reorganizational changes in the past several years. George is married and has four grown children, all of whom he financed through college. George plans to retire at age 65 with a defined benefit pension plan and a 401(k) plan. His pension plan will provide an income of approximately \$55,000 and his 401(k) is projected to have a value of approximately \$500,000, which should yield approximately \$40,000 annually. His personal assets are modest because George funded 100% of his children's college costs, but still should yield about \$12,000 annually. George feels he and his spouse can live reasonably well on Social Security, his pension, and his 401(k), but he is concerned about the possible need for long-term care.

- His company has introduced him to a new “after-tax savings plan” called the Executive Roth. The balance in the plan can be distributed to him at his discretion when he determines he requires the income, as the plan does not require him to set a date for such distributions.
- His company, at the same time, introduces a plan that will allow him and his spouse to purchase—through a guaranteed issue arrangement—a special “Long-Term Care” plan designed for families desiring to protect their assets as well as to provide resources to fund expenses associated with conditions of aging.
- After much discussion, George and his spouse applied for the long-term care policy that will ensure them financial independence from their children and from the government. The plan provides benefits for 5 years at a benefit level of \$6,000 per month. The premiums are \$20,000 annually for both policies and will be paid up in 10 years. George can fund the premiums before retirement through a payroll deduction plan, but he is concerned about the cost after retirement. His company will contribute 25% of the cost of the LTC policies.
- George decides to participate in the ERP and the LTC, although it will be a stretch. The premiums for the LTC are approximately \$1,666 monthly and the contributions for the ERP are \$2,500 monthly.
- However, when George retires in 5 years he will have two outstanding benefits available to supplement his retirement plans:
 - First, he will have accumulated approximately \$180,000 of cash in his ERP plan, which may be used to fund the balance of the premiums due on his LTC policy.

- Second, he will maintain a life insurance benefit of approximately \$300,000, which will guarantee his spouse comfort and support if he predeceases her.
- When George retires in 5 years, the \$1,666 per month will be funded from withdrawals made from the ERP; however, based on a conservative estimate of returns, the principle in the ERP will continue to increase in value after the funding of the LTC policy is satisfied, and George will still maintain a substantial life insurance benefit for his beneficiaries.

Case Study C

The third and last case study involves a physician who is employed by a large medical school in the Midwest. His name is Dr. Suture. He is 55 years old and has been practicing medicine for 25 years. Until recently, the medical school has provided him with a \$1,000,000 Split Dollar Life Insurance Program. New legislation and IRS regulations no longer allow Split Dollar to receive the favorable tax treatment once believed to be available. The hospital wants to provide Dr. Suture with a benefit plan that will continue to be attractive and tax-efficient. After much deliberation and study, the school decided to provide Dr. Suture with two benefit plans that he would have difficulty securing on his own:

- The first plan involves an annual contribution of \$100,000 to a Professional Roth Plan. This contribution will increase by 25% per year until age 65. Should Dr. Suture leave prior to age 65, he will own and control the values that have accumulated to that point and will forfeit all future contributions. The plan also allows Dr. Suture to make supplemental voluntary contributions to the plan at his discretion.
- The second plan involves purchasing two additional insurance contacts for him.
 - The first contact is a disability income policy that will provide income benefits of 75% of his income should he become disabled. The premiums will be 100% funded by the medical school and will be paid until he reaches retirement at age 65. The plan is issued under a guaranteed issue program and the premium is \$18,000, which is not included in Dr. Suture's taxable income.
 - The second contact is a Long-Term Care policy providing benefits for both himself and his spouse in the amount of \$8,000 per month beginning 90 days after he or his wife are deemed eligible to receive benefits. The policy provides for an inflation rider of 5%. The premiums are payable for 20 years, at which time both policies will be paid up. The hospital will pay 100% of the cost of both policies while Dr. Suture is employed. His premiums will not

be included in his taxable income, but the cost of his spouse's will be taxable to him.

- Because the premiums are payable for 20 years, after his retirement he will be responsible for the premiums for the remaining period of 10 years. He intends to fund these premiums using withdrawals from his PRP.
- It is projected that the PRP funded by the medical school plus his supplemental contributions will have a value of approximately \$3,000,000. This account will generate annual income of approximately \$250,000 while preserving a life insurance benefit of approximately \$6,000,000.
- He estimates his personal assets will provide for any additional income requirement that he and his spouse may require. He also anticipates making gifts to his children and grandchildren as well as to the medical school.

In each of the above case examples, the Executive Roth played an integral part in aiding the individuals in accomplishing their independent financial goals with dignity and confidence.

The purpose of this article was to show how the Executive Roth can be used in conjunction with a personal financial plan to create a sound long-term financial plan for individuals planning for their retirement. The essential ingredients of the plan in each of the sample cases involved the following characteristics:

- First, the plan could not take place without the support and sponsorship of an employer who is willing and able to offer the planning components of the ERP/PRP and the Long-Term Care insurance programs.
- Second, the ERP/PRP is designed to provide maximum flexibility to the owner of the contract. Unlike traditional deferred compensation, 457(f), or even qualified plans, the ERP/PRP allows the participant to choose when and how much income he/she may require without the burden of having to make these decisions years in advance of the necessity.
- Third, the tax deferral of earnings and the non-taxable distributions create the necessary leverage to support and maintain a healthy lifestyle while providing access to funds necessary to pay for vital insurance coverage after retirement. This financial freedom will aid in fostering the enjoyment of a well deserved retirement.

In summary, a well designed ERP will not only provide the supplemental retirement income required for a long and healthy post-retirement, it will also provide a source of premiums for the long-term care insurance that can be relied on when a retiree's health fails.