LAGOS WEALTH ADVISORS
BUILDING, PROTECTING AND PERPETUATING FAMILY WEALTH

VOLUME 19, ISSUE 12

# ADVISOR'S BULLETIN

## WHAT'S IN THIS MONTH'S NEWSLETTER

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## WHAT EVERY LIFE INSURANCE PROFESSIONAL NEEDS TO KNOW ABOUT DEFERRED COMPENSATION AND SECTION 409A

### A MESSAGE FROM MICHAEL W. LAGOS, CFP®

Dear Strategic Advisor:

Our business-owner clients often use life insurance as the basis for sweetening the compensation package of one or more key employees.

If an entrepreneur client is a candidate for implementing a life insurance-based employee benefit in her business, she usually chooses between

- a bonus plan,
- a split-dollar plan, and
- some kind of deferred compensation plan.

Deferred compensation plans come in all sorts of variants. One kind is a Section 457 plan—available only to government entities or nonprofits—in which the most significant contribution component is employee salary deferrals.

Life insurance professionals are much more likely to deal with deferred compensation plans that are funded entirely with employer money. Such plans are direct alternatives to bonus arrangements. While a bonus arrangement has the advantages of an immediate tax deduction for the business and ease of administration, deferred compensation gives the employer much more control over whether and how the employee benefit is ultimately paid.

In 2005, Section 409A of the Internal Revenue Code was implemented. Its primary purpose was to fight perceived tax abuses in the implementation and administration of deferred compensation plans. The code section imposed significant penalties on the employee participants when the employer failed to comply with the requirements of Section 409A.

In the 15 years since the original effective date of Section 409A, its scope and effect have evolved. Life insurance professionals who promote plans with deferred compensation elements need to be familiar with its provisions and nuances to better advise their clients.

Regards,
Michael W. Lagos, CFP®

## WHAT EVERY LIFE INSURANCE PROFESSIONAL NEEDS TO KNOW ABOUT DEFERRED COMPENSATION AND SECTION 409A

**Deferred Compensation**

The variations on deferred compensation are nearly endless. Life insurance professionals tend to focus on deferred compensation configurations that

- have characteristics similar to bonus arrangements and
- center around the use of permanent life insurance as the funding vehicle.

**SERP**

One of the drawbacks of bonus plans that business owners complain about is the inability of the company to take back the life insurance policy in the event the key employee leaves early. The direct alternative that answers the bonus plan drawback is a kind of deferred compensation plan sometimes called a supplemental employee retirement plan (SERP). Nearly all life insurance-based deferred compensation plans are designed as SERPs.

**HOW THEY WORK**

1. The corporation enters into an attorney-drafted salary continuation agreement with the key executive. The agreement spells out benefits to be provided if the executive fulfills certain conditions, such as remaining with the corporation until retirement. The employer's obligation to pay is NOT directly tied to the life insurance coverage.

2. The business purchases sufficient insurance on the key executive's life

- to indirectly fund the after-tax cost of the promised benefits or
- to recover its premium costs or
- to cover the cost of both benefits and premiums.

3. The life insurance policy is owned by the corporation, which pays the premiums and is the named beneficiary.

4. When the benefit payout is triggered by retirement, death or otherwise, the payout made by the employer is tax deductible and income taxable to the employer or his family. The company may recover the costs of paying out the benefit from the life insurance policy's cash values or death benefit.

**VARIANTS**

There are a number of different ways to design SERPs. For example:

- The plan may provide for a preretirement death benefit payable to the key employee's beneficiaries rather than a supplemental retirement benefit. Such plans are usually called death benefit only (DBO) plans.

- The plan may provide for a stream of income for the employee at retirement.

- The plan may provide for a lump-sum payment at retirement or after a period of years.
- There is almost complete flexibility regarding design of a vesting schedule.
- The plan may be designed with a defined benefit-type payout, or it may be designed in a defined contribution (401k-like) style.

**TAX CHARACTERISTICS**

SERPs have two main tax features that are keys to deciding whether it's the right fit for a particular situation:

1. While the key employee generally does not recognize income on the SERP benefit until it is paid, the employer does not get a tax deduction for amounts it sets aside now to pay deferred benefits later.

2. The employer is generally able to deduct SERP benefits when they are paid. The employee likewise usually pays income tax on SERP benefits when received.

While those general rules are pretty simple, employers and employees must navigate some highly technical potential pitfalls in a successful SERP implementation.

- Constructive receipt issues
- Substantial risk of forfeiture issues
- Section 409A issues

For these reasons, which we will describe in more detail below, it is essential that the SERP agreement be drafted by an experienced employee compensation attorney. Furthermore, the employer should consider having a third-party administrator help with SERP administration.

Constructive Receipt

Under the doctrine of constructive receipt, a taxpayer is liable for the tax associated with income over which he has control, even if he has not yet taken possession of it.

Here is how the IRS describes the issues of constructive receipt in connection with deferred compensation plans:

[T]axpayers must include gains, profits, and income in gross income for the taxable year in which they are actually or constructively received. Under the constructive receipt doctrine [codified in IRC § 451(a)], income although not actually in the taxpayer's possession is constructively received by him in the taxable year during which it is credited to his account, set apart for him, or otherwise made available so that he may draw upon it at any time, or so that he could have drawn upon it during the taxable year if notice of intention to withdraw had been given. However, income is not constructively received if the taxpayer's control of its receipt is subject to substantial limitations or restrictions. . . .

Establishing constructive receipt requires a determination that the recipient had control of the receipt of the deferred amounts and that such control was not subject to substantial limitations or restrictions. It is important to scrutinize all plan provisions relating to each type of distribution or access option. It also is imperative to consider how the plan has been operating regardless of the existence of provisions relating to the types of distributions or other access options.

https://www.irs.gov/businesses/corporations/nonqualified-deferred-compensation-audit-techniques-guide

**Substantial Risk of Forfeiture**

The idea of a substantial risk of forfeiture is tied to the IRS's economic benefit doctrine. Here is what the Service says about that:

> Under the economic benefit doctrine, if an individual receives any economic or financial benefit or property as compensation for services, the value of the benefit or property is currently includible in the individual's gross income. . . .
>
> A substantial risk of forfeiture exists if rights in the transferred property are conditioned upon the occurrence of a condition related to a purpose of the transfer and there is a substantial possibility that the property will be forfeited if the condition does not occur.

The existence of a substantial risk of forfeiture generally allows the participant in a deferred compensation arrangement to put off the income tax result until the risk of forfeiture is removed.

The combination of the concepts of constructive receipt and substantial risk of forfeiture has led nearly all nonqualified deferred compensation plans to be structured as an unsecured promise to pay the executive later on by the business. Where permanent life insurance is used to help a business keep its promises under a deferred compensation plan, the commitment to pay is not tied directly to the policy—again, so that constructive receipt and current economic benefit issues are avoided by the participant.

Section 409A

Section 409A was added to the Revenue Code in response to perceived tax abuses by those who had implemented deferred compensation plans.

**OVERVIEW**

Section 409A established detailed rules over what could and could not be treated as deferred compensation. Some of those rules were a clarification of those that had existed previously, while others were new, or an expansion of the scope of old requirements.

The penalties for failing to comply with the 409A rules are severe. Noncompliance will cause an employee's deferred compensation (and related investment earnings) to

- become taxable immediately upon noncompliance and
- be subject to a 20 percent additional tax penalty (with a possible assessment of interest).

**TECHNICAL REQUIREMENTS**

One of the requirements for a deferred compensation plan's compliance is that the plan must be in writing. That fact plus the other detailed requirements of Section 409A and other Revenue Code Sections lead us to insist that clients' deferred compensation arrangements must be drafted by an experienced attorney.

Here is a short list of some of the other technical requirements a deferred compensation plan needs to satisfy in order to comply with Section 409A:

- Virtually any promise by the employer to pay a benefit associated with work in one year later than March 15 of the following year is treated as deferred compensation subject to Section 409A.

- The plan document may provide that deferred compensation payments may only be made in the event of

    - ◊ Separation from service
    - ◊ The participant's disability
    - ◊ The participant's death
    - ◊ A fixed time or under a fixed schedule as set forth in the document
    - ◊ A change in control of the business's ownership
    - ◊ An unforeseen emergency

- The plan may not permit a participant to accelerate the timing of a benefit.
- The plan may not be administered in a way that is inconsistent with the provisions of the plan document.

What practical effect do these requirements have? Here's an example. In the past, SERPs sometimes allowed for a lump-sum distribution or a stream of payments to a retiring employee—at the participant's election. A provision of that type would violate Section 409A. Any deferral contribution made into such a plan—by either the employer or the employee—would be subject to immediate income taxation and a 20 percent additional penalty tax. The combination of an immediate income tax result for the participant and an extra 20 percent tax makes an employee's participation in a noncompliant deferred compensation plan potentially very expensive.

It is interesting that the penalty is imposed on the participating employee rather than the employer sponsoring the plan since the employer arguably has more control over the plan's potential compliance with Section 409A. In a recent case an employee who had to pay the taxes associated with a failed plan sued his employer for reimbursement.

**RECENT COURT DECISION**

The United States Court of Appeals for the Sixth Circuit was recently asked to rule on a complaint related to a deferred compensation plan in Wilson v. Safelite Group, Inc., No. 18-3408 (July 10, 2019). Under the facts of that case, Safelight's President Dan Wilson sued the company for its failure to properly administer the deferred compensation plan covering selected executives.

> Wilson was the president and CEO of Safelite from 2003 to 2008. In 2005, Safelite's board of directors created the Safelite Group, Inc. 2005 Transaction Incentive Plan (TIP), which provided for substantial bonus payments to its participants—five Safelite executives, including Wilson—if they secured a strategic buyer for the company.
>
> By late 2006, Belron SA emerged as a likely buyer. Realizing that Belron's acquisition of Safelite would trigger significant payments under the TIP that could increase participants' tax obligations, on December 29, 2006, the board adopted the Safelite Group, Inc. Nonqualified Deferred Compensation Plan (Safelite Plan), a plan to allow participants to defer compensation and thereby avoid certain tax consequences. At the time the Safelite Plan was adopted, only four executive employees, including Wilson, were eligible to participate in it. In February 2007, less than two months later, Belron purchased Safelite for $334 million, generating substantial payments to the TIP participants that could be deferred by operation of the Safelite Plan.

The Safelight Plan provided

> . . . two timing options for participants to receive distributions of deferred income. The default distribution of deferred compensation for each participant is payment "in a lump sum as soon as administratively feasible after the [participant] terminates" from employment. A participant can elect to receive deferred distributions on January 1 of a designated year or following a disability, and that distribution can be "in a lump sum or monthly . . . or annual payments over a period of up to ten years," subject to some limitations. Distributions made during a participant's employment are referred to as "in-service distributions."
>
> Wilson properly submitted an election form and so became a participant in the Safelite Plan. Between 2006 and 2013, he elected to defer hundreds of thousands of dollars of compensation each year.

In 2014, a federal tax audit revealed that some of Wilson's elections failed to comply with Section 409A's requirements. As a result, Wilson owed income taxes and incurred substantial tax penalties.

Wilson then sued Safelite in federal court, making state law claims for breach of contract and negligent misrepresentation. Safelite moved for partial summary judgment on Wilson's state law claims, arguing that they were preempted by ERISA. The district court granted Safelite's motion, finding that the Safelite Plan was indeed exclusively governed by ERISA. Wilson appealed to the Sixth Circuit.

The Sixth Circuit affirmed the finding of the federal district court.

It is worth noting that the district and appeals courts did not say Wilson had no right to try to collect against Safelight. The courts only said that under the deferred compensation plan, Wilson's exclusive remedies were those provided under ERISA.

**Conclusion**

Compliance with 409A is important. The Wilson case demonstrates that the IRS is reviewing employer's Section 409A compliance on audit. Failure to comply with Section 409A can lead to bad tax results for participating employees. A bad tax result for the employee may lead to a dispute over paying the tax and penalty between the participant and the employer.

Financial professionals need to be circumspect about implementing any life insurance-based employee-benefit plan. Such plans have the potential to include deferred compensation elements that would subject them to Section 409A's provisions. The consultants at Advanced Underwriting Consultants (AUC) have seen parts of proposed restricted bonus plans, SERPs, and buy-sell arrangements that would likely fail to meet the requirements of Section 409A and subject participants to unexpected tax results.

It is essential that the SERP or other deferred compensation agreement be drafted by an experienced employee compensation attorney, as Section 409A has detailed requirements about what the plan must include. Furthermore, since Section 409A also includes particulars about plan operation, the employer should consider having a third-party administrator help with SERP administration.

In the Wilson case, the participant sued his employer over Section 409A noncompliance. Could the next case include a life insurance professional as a defendant? Stay vigilant; protect your business-owner clients, their employees, and yourself.

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## *Building Protecting and Perpetuating Family Wealth*

LWA strives to develop and maintain sound financial plans designed to achieve our client's wealth accumulation, preservation and transfer objectives, with the goal of preserving their wealth for multiple generations. We provide these services in a confidential and consultative manner, building life-long relationships based upon education, trust, communication and service.

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