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financial planning

Executives need financial planning help too!

>> BY JAMES FRAWLEY

The government is frustrated over seniors' difficulties with the expanded Medicare menu. Evidently, having so many choices has led to confusion, rather than informed decisions.

Maybe they should seek advice from corporate executives, who face a similar dilemma deciphering their compensation alternatives. While highly paid employees may appear to suffer from nothing worse than an abundance of riches, many are wasting money through inaction or ill-advised choices. The effects of these decisions on their retirement plans can be significant. It's an opportunity for wealth advisors to serve a unique market niche.

The difficulty for highly paid employees seems to lie in one or more areas:

- **Misunderstanding.** The complexity of executive compensation is akin to that of the overall Tax Code. There are a variety of plans, each with its own restrictions and contribution limits. Everyone knows about their company's 401(k) plan — although a surprising number don't take full advantage — but hybrid excess-savings and deferred-compensation plans for executives are more often underutilized or inefficiently allocated.

- **Misinformation.** Eligibility and changing contribution amounts are key culprits. Executives commonly make choices without revisiting their decisions for years. Contribution limits for some plans have more than doubled in the past decade.

- **Misalignment.** Perhaps the biggest problem is the efficient allocation of contributions among the various plans. The alignment can vary enormously, depending on current living expenses, tax situation, age, years to retirement, matching company funds and other factors. Many executives lack a strategy that incorporates all the relevant data.

- **Misfortune.** Many have the bulk of their retirement funds tied up in non-qualified plans invested in company stock and options. These plans are not protected by ERISA and are vulnerable to loss through corporate bankruptcy or lawsuits. The inability to roll over these funds can also have a deleterious effect on retirement planning and career decisions.

- **Missing the boat.** Once an executive realizes that significant money has been lost, corrective action can be taken, but in many cases, the money already eviscerated from their retirement fund can never be regained. Missing the boat is often the result of executive schedules or relentless travel. It may also be due to not having a trust relationship established with an advisor knowledgeable in the nuances of executive compensation.

MATCH BENEFITS AND NEEDS

Contributions to one plan typically reduce the amount available for another. The key is to find the best combination of funding to maximize executive benefits. Easier said than done.

Once the income ceiling on 401(k) contributions — $225,000 for 2007 — is reached, highly compensated employees typically have alternatives such as excess-savings and deferred-compensation plans. ES plans usually feature matching company dollars comparable to their 401(k) plans. Executives receiving 4 percent matching company dollars in their 401(k) (up to the $225,000 ERISA limitation) will typically also receive 4 percent matching company dollars for contributions to their ES plan on income above $225,000.

> THE PRETTIEST GIRLS AT HIGH SCHOOL DANCES OFTEN SPEND THE EVENING WAITING TO BE ASKED TO DANCE BECAUSE **THE BOYS ARE INTIMIDATED BY THEIR BEAUTY.**

While the 2007 cap on pre-tax contributions to a 401(k) is $15,500, executives are free to contribute up to 25 percent of their salary and bonus. They can also contribute an additional $5,000 annual "catch up" if they are past age 50. I've known executives who contributed the full 25 percent of their salary and bonus into their 401(k) for years, much of that amount going in on an after-tax basis with no matching company dollars. Meanwhile, their funds are locked up until age 60.

These executives typically did not realize that they could have done better by utilizing the company's ES plan to put more pre-tax dollars aside while receiving company-matching funds. Fortunately, there is a way to retrieve the after-tax portion of a 401(k) plan while the executive is still working. Typically, some of the rolled-out, after-tax portion represents market growth that must, in turn, be rolled over into a new or existing IRA or other qualified plan. The balance of the after-tax portion is free to be invested as the executive wishes.

There may also be circumstances where working executives want to tap these funds, for example to use as a down payment on a property. Instead of taking out a loan against the 401(k), executives can simply withdraw their after-tax 401(k) contributions and use the funds for the down payment, home improvement or other need.

In an ES plan, execs can choose to contribute from 1 percent to 20 percent of their total salary and bonus up to $1 million and receive matching company dollars. For example, if an executive earns $750,000 annually consisting of a $250,000 salary and a $500,000 bonus and the company match is 4 percent, the ES plan could generate an additional $21,000 in matching dollars for the year (4 percent of $525,000, the difference between $225,000 and $750,000). This is in addition to the matching dollars in the executive's maximized 401(k).

The amount can be significant. The conundrum here usually involves tax considerations. The excess-savings plan allows for pre-tax contributions, but only up to 20 percent of combined salary and bonus.

How much to contribute to the ES plan must also be decided within a limited time period each year. The decision does not take effect until the following year, and it's easy for deadlines to go by without notice for busy executives. Once the annual deadline passes, executives are locked into existing parameters through the end of the following year. If circumstances in their lives have changed, this can be a costly oversight.

An alternative or adjunct to the ES plan is a deferred-compensation plan. The DC advantage is the deferral of taxable income. Contributions to a DC plan offset contributions to an ES plan and vice-versa in terms of total contributions.

In a DC plan, execs can contribute a fixed amount of their salary and bonus, which can kick in before or after the $225,000 401(k) limit, depending on whether they wish to contribute a large portion of their bonus. In a DC plan, execs can contribute up to 95 percent of their bonus, as opposed to a maximum of 20 percent of salary and bonus in the ES plan. For executives getting hammered on taxes (including the alternative minimum tax), deferring as much income as possible may be an irresistible strategy.

However, the DC plan has no matching company contribution, and since it is a non-qualified plan, the funds are not guaranteed and cannot be rolled over when the executive retires or leaves the company. Taking forced distribution and paying taxes at the highest rate on funds from a non-qualified plan can be tough medicine for an executive still in the workforce.

So the executive in our previous example, earning $750,000 and wishing to maximize tax savings, could defer as much as $475,000 of his $500,000 bonus by stashing it in a DC plan. However, doing so means that the exec could not contribute anything to the ES plan, which in turn means losing out on company matching dollars.

Thus, the decision of how much to contribute to each plan is based at least in part on balancing the benefits of tax savings against those of matching company dollars. Naturally, the individual exec's current income needs and time to retirement must also be evaluated.

The hidden danger in overstuffing the DC plan to gain the tax benefits is that having a disproportionate amount of one's retirement funds in a non-qualified plan can leave the executive vulnerable. If at any time before or after the exec's retirement the company runs aground, goes bankrupt or is decimated by a lawsuit, the executive could lose most or all of their contributions to a non-qualified plan.

THE BIG PICTURE

Almost every large company offers its highly compensated executives stock options and grants, a 401(k) and catch-up provisions. Some offer matching company funds. Most have pension plans and some have ES and DC plans. Some limit contributions to the various plans. A large company that I work with allows its executives to put as much as 95 percent of their bonus into a DC plan. Some of their executives earn more than $300,000 annually in bonuses and can put up to $285,000 pre-tax into the plan.

But is that the best thing for them to do?

From an advisor's perspective, it's usually not a matter of which plan to sign up for or maximize, but rather about analyzing the individual's circumstances and creating the maximum benefits based on all the relevant factors.

We think of executives as smart, successful, educated people who can make their own financial decisions. In my experience, most have never been approached by an advisor offering to help them evaluate their choices and make informed decisions. Perhaps there's an intimidation factor in play. Advisors tend to assume executives either don't need help or already have someone helping them. I'm reminded of the prettiest girls at high school dances, who often spend the evening waiting to be asked to dance because the boys are intimidated by their beauty.

Most executives are too busy with their careers, traveling and trying to carve out a few hours to spend with their families or decompress to sit down and study their compensation plans. They may ask peers for advice or simply do nothing. If they do have someone advising them, it's often the broker who manages their money but has little expertise with the intricacies of compensation plans; there's no true consulting relationship. And that's exactly what most executives need: someone to dissect the company benefits package, determine the most efficient combination and stay on top of any changes in both the plans and the executive's circumstances.

Typically, savvy businesspeople that may regularly make multimillion-dollar decisions for their companies are far less savvy when it comes to their own compensation. Most have no desire to do this on their own, and want someone trustworthy to take over the responsibility of staying on top of changes in tax law, personal circumstances, beneficiary changes and other relative factors.

Much like a trusted executive secretary coordinating an executive's activities, a trusted advisor can serve a similar function as the executive's planning, investment and compensation advisor. Just as executives retain full control over their schedules while relying on their assistant's input, executives retain control of their financial empires while relying on the expertise and counsel of a trusted advisor. It's a familiar, reliable advisory relationship where, as advisors, we are engaged to serve as the chief financial officer for executives' financial well-being. Importantly, the executives ultimately make their own decisions.

Many companies now include financial planning services as part of an ancillary benefits package, so the cost of advisory services may be reimbursed by the company. Many execs aren't aware they have such an option.

Once you look into this market niche, you'll probably be as amazed as I was at how little many executives know about their compensation alternatives. They simply don't have the free time to do the research and paperwork to stay on top of everything. I find I often have difficulty understanding some plans and have to contact the plan administrator for an explanation or clarification.

Providing clarity is one of the most important benefits we bring to the table for busy executives. Invest the time to learn the complexities and make the contacts: You may well develop a whole new aspect of your business practice. **AT**