



THE LAW OFFICES
OF
Louis P. Lepore

1110 South Avenue • Staten Island, NY 10314
Tel: 347-273-1385 • Fax: 347-273-1484

40 Wall Street • New York, NY 10005
Tel: 212-400-7197 • Fax: 347-273-1484

331 Newman Springs Road
Building 1, 4th floor, Suite 143
Red Bank, NJ 07701
Tel: 732-784-2826 • Fax: 347-273-1484

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A monthly newsletter for Accounting, and Financial Professionals with a focusing on Estate Planning, Elder Law, and Special Needs Persons.

The Planner is a newsletter to inform and educate Accounting and Financial Professionals of the ever changing areas of estate taxes, and elder law to better service their clients.



From: Louis Lepore

Louis Lepore is an attorney admitted to practice law in the states of New York, New Jersey, and Florida. He has dedicated his practice of law to providing quality legal representation and personal attention to all of his clients on estate planning and elder law issues.

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The Continuing Significance of Non-Qualified Deferred Compensation

If you work with business owners and their key employees - or you would like to - you need to be conversant about Non-Qualified Deferred Compensation (NQDC) plans. NQDC is often a significant component of key employees' compensation because qualified plans are inadequate to meet the retirement needs of those with above average compensation. Also, many employers use NQDC as a tool to enhance retention of their key employees. NQDC plan design and funding is highly flexible so it is useful in many different situations. For all these reasons, it is important that all wealth planning professionals have a basic understanding of NQDC and its application. This issue of The Planner explores NQDC plans that do not require current funding by employers.

Who Has NQDC Plans?

- 85% sponsor NQDC plans;
- 71% finance plan liabilities, with 5% considering doing so;

- 91% credit mutual funds and/or company stock;
- 68% credit earnings daily; and
- 97% use a third party administrator.

But NQDC plans are not just for enormous companies. There are approximately 64,000 U.S. companies that have NQDC plans in place for their key employees. As the number of employees increases, so does the likelihood of a NQDC plan: from 13% of companies with less than 100 employees to 84% of companies with 50,000 or more employees.

What Are NQDC Plans?

As their name implies, NQDC plans are not ERISA-qualified plans. Because of that, they are not subject to most of the strict ERISA requirements for qualified plans. NQDC plans can be custom tailored to help the employee beneficiary achieve a wide variety of financial objectives with different timing. Some examples are

providing a retirement income stream, money to buy a second home, funding for children's or grandchildren's education, and income tax planning.

Unlike ERISA plans, which require the plan sponsor to transfer ownership of assets to a trustee, an NQDC plan creates a contractual obligation between the employer and the employee. There is no "pot of money" to pay the benefit. Instead, paying the promised benefit is a contractual obligation of the employer. If the employer fails, the NQDC plan participants are among its unsecured creditors.

Planning Tip: For income tax purposes, participants do not recognize the income when it is deferred under an NQDC plan. Income is recognized only when the employee makes withdrawals from the NQDC plan.

An Example:

Ms. Key Employee has a base income of \$150,000 and an annual bonus of \$50,000. Ms. Key Employee elects to defer 10% of her base pay and 50% of her bonus, for a total of \$40,000 per year. She has three objectives: (1) funding her two children's higher education; (2) buying a vacation home; and (3) saving for retirement.

Ms. Key Employee can break up and allocate the deferrals as she pleases, and she can dictate how long each allocation should last. Thus, if her children are approaching college years, she can allocate 70% of her base pay deferral (\$10,500) for the older child, but only for 4 years, and 30% of her base pay deferral (\$4,500) for the younger child for four years, then increasing to 100% (\$15,000) for an additional two years. She can also allocate to pay out 30% of her bonus deferral (\$7,500) for the vacation home, but only beginning in year 2. She could then allocate the balance of her bonus deferral towards retirement.

Most plans have a November-December enrollment for "regular" deferrals and performance-based compensation (PBC). Enrollment for "regular" deferrals may not be changed after the beginning of the plan year for which they are applicable. However, the law and many plans allow changes to PBC deferral up to mid year. Each deferral election must specify the percentage to be deferred, whether the percentage will apply to salary or

PBC, when withdrawals from the deferred compensation will begin, and the timing of the withdrawals thereafter. An election for an NQDC plan year is "irrevocable" once the enrollment window for that plan year closes.

Subsequent changes to an NQDC plan withdrawal election are permitted but must be made at least 12 months prior to the scheduled withdrawal and result in the withdrawal's being delayed at least five years.

Planning Tip: NQDC plan deferrals but can be suspended in certain cases of hardship.

Planning Tip: Deferral agreements may be creative. For example, an employee can defer 10% of salary and a percentage of bonus that depends on the size of that bonus ("ladder" bonus), for example:

- 1) If bonus is less than x then defer 0%
- 2) If bonus is between x and y then defer 25%
- 3) If bonus is between y and z then defer 50%

"Separation from service" is the triggering event for retirement distributions to begin. However, many plans do not distinguish between the employee retiring and the employee quitting (e.g., to go work for a competitor).

Planning Tip: Consider requirements for a minimum attained age, length of service or both to create a distinction, such that the employee's distribution elected is valid only if the employee meets the requirements. If the employee does not meet the requirements, the plan can provide for a lump sum distribution.

Funding the NQDC Plan Liability

There are three basic ways the employer may handle its liability to the participants under an NQDC plan: (1) do nothing; (2) purchase taxable investments (e.g., mutual funds); and (3) purchase tax-deferred corporate-owned life insurance (COLI) on the participants. The employer may also combine approaches, as for example by using both COLI and making taxable investments to hedge the company's exposure.

There is no "best" approach. Which approach is "best" for a particular employer depends on the company's:

- Income tax bracket;

- Cost of money;
 - Earnings assumption;
 - Realized vs. unrealized distributions;
 - Cash flow; and
 - Other factors.
- here are advantages and disadvantages to each funding method.

The Do Nothing Plan

The advantages of not financing the NQDC plan include (1) simplicity; (2) if the company's ROE is greater than the promised benefit, the spread benefits the company; and (3) it does not tie up cash needed to grow the company. The disadvantages are (1) it depends on future liquidity (increased risk to participant); (2) the company is liable for benefit regardless of earnings; and (3) "legacy vs. liability"- leaving future management the responsibility for generating the cash flow to pay the benefit liability when due.

Taxable Investments

The advantages of making taxable investments (typically mutual funds) to provide assets that can be sold to pay NQDC benefits are (1) many investment options; (2) direct crediting of earnings; and (3) it is easy to understand. The disadvantages are: (1) the earnings on the investments are "taxable" to the company; (2) it requires the highest cash flow to support the income tax on the earnings; and (3) transaction accounting and recordkeeping may be difficult.

Corporate-Owned Life Insurance (COLI)

The advantages to buying COLI to provide funds to pay NQDC benefits are (1) earnings accumulate "tax deferred;" (2) distributions made by policy loan are tax-free (subject to contract limitations/charges); and (3) life insurance death proceeds are tax free to the company as beneficiary. The disadvantages are: (1) the cost of life insurance; (2) the underwriting process; and (3) the need to educate the client and potentially other advisors.

According to a recent Fortune 1000 survey of NQDC plans,

- 61% use COLI, either primarily or in combination with

the other means for funding;

- 45% use primarily taxable investments;
- 23% use primarily employer stock; and
- 15% use primarily other funding mechanisms.

Planning Tip: Through the use of a "rabbi" trust, the assets purchased to hedge the employer's liability to the NQDC plan participant can be protected from all risks except that of the employer's bankruptcy.

Planning Tip: Technical Bulletin 85-4 provides the generally accepted accounting principles (GAAP) for corporate-owned life insurance. In general, this accounting treatment, over the life of a plan, can result in a more favorable accounting treatment for the company when compared to the accounting used for the other NQDC financing methods.

Administering the NQDC Plan

Administering an NQDC plan can be as simple or complex as the employer chooses. The simplest NQDC plans simply credit a fixed annual interest rate to plan deferrals. At the other end of the spectrum, NQDC plans with third party administrators may offer participants control over his or her deferral accounts through internet access, hypothetical investments in selected mutual funds, daily crediting, and combined reporting with the participant's other accounts with that administrator.

Planning Tip: With an NQDC plan in which the employer's liability is funded with taxable investments, the administrator can match the plan's actual investments with the hypothetical investments made by the plan participants to minimize the company's exposure.

Conclusion

Non-qualified deferred compensation creates significant planning opportunities for company owners and key employees, including increased retention of key employees. By working together during the design, implementation and administration of NQDC plans, the planning team can ensure that the selected NQDC

plans meet the planning goals of both the employer and its key employees, which often include its owners.

Planning for Long-Term Care

Studies predict that approximately 40% (2 out of every 5) of Americans reaching age 65 will need some type of long-term care (LTC). Some of your clients would prefer to stay at home, no matter what the cost. However, without proper planning, the lack of available services and the staggering price tag for full-time home health care may leave them without that option.

A prior issue of *The Wealth Counselor* provided an overview of planning for Medicaid (Medi-Cal in California). This issue of *The Wealth Counselor* examines additional LTC planning options. Like so many others, this is an area where the planning team needs to work together to develop and implement a unified plan to accomplish each client's LTC goals and objectives.

Medicare - Don't Count on It for Long-Term Care

Many seniors think that Medicare will pay for LTC if they need it. That is simply not true. Medicare coverage is limited to: qualified medical expenses (80% of an approved amount for doctors, surgical services, etc.); hospitalization for 90 days per benefit period with a total deductible of \$1,024.00 for the first 60 days and a co-payment of \$256.00 per day for the remaining 30 days, and an additional one-time, lifetime benefit of 60 days of hospitalization, with a co-payment of \$512.00 per day (for a maximum of 150 days).

Medicare only pays for a limited period of "skilled" nursing home care that begins within 30 days following a hospital stay of at least 3 days. The maximum period is 100 days per benefit period. "Skilled" care is that provided under the supervision of a doctor that requires the services of skilled professionals, such as physical therapists or registered nurses. Medicare never pays for any "custodial care," which is basic personal care and other maintenance-level services. If the patient is eligible, Medicare will pay 100% of the costs for up to 20 days of skilled nursing home care. If the patient is eligible, from day 21 through day 100, the patient has a \$128.00 per day co-payment. If a patient stops needing

skilled nursing home care, the patient ceases to be eligible and Medicare stops paying. Home health care may be available in limited amounts, but only if "medically necessary."

For all Medicare benefits there are deductibles and co-payments, which can be substantial. Lifetime limits can be reached in the case of catastrophic illness. Plus, as the cost of Medicare rises, so does the pressure on the government to make it "means tested" instead of a universal program. There are excellent private "Medigap" insurance policies available to cover the gap between Medicare coverage and actual cost.

Planning Tip: Seniors need to understand Medicare's limitations. It does not cover hospital costs beyond 150 days, skilled nursing home costs beyond 100 days, or any custodial nursing home or non-skilled home health care.

Planning Tip: Those eligible for Medicare should be encouraged to buy "Medigap" insurance. However, seniors need to understand that Medigap insurance does not cover LTC that Medicare does not partially pay for.

Self-Insuring LTC Costs

Self-insuring for possible LTC expenses requires a close collaboration of financial planning and estate and tax planning professionals to ensure that there are sufficient assets available to cover possible costs for as long as needed. The collaboration requires a comprehensive look at the overall financial condition of the client, as well as a thorough understanding of the client's health and wishes regarding care in the event of incapacity.

Planning Tip: Use a thorough fact-finding questionnaire to assemble all the information needed for the analysis. This will include client assets, current and anticipated income and expenses, and other data, such as where care will occur, the level of support available from family caregivers, and any family history of incapacity. This information will provide the foundation for the planning required to maximize the value of Social Security income, fixed pensions, dividend, interest, and other income streams, along with maximizing tax deductions for things such as medical expenses.

Planning Tip: For LTC self insurance to work, the client needs a qualified financial planner whose investment strategies will produce asset growth and income sufficient to fund the client's projected LTC expenses. Armed with knowledge of the client's assets and projections for income and expenses, the client's advisors can assess the client's ability to implement a plan to self-insure LTC and recommend an appropriate investment strategy.

LTC Insurance

Most clients will not be able to fully self-insure for LTC, given the current and projected costs of LTC. Those who cannot but are insurable and can afford the premiums should integrate an LTC policy into their comprehensive wealth plan. Doing so can obviate the need for Medicaid planning later.

Planning Tip: The two types of LTC policies available are cash payment and reimbursement. The former pays cash to the insured. The latter reimburses the insured for actual costs incurred.

Planning Tip: Policy benefits to look for in an LTC insurance policy include: nursing home and home care coverage; sufficient daily payouts (\$200.00/day is a good start); elimination periods (the number of days you must be in the nursing home before benefits begin, typically 0 to 100 days); duration of benefits (3 years, 5 years, lifetime); renewability (make sure it is guaranteed renewable); waiver of premiums (insured pays no premiums while receiving benefits); and inflation protection. As with life insurance, the older an applicant, the more difficult it is to obtain insurance and the higher the premium for equivalent coverage.

LTC Advanced Planning Strategies

If total LTC self and/or third-party insurance are not options, other options may be considered.

The Medicaid Trust

One currently-effective planning technique is to transfer assets into a "Medicaid" trust. In a Medicaid trust, the trust maker retains the right to all of the trust income for life while irrevocably giving up the right to receive or benefit from any of the trust principal. The assets in the trust are not available to pay for the cost of the trust maker's LTC.

Planning Tip: Retaining the right to receive the trust income keeps the trust assets in the trust maker's estate for estate tax purposes, thereby giving a basis adjustment at death which wipes out any unrecognized capital gain or loss on the trust assets. By using a Medicaid trust, a senior can preserve capital and still qualify for Medicaid, but only after expiration of the look-back period for the transfer to the trust (which can be as much as 60 months (5 years)).

Planning Tip: The "penalty period" starts from the date the applicant applies for Medicaid and would be eligible but for the disqualifying transfer. Its length is determined by dividing the state's average daily private pay nursing home cost into the total of the transfers made during the look-back period.

Planning Tip: For the Medicaid trust strategy to work, insurance, an income stream, or other assets must be sufficient to pay for LTC if needed during the waiting period before applying for Medicaid.

A Medicaid trust can allow the trustee to distribute principal during the trust maker's lifetime for the benefit of the trust maker's spouse, children, or other designated beneficiaries, just not to or for the benefit of the trust maker. Many trust makers choose to maintain the right (called a Special Power of Appointment) to change the current or ultimate beneficiaries of the Medicaid trust by "reappointing" the assets to different family members at a later date.

Planning Tip: Retaining a Special Power of Appointment prevents the trust maker's contributions to the trust from being taxable completed gifts at the time of contribution. A distribution of trust principal to a beneficiary during the trust maker's life is a completed gift.

Making Gifts

If a Medicaid trust is not desired, it is still possible to make "outright" gifts of property, wait until the look-back period expires, and then apply for Medicaid or use other planning techniques to qualify for Medicaid at the earliest possible date.

Protecting the Home

If the home is the only asset to protect, a deed to children or others with a retained life estate for the client will protect both the property and the client's Medicaid eligibility upon expiration of either 60 months from the date of the conveyance or the applicable "penalty period." As with other advanced planning strategies, because the penalty period begins only after the applicant has applied for Medicaid and is otherwise eligible, the client must have other LTC funding available to get past the look-back period, or someone willing and able to pick up the LTC costs during the penalty period.

Planning Tip: If the home is sold while the client is receiving LTC under Medicaid, a portion of the sale proceeds equivalent to the value of the life estate (using Medicaid tables that give a higher value than an IRS life expectancy table) will have to be paid to the nursing home unless protected using other Medicaid planning strategies.

Crisis LTC Planning

Even if the need for LTC is imminent or immediate, sophisticated Medicaid planning opportunities can be employed to protect a substantial portion of the client's assets. Carefully working within the Medicaid transfer rules can allow clients to provide security for themselves and a legacy to their families, while ensuring that they will remain eligible to receive LTC under Medicaid when necessary. For example, by combining the gifting of assets with the structuring of other asset transfers as an exchange for a secured interest (much like a loan) through the use of a promissory note, private annuity, or Grantor Retained Annuity Trust (GRAT), clients can pay for expenses during the waiting period that begins upon making the gifts. This allows them to channel assets to a trust, or to children and grandchildren, while receiving sufficient income through the note or annuity payments to pay for their care until they become Medicaid eligible.

If the client can live at home with the assistance of home health care, one can transfer assets and qualify for Medicaid immediately to cover home care costs in some jurisdictions. The planning team must exercise caution, however, because home health care may be appropriate

initially, but if the client's condition deteriorates to the point where he or she cannot safely stay at home, nursing home placement may be required. If the client requires this higher level of LTC, he or she must file a new application, and the Medicaid transfer rules will then apply. Thus, when planning for home care, the client and planning team must evaluate the possible need for institutional LTC services before making transfers.

Planning Tip: Moving in with a relative or family member may be another option for seniors. It may also be advisable for the client to put in place a caregiver agreement and/or personal service contract to make a transfer to a family member as compensation for their providing home care services.

Conclusion

Counseling clients on their LTC options, including the availability of LTC insurance, is an integral part of comprehensive wealth planning. By working together, the planning team can ensure that assets are available as needed to meet each client's unique LTC planning goals and objectives.

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