Course Objective

This course was created to teach advisors (CPAs, EAs, accountants, attorneys, financial planners, and insurance advisors) about the problems with traditional non-qualified deferred compensation (NQDC) and two unique but simple alternatives to NQDC.

NQDC is traditionally a topic that most advisors think only works in large C-Corporations that retain earnings and is mainly used to retain key employees. While that is the old use of NQDC, through the topics learned in this material, advisors will learn how to bring one unique income tax deferral plan to small business owners (which does not require inclusion of employees) and with a second plan advisors will learn how to improve in a dramatic way the use of old school NQDC. Readers will also learn how the American Jobs Creation Act of 2004 negatively affected traditional NQDC.

Non-Qualified Deferred Compensation Alternatives to Traditional Solutions

Introduction

Advisors of all fields have a common goal when dealing with clients. That goal is to provide the best advice possible and to accomplish the most important goals of the client. As with the other educational modules, this material is geared towards helping high income/net worth clients. There is no better way to show value to a high income client than to show that client how to reach retirement early and if possible in a tax deferred or favorable manner.

This material will cover traditional old school non-qualified deferred compensation, what is wrong with it today, and an alternative to traditional plans that have been in the market place for the last 20 plus year.

This material will also cover a very exciting income deferral tool that effectively creates a tax deferred asset which will grow at market rates of return prior to disposition to the employer and in turn to the employees.

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WealthBuilder® Annuity
A factoring plan using a deferred installment note for payment

Introduction

What are the top two complaints high-income medium to small business owners make to their advisors (especially CPAs/accountants)?

> "Why am I paying so much in come taxes and why is no one giving me advice to reduce my annual income tax bill?"

> "I'd like to retire early but everyone keeps telling me the most money I can put away for retirement is $42,000 into my 401k/profit sharing plan"

What are the top two complaints advisors (especially CPAs/accountants) have about their high income small to medium size business owner clients?

> "Why does my client keep complaining about paying too much in income taxes? Isn't that a good thing since it means the client is making good money."

> "Why does my high income small business owner always bring me a new tax scam each year that I am forced to review and recommend against? Can't the client just pay his/her income taxes?"

The following is a list of what could be termed income tax scams (many of which the IRS has issued warnings against.

-The Irish Leasing Company scam

-S-ESOPs for professional companies

-The "offshore" credit card scam

-412(i) Defined Benefit Plans using a five pay "sponge" policy (listed tax transaction)

-Union 419A(f)5 Welfare Benefit Plans (listed tax transaction)

-And many more.

Advisors do not have to know all of the above topics to get the picture that there are a lot of bad plans in out there that your clients should stay away from.

In addition to all the "bad" plans in the marketplace, there are a handful of "legal" plans that clients are being pitched from their local insurance agents.

Most clients will decide not to use the following list of topics, but many do implement one due to the fact that neither they, nor their advisors, know what other options are available in the marketplace. The legal alternative plans being pitch to clients are:

-412(i) Defined Benefit Plans

-Section 79 Plans

-Non-Qualified Deferred Compensation Plans (traditional)

This material was specifically written to educate advisors in areas they might not otherwise learn, and have those topics not only be new, but applicable and usable for many clients.

WealthBuilder Annuity discussed below is a very simple but powerful income tax deferral plan for a corporation, partnership or individual who is a cash based tax payer and is looking to defer current income for up to 30 years.

What is Factoring?

While nearly every CPA/accountant is familiar with "factoring," many non-CPA/accountants are not. Factoring in its traditional sense is the sale of accounts receivable (future contractual payments) to a factoring company in exchange for an immediate payment at a discount.

Example:

A classic example is a medical office that has plenty of good accounts receivables (A/R) from insurance companies but, because of an incompetent insurance and billing staff, cannot collect the money. The medical office has bills it cannot pay and it could go to a factoring company who would buy the good A/R at a discount (5-30%) and issue the medical office a check immediately. The medical office is happy because it received immediate cash to pay bills and when the money is collected from the insurance companies (usually close to 100% for medical offices), the factoring company is happy because it made a nice profit in a short period of time. This is a true win / win situation.

Factoring is quite prevalent in the manufacturing community when there is a cash flow crunch due to delinquent payers.

Factoring itself is a way to reduce a corporation's income because of the factoring fee, but as a general rule, clients **do not** look at factoring as a way to build wealth in a deferred manner.

WealthBuilder® Annuity (WBA); A unique factoring plan

WealthBuilder Annuity (WBA) is a one of a kind factoring plan that helps clients build an income tax deferred sum of money which can grow at market rates and be used by the business or client sometime in the future. WBA is a factoring plan, but it is unlike any other.

How does WBA work?

WBA is very simply the sale of accounts receivable (A/R) through payment via a long term installment note from a factoring company.

While those that are familiar with factoring can grasp this concept in short order, to help those that are not familiar with factoring the following example should help. Let's assume we have a cash based business. (**WBA does not work with accrual based tax payers**).

1) The business sells a specific amount of A/R to a Factoring Company ($50,000-$300,000+).

2) The Factoring Company (hereinafter FC) takes a 5% factoring fee on the A/R factored and issues to the business an **installment note** for payment of the remaining 95%. This installment note has repayment terms as dictated by the business selling the A/R.

3) When the business collects the A/R that was sold (as an agent of the factoring company), that money is transferred to the FC.

4) The FC invests the money it receives (minus the 5% factoring fee). Typically, the money is invested in indexed annuities that have minimum guarantees and growth pegged to the S&P 500 index.

5) When the installment note comes due to pay the business, the FC pays back the initial amount factored (minus the original factoring fee) plus any growth on the money (as it was pegged to the S&P 500 index).

6) The business may choose to use the money for any business purpose, including the option of paying it to the owners or employees as a bonus.

Example

Assumptions: Assume the client Dr. Smith, age 40, works for XYZ Orthopedic Clinic, P.C., makes $600,000 a year, and has an extra $100,000 he does not need to take home as income this year. Further assume the medical practice at any given time has $700,000 of real A/R on the books and Dr. Smith's patients represent $200,000 of that A/R.

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Implementation:

1) XYZ Orthopedic Clinic contracts with FC to sell $100,000 of A/R in exchange for an installment note that will be payable starting in 21 years, and will pay a lump sum when Dr. Smith is 61 years old.

2) The FC takes a 5% factoring fee and invests $95,000 (typically the money is invested in indexed annuities with a minimum guarantee and growth pegged to the S&P 500 index).

3) If that $95,000 grew at 7% for 21 years, there would be $310,835 at the end of the 21-year period. That $310,835 would come back to the medical practice via the installment note in lump sum at the end of the 21st year (when Dr. Smith is age 61).

4) The medical practice can use the money for any business purpose and can choose to disperse it to Dr. Smith as income. If Dr. Smith received the $310,835 in a lump-sum bonus from the medical practice, he would have **$186,501** left after paying tax on the money in the 40% tax bracket.

5) In the above example, if Dr. Smith invested $60,000 post-tax in the stock market for the same 21-year period, he would have **$130,686** in a post-tax brokerage account. Therefore, WBA worked **45% better than post-tax investing**.

Continuous contracting

In the previous example, if the medical practice so desires, it can choose to sell a similar or different amount of A/R each year. Using the Dr. Smith example, XYZ Orthopedic could factor $100,000 a year for 10 years. If the money at the factoring company grew at 7%, there would be $2,481,844 that could be paid in a lump sum to the medical practice at the end of 21 years.

If the medical practice did not desire to have an installment note paid in a lump sum, it could direct via the installment note to have that money paid to the medical practice over any period of time up to 30 years.

If the contract called for equal payments for 20 years, the medical practice could receive via the installment contract $195,335 a year for 20 years. Again, the medical practice can use the money for any business purpose including paying bonuses to its key employee(s) (Dr. Smith starting when he is age 61).

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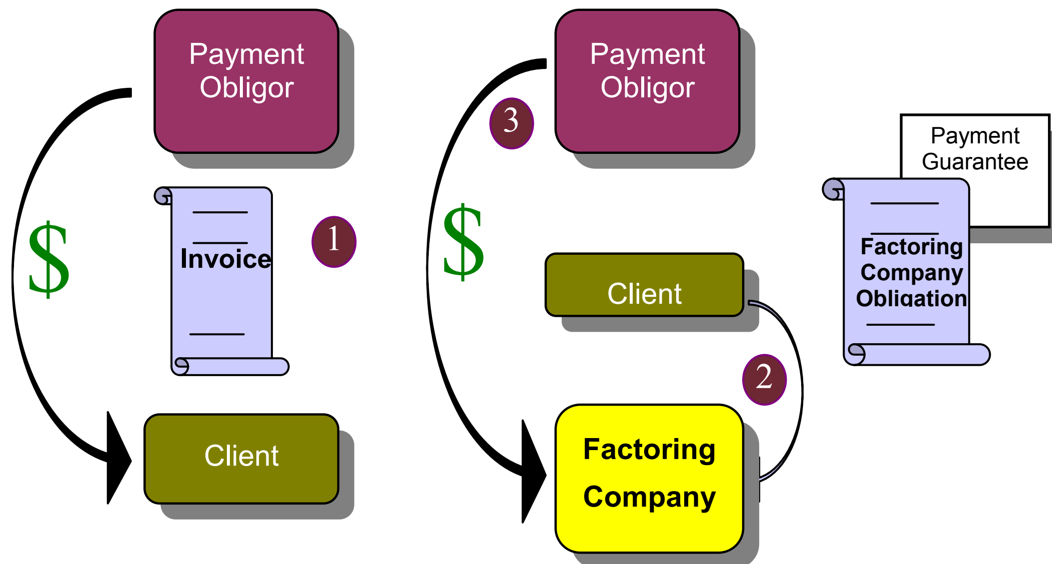
WBA vs. Post-Tax Investing

In the 10-year continuous contracting example, Dr. Smith could take $195,335 a year for 20 years as taxable income (leaving **$117,201** a year after tax in the 40% bracket).

If Dr. Smith instead of implementing WBA took his $60,000 after tax ($100,000 x 40% tax) and invested it in the market at 7% (where typical income and dividend taxes are levied ever year), Dr. Smith could take out of his brokerage account **$77,318** a year after tax for that same 20-year period. WBA returned to Dr. Smith **52% more income** each year from ages 61-80.

WBA is a terrific and simple income deferral/wealth building tool that will be a nice fit for many clients, and is a planning method advisors will not have to spend hours explaining to the client.

(It is assumed that the money invested post-tax and the money at the factoring company has an annual money management or administration fee of 1.5% and the use of a 1% bonus for 12 years on new money that goes into the EIA to fund repayment of the installment note)



1) A client is entitled to payment pursuant to an Invoice on accounts receivables that have not been collected.
2) Client factors payment right/receivable to Factoring Company (FC) in exchange for FC Obligation and Payment Guarantee.
3) Payment Obligor directs payment to FC on scheduled due date.

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Who can use WBA?

Any cash based accounting client (i.e. non-accrual based tax-payer). Accrual based accounting clients cannot use WBA due to the fact that the accounts receivable with an accrual based tax payer are booked as income at the time of sale vs. the time of payment.

What types of receivables does WBA make the most sense for?

- Medical Fees (physicians)
- Contract Rights (which includes commission income for insurance and financial planners)
- Consulting Fees (architects)
- Attorney, CPA/accounting Fees
- Endorsement Fees (professional athletes)
- Real estate developer (rental income)
- ESOP Repurchase Liability

This concept is perfect for physicians due to the large amount of A/R on the books at any given time, but will work equally as well for CPAs/accountants, attorneys, architects and any other cash based client who has accounts receivable.

One interesting type of client who can take advantage of WBA is the professional athlete or entertainer. Most professional athletes get paid from teams (baseball, basketball, football…). While there is little we can do to help them defer w-2 income from a ball team, most professional athletes have endorsement contracts, and they do not currently need that money. WBA is ideal for helping those clients defer that income to a time when the athlete is no longer collecting a paycheck from the team.

WBA will also work for professional golfers, race car drivers, and any singer/songwriter or professional actor.

Pros and cons of WBA

Pros –

A) Simplicity –All a business has to do is identify A/R it would like to factor, sell the A/R via an installment note and, at a set time in the future, have the amount factored and the growth on that money returned to the business.

B) Principal Guarantee –The Factoring Company typically uses products that have guaranteed minimum rates of return to assure that they will always have the money needed to pay the installment that eventually becomes due.

C) Variability –With WBA, the business chooses to implement the plan annually for whatever amount it sees fit. One year the business could factor $50,000, and the next year it could factor $0 or $250,000, or whatever amount is appropriate. Because each year becomes a new installment note payable by its own terms, there is no requirement to fund every year.

D) Tax Simple – While most CPAs/accountants are not used to reviewing the "creative" income tax reduction plans in the marketplace, all CPAs/accountants are familiar with installment notes and factoring. WBA is a plan that should not be difficult for an advisor or client to review and approve as a conservative income tax reduction/business continuation plan.

Cons –

A) Lack of investment control – WBA uses indexed annuities as the investment and so for clients looking to day trade stocks WBA will not be the best option. However, for advisors looking to help their clients implement plans that are tax favorable and conservative from a financial side, the use of indexed annuities should be a good fit.

B) Lack of flexibility when repaying the installment note – Except for certain circumstances, the time table for repayment of the note will be set the day the installment note is issued. So, if the business selling their A/R accepts a note where payment will not happen for 15 years and the business needs money, it will not be able to go to the Factoring Company and demand early payment without paying a penalty of between 2-15% depending on when a demand for payment is issued.

Early payment options

The following circumstances allow Seller to receive early payment on the note:

1) Death of an identified key executive.

2) At the discretion of Seller: Anytime after the note has been in place for twelve months with 90 days written notice to the FC. With this option, the Seller is assessed a 2-15% penalty on the balance to be paid back to Seller.

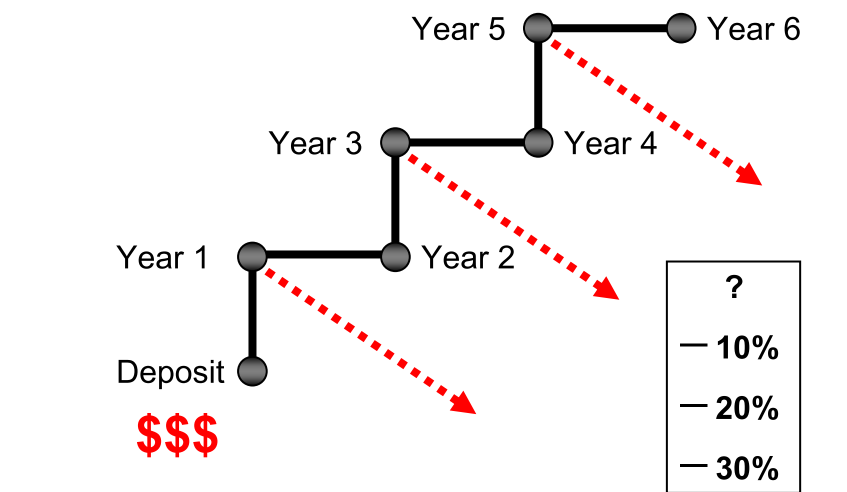
3) Change in the Tax Law that would make WBA not viable for either Seller or FC.

Principal Protection

For years clients did not want to hear about why they should have a certain amount of their invested assets in a 'principally" guaranteed investments. Until the stock market crash in 2001, everyone seemed to think that the stock market was always going to return 12% plus every year.

The correction in the stock market created a flood of investments into equity indexed annuities. Indexed annuities are covered in much more detail in the annuity education module, but the allure of indexed annuities is that they give the client principal protection while still allowing the client to participate in growth during upswings in the market.

The following will give readers a visual for how a typical point to point (annual reset) equity indexed annuity works.



An investor deposits money into the indexed annuity and if the indexed investment goes up, the client keeps the return. If the indexed investment (typically the S&P 500) goes down, the client's balance from the previous year is protected (the client does not partake in the dotted red arrows above which show a negative investment return in years two, four and six)

As noted by the name of WealthBuilder Annuity, the investment that is used by the factoring company to pay back the installment note to the client (seller of the accounts receivable) is an indexed annuity. Therefore, the plan has principal protection.

Many advisors are tired of getting calls from clients when the stock market goes down. With WBA, advisors can move money owed to a client into a principally guaranteed investment. For some advisors the thought of principal protection is boring, but for many, it is not.

Due to technical issues outside the scope of this material an explanation of why the factoring company cannot pass through to the client 100% principal protection on the investment will not be included. What can be stated briefly is that If that WBA investment was in an absolutely 100% principally guaranteed investment, the client would have to pay tax on the interest every year even though the installment note did not pay.

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The following is the language in the installment note that deals with principal protection:

Principal Protection Credit:

> If the Index Growth is negative or results in a loss for the period, the Obligee will be credited an amount equal to eighty percent (80%) of the negative Index change. *For example*, if the Principal Amount of the Obligation due to the Index value as of the current anniversary of the Effective Index Measuring Date is 90 and the Principal Amount of the Obligation due to the Index value as of the last anniversary of the Effective Index Measuring Date was 100, there would be a negative change of 10. Due to the Principal Protection Credit, rather than realizing the full loss of 10, the Obligee (and thus the Principal Amount of the Obligation) will be credited back 80% of the negative change, thus resulting in a negative change of only 2 for the Obligation.

Interest Rate Cap Increase:

> To the extent that the Principal Protection Credit is utilized during an Index Growth Calculation to mitigate a negative Index change during a measuring period and there is a subsequent positive Index Growth change in excess of the Maximum Interest Rate Cap, the Maximum Interest Rate Cap will be modified to allow the Index Growth to recover previous loss incurred. *For example*, during the first measuring period, there was a negative Index Growth and the Principal Protection Credit resulted in a negative change of 2%. The next year, the Maximum Interest Rate Cap was set at 10% but the actual Index returned 15%. The Interest Rate Cap Increase would adjust the Maximum Interest Rate Cap for the measuring period to a sufficient level to recover the prior loss.

The principal protection for the client is only 80% in any given year. However, with the ability to raise the annuity cap (above what the actual annuity offers), the client can recoup down years in the following year(s) so the investment can catch up and ultimately setup a situation where the actual value of the annuity is the same that will be paid to the client via the installment note.

Technical Questions Advisors will ask

The main question an advisor will have is why does the client not constructively receive the money in WBA when it is collected. The IRS defines constructive receipt as the date when a taxpayer received income (which is interpreted also as the first date the taxpayer has the right to claim it, whether or not that claim was actually exercised).

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Below is a detailed discussion of constructive receipt, but in a simple statement, WBA does not create a constructive receipt problem because the client **sold the A/R before payment came into the business**. Therefore, when the A/R was collected and transferred to the factoring company it was no longer owned by the client's business and therefore it is not income to the business.

If a business selling A/R retained control of the money while at the factoring company or if the business could call the note early without a penalty then, the IRS would have a very good argument that the client did constructively receive the money in WBA. Since the money invested to pay back the installment note, which is invested in indexed annuities, is owned by the factoring company, and because the installment note cannot be called early without a penalty, constructive receipt should not be an issue for the client.

Detailed Discussion on the Constructive Receipt Doctrine

The general rule of constructive receipt provides that "income, although not actually reduced to the taxpayer's possession, is constructively received by him in the taxable year during which it is credited to his account or set apart for him so that he may draw upon it at any time or so he could have drawn upon it during the taxable year if notice of intention to withdraw had been given." A taxpayer will be in constructive receipt of an amount, and, consequently, immediately taxable on such amount, if the following conditions are satisfied: (i) the amount is due; (ii) the amount is appropriated on the books of the obligor; (iii) the obligor is willing to pay; (iv) the obligor is solvent and able to pay; and (v) the obligee has knowledge of the foregoing fact (PLR 9624009 (June 14, 1996)).

In other words, for constructive receipt to apply, the Seller must have a current right to receive the income regardless of actual possession. Thus, the right to receive income must be fully matured, according to the Service, in order for constructive receipt to apply, "The obligee's demand for payment must be the only thing that would be necessary to receive payment."

Treasury Regulations provide that constructive receipt occurs when income is credited to the taxpayer's 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 draw had been given. Case law shows that to constitute constructive receipt money must be placed unconditionally at the disposal of the taxpayer without substantial limitations or restrictions as to time, manner, or condition upon which payment is to be made. (*See* Rushing v. Commissioner, 441 F. 2d 593 (5th Cir. 1971); *see also* George A. Manos and Louise G. Manos v. Commissioner, 8 T.C.M. 1025 (1949).)

A good example of how a taxpayer can sell a right to income under the installment method, even if the transaction occurs shortly before the taxpayer would recognize income absent a sale, is Rushing v. Commissioner. In Rushing, the taxpayers owned 50 percent of the stock in two corporations. The taxpayers,

as directors, voted to adopt plans of liquidation for both corporations. The corporations were liquidated within twelve months of the day the respective plans of liquidation were adopted.

The reason for adopting these plans was to qualify under the then existing provisions of Section 337 of the Code, which permitted a corporation to avoid recognition of gain on the sale of its assets if it completely liquidated within twelve months of the adoption of a plan of liquidation. Shortly after the adoption of these plans, the corporations sold substantially all of their assets. One day and twenty-nine days, respectively, before the deadlines for liquidating, the taxpayers sold their stock in the corporations to two irrevocable trusts they had created for their children in exchange for notes payable over a period of years.

The notes were secured by the general assets of the trusts. The taxpayers did not report their gain for the liquidation of the corporations. Instead, the taxpayers elected to report the gains on the sales of their stock using the installment sales method. Thereafter, the corporations were timely liquidated and the proceeds paid to the trusts. Had the taxpayers retained their stock and received the liquidation proceeds, they would have had to recognize the entire gain on the liquidations in a single year, that is, the year in which the liquidation proceeds were distributed.

The Court of Appeals for the Fifth Circuit affirmed the Tax Court's holding in favor of the taxpayers. The only question was "whether they must pay taxes on the entire amount of the gain in the year the corporations were liquidated or ... over a period of years as the installment payments are received from the trusts."

The answer to this question simply turned on whether the taxpayers had **retained any direct or indirect control over the proceeds** or any economic benefit therein. Since "[a]n autonomous entity [i.e., trust] controlled the proceeds, and no right of recapture inured to the benefit of the taxpayers," and since the "taxpayers retained no effective benefit or control over the liquidation dividend," and "the taxpayers' only effective means of obtaining the benefit or control over the liquidation proceeds was under the contract of sale with the trust, a contract which provided for payments to be made on the installment basis" the taxpayers were not taxable on the liquidation proceeds and were permitted to recognize the gains on their stock sales under the installment sales method.

Under WBA, the seller is the obligee under an installment obligation. The invested funds are owned solely by the factoring company. The seller is a mere general unsecured creditor of the factoring company and is only entitled to receive payments under the Obligation in accordance with the payment schedule, which must be determined prior to consummation of the underlying Receivables factoring transaction. Consequently, the seller of A/R in the WBA plan is not in constructive receipt of any receivables factored under the program or otherwise payable under the Obligation until such amounts are actually paid to the seller in accordance with the obligation's payment schedule.

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Economic Benefit Doctrine

The theory of economic benefit subjects a cash method taxpayer to taxation on the receipt of property that confers a present economic benefit whether or not the taxpayer is capable of realizing the income immediately. In order to be taxable under this doctrine, a taxpayer's rights to property must have fully vested such that the taxpayer's rights are not subject to substantial restrictions or limitations. In Sproull v. Commissioner, the court held that the economic benefit doctrine applies when assets are unconditionally and irrevocably paid into a trust or fund to be used for the taxpayer's sole benefit (16 T.C. 244 (1951), aff'd 194 F.2d 541 (6th Cir. 1952)).

Hence, there must be an identifiable property and the taxpayer's rights to that property must have vested although he does not have immediate possession of that property.

Under WBA, the Seller's rights to income from the obligation have not vested and the seller has no rights or ownership interests in the funds invested by the factoring company (See PLR 9624009; Thomas v. U.S., 99-1 USTC 50,451 (S.D. Ohio March 31, 1999), aff'd, 85 AFTR 2d 2000-1886, (6th Cir. May 2000))

Instead, the Seller is a mere unsecured creditor of the factoring company and the factoring company is engaging in business transactions, including other purchase transactions under WBA, which can result in liabilities. Accordingly, the economic benefit doctrine will not apply to the Seller's receipt or holding of the Obligation.

Cash Equivalency Doctrine

Under the cash equivalency doctrine, a taxpayer is required to recognize income when he or she receives property that is the "equivalent of cash". The seminal case in the cash equivalency area is Cowden v. Commissioner (289 F.2d 20 (5th Cir. 1961)). In Cowden, the Court held that "if a promise to pay of a solvent obligor is unconditional and assignable, and of a kind that is frequently transferred to lenders or investors at a discount not substantially greater than the generally prevailing premium for use of money, such promise is equivalent of cash and taxable in like manner as cash would have been taxable had it been received by the taxpayer rather than the obligation". The WBA Obligation is a general unsecured obligation of factoring company. The Obligation does not guarantee the payment of principal. The Obligations are not readily tradable and there is no organized market for the sale of the Obligations. Thus, the cash equivalency doctrine should not be applied to the receipt of the WBA Obligation.

Installment Sales

The second main issue to deal with is whether accounts receivable can be sold via an installment note. There is significant guidance on this issue which is outlined below.

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Section 453 of the Internal Revenue Code of 1986, as amended, (the "Code") provides a general rule and then contains explicit "carve outs" for certain types of property the sale of which Congress has determined not to be appropriate for installment method treatment. The text of the salient portions of Section 453 are instructive:

> 453(a) General Rule. Except as otherwise provided in this section, income from an installment sale shall be taken into account for purposes of this title under the installment method.
>
> 453 (b) Installment Sale Defined. For purposes of this section:
>
> (1) In General – The term "installment sale" means a disposition of property where at least 1 payment is to be received after the close of the taxable year in which the disposition occurs.
>
> (2) Exceptions. The term "installment sale" does not include–
>
> (A) Dealer Dispositions. Any dealer disposition (as defined in subsection (l)).
>
> (B) Inventories of Personal Property. A disposition of personal property of a kind which is required to be included in the inventory of the taxpayer if on hand at the close of the taxable year.

The exceptions to the general rule are set forth in the Code itself. Receivables are neither mentioned nor alluded to in any of the text as being excepted or carved out in any manner.

A threshold for qualification of a sale for installment method treatment is whether the asset sold constitutes "property" within the meaning of Section 453. When a term such as "property" is used in the Code, it is given its natural and normal meaning absent a policy reason indicated in the relevant statutory provision or its legislative history for using a more restricted meaning. *See* Realty Loan Corp. v. Commissioner, 54 T.C. 1083 (1970), *aff'd* 478 F.2d 1049 (9th Cir. 1973). E.I. duPont De Nemours & Co. v. U.S., 471 F.2d 1211 (Ct. Cl. 1973) ("Unless there is some special reason intrinsic to the particular provision . . . the general word 'property' has a broad reach in tax law."). Many tangible and intangible properties, including unaccrued contractual rights and authors' manuscripts, arise directly from the performance of services and are treated as property eligible for installment sale by the Courts and the Service.

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(See Rev. Rul. 234, 1953-2 C.B. 29 (authors manuscript held to be property eligible for installment sales treatment); Hempt Bros. Inc. v. U.S., 490 F.2d 1172 (3rd Cir. 1974) - accounts receivable held to be "property" for purposes of section 351 (a) of the Code; *see also*, H.B. Zachry Co., 49 T.C. 73 (1967) (carved out oil payment rights held to be "property" for purposes of Section 351 even if viewed as a "pure income right"); W.W. Pope v. Commissioner, 24 T.C.M. 1096) (1965) (taxpayer in the business of constructing standardized homes on purchasers' lots with materials owned by taxpayers was a dealer in personal property eligible to use the installment method); *see also,* North Dakota State University v. U.S. 255 F.3d 599 (8th Cir. 2001) (non-transferable tenure rights determined to be "property"); *see also*, Roberts Co. v. Commissioner 5 T.C. 1 (1945) (attorneys fees are property for purposes of Section 351 of the Code)).

In Realty Loan, the taxpayer was a closely held corporation engaged in the mortgage banking and mortgage servicing business. The taxpayer sold his business in exchange for a series of payments to be made over a six-period, The payments were principally for the right to receive his servicing fees. The taxpayer contended that he was eligible to report his receipt of income under the installment method, while the Internal Revenue Service ("Service") argued that the servicing fees were not capital assets and thus could not be property for purposes of Section 453 of the Code.

The Tax Court held that the servicing contracts were property in the ordinary sense even though they were not capital assets and the gain derived from their sale was not a capital gain. The Ninth Circuit affirmed and held that the installment sale of the unaccrued contract rights, together with other kinds of property, is consistent with the purpose of Section 453 of the Code.

The Ninth Circuit stated:

> The Commissioner's brief suggests his actual concerns with the installment sale of un-accrued contract rights. However, the Commissioner has not shown how the installment treatment of the sale of such rights could be an abuse of the installment sale provisions of the Code. Allowing installment sale treatment of unaccrued contract rights together with other kinds of property is consistent with the purpose of §453's predecessor as stated by the Supreme Court: the avoidance of the hardship of immediate taxation of unreceived and unreceivable sums and the avoidance of the difficulty of valuation of installment obligations. 478 F. 2d at 1051.

(See also Mitchell v. Commissioner, 65 T.C. 1099 (1976) aff'd, 590 F.2d 312 (9th Cir. 1979) (Service conceded at trial that the installment method could be used to report the sale of stock options); Rev. Rul. 73-437, 1973-2 C.B. 156 (taxpayer engaged in selling standardized homes constructed by him on customers' lots, from pre -cut material that he furnishes is a dealer in personal property under Section 453(a) of the Code and may adopt the installment method of accounting); Jensen, Venerable Assignment of Income Doctrine Still Beset By Confusion, 93 TNT 245-85 December 3, 1993) (discussing hypothetical factual situation where a professional athlete sold his right to vested future payments on

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a deferred payment basis and stating: In view of the great freedom that employees and sellers of property have in deferring recognition of income, it is difficult to discern how tax policy would be subverted by either allowing [the athlete] to use the installment sales method or allowing him to defer recognition of income until actual receipt of the annual payments”)).

The Ninth Circuit went on to state that we give “property” its natural and normal meaning and held that the mortgage servicing contracts sold here were “property” eligible for installment sale treatment under Int. Rev. Code 1954 §453. 478 F. 2d at 1052. Under the 9th Circuit’s analysis, the Receivables present an even stronger case for qualification under Section 453 of the Code because, unlike the mortgage servicing contracts in Realty Loan, the Seller’s right to income from the Receivables has accrued and no further performance is required.

Moreover, income from the Receivables is unreceived and unreceivable and future payments due under the WBA obligation share these characteristics until payment is actually made. Therefore, in keeping with the United States Supreme Court’s instructions (*See* Gregory v. Helvering, 293 U.S. 465, 55 S.Ct. 266 (1935) discussion supra), the hardship of taxation should not occur until the Seller has received payment following disposition of his or her Receivables.

In PLR 9533008 (May 9, 1995), the Service determined that a right to future payment of previously earned compensatory income was “property” for purposes of §1001 of the Code. In PLR 9533008, the employee/taxpayer was transferred, as compensation for services rendered, the right to receive a specified percentage of income earned by the employer/corporation from two partnerships in which the employer had interests. The employee was not transferred an interest in either of the partnerships nor was he otherwise deemed to be a partner in either partnership. Thereafter, the employee sought to sell these income rights to a trust in an arm’s length sale.

The Service concluded that, although the compensatory right was an “unfunded and unsecured promise to pay money in the future and as such, was not property for purposes of section 83 of the Code,” the right was, in fact, “property” for purposes of Code §1001 and that a disposition of that property had occurred. The Service held that the employee would have ordinary income includable on his federal income tax returns “in the years in which payments for the sale are received from the trust.” (The Service did not elaborate in the ruling whether this conclusion was as the result of the application of the installment method or was based on the cash method of accounting (which generally requires income recognition only when a taxpayer receives cash or a cash equivalent)).

Similarly, in Revenue Ruling 2002-22, the Service ruled that an employee’s rights under a deferred compensation plan were property for purposes of Code Section 1041. (*See also* Davis v. Commissioner, 119 T.C. No. 1 (July 3, 2002) (Service acknowledged that taxpayer’s right to future annual lottery payments was “property in the ordinary sense of the word”, even though Tax Court held that such right was not a capital asset and that income upon disposition was ordinary)).

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Section 1001(d) of the Code authorizes the use of the installment method of reporting gain from the sale of "property" disposed of pursuant to an installment sale. In fact, Treas. Reg. Section 1.1001-1(d) explicitly provides that "[i]n the case of property sold on the installment plan, special rules for the taxation of gain are prescribed in section 453."

Summary on WBA

Outlined in the proceeding material is a unique but simple income deferral plan that will be helpful to many clients. The concept simply takes a client's accounts receivables and sells them to a factoring company in exchange for a long term installment note.

If you are an advisor who would like to bring a nice, simple income deferral tool to your medium to small business clients, then dealing with WBA is a good way to accomplish that goal. In the "advanced" market there are few ways for clients to income tax defer $50,000-$5,000,000 in one year.

It seems that every insurance advisor's favorite tool of the moment is a 412(i) Defined Benefit Plan, which can work for only a small percentage of very small employers with few employees (you can read in detail about 412(i) plans in the qualified plan educational module). On the other hand, the WBA has much broader potential usage. The following are a few of the main benefits of WBA:

-WBA is not a retirement plan and is not governed by ERISA (and therefore does not require any funding for employees.

-WBA does not require any mandatory funding (412(i) and Section 79 Plans typically must be funded for five years).

-WBA can have the money return to the client any time after 12 months, which means the money can come back before a principal owner of a company turns 59.5 years old.

If you are an advisor who is tired of getting the same question each year from your high income clients (i.e. "How can you reduce my current income taxes?"), then incorporating the WBA into your practice would be a great way to show your clients a simple but unique way to defer current income for up to 30 years.

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Non-Qualified Deferred Compensation and The Evolution of The Leveraged Bonus Plan

Executive compensation has historically outpaced the deferral limitations set forth in qualified retirement arrangements like 401(k) plans and individual retirement accounts (IRAs). Consequently, companies have had to look to other options to fund the retirement income expected by their highly compensated key employees. To meet this need, non-qualified deferred compensation ("NQDC") arrangements have become a staple at most public companies, as well as many privately held businesses. Over the last 20 years, NQDC has become a significant portion of the participants' expected future retirement cash flow.

While companies have been motivated to provide NQDC to key employees for a number of reasons, the cost of providing these benefits is significant. On October 22, 2004, the American Jobs Creation Act of 1994 (the "Act") was signed into law resulting in dramatic and fundamental changes in the NQDC arrangements offered by all companies. The Act increases the complexity and cost of providing a NQDC plan for employers and introduces a new set of significant limitations for both the employer and employee.

In reaction to the changing executive benefits marketplace, including the new restrictions of the Act, many employers and advisors are looking anxiously for alternative programs that will meet the objectives of employers without the cost and complexity of traditional NQDC arrangements. While there are a number of creative ideas in the marketplace (most with a commensurate share of risk), many employers are taking a closer look at simple bonus plans that create a current deduction for the employer while leaving the executive with the funds necessary to purchase an individually owned retirement plan.

While simple bonus plans are not new, the long-awaited introduction of non-recourse financing to the purchase of these plans recently arrived. Leveraged bonus programs represent an exciting new option to significantly reduce the employer's cost while providing a robust retirement benefit to the executive.

Executive Benefits Basics

Companies have long known that in order to *attract* talented executives to their businesses, competition required the offering of specialized retirement benefits. Once on board, these benefits are used to *motivate, reward and retain* the key employees of the company. Companies have gravitated to traditional NQDC arrangements because such plans offer a *flexible design*, allowing a enough variability within a single plan to meet the needs of a number of

individuals while at the same time provide a *selective fringe benefit* – that is, management may single-out specific executives and treat them uniquely.

In addition, companies have been willing to invest in executive benefit arrangements, but only as long as the company received "credit" for the providing the benefits. Companies realize that simply paying more compensation is not the answer. In other words, the participants must perceive that the company is making an investment in the executive's future retirement. A plan that simply provides an annual bonus or other stipend that is not coupled with a retirement arrangement creates an "entitlement" and the company is soon "expected" to provide the additional compensation without regard to the executive's future retirement.

Traditional NQDC arrangements met the objectives of companies and generally have been viewed favorably by participants. Typically, these plans are funded with corporate-owned life insurance. The most common form of these plans calls for the participant to voluntarily defer a percentage of his or her income each year.

For example, a person making $500,000 per year might choose to defer 20% or $100,000. Rather than paying the person the compensation, the company will use the $100,000 to pay the premium on a life insurance policy owned by the company insuring the life of the participant. The company's obligation to provide future retirement benefits to the participant is memorialized in a contract and the company will look to the cash build up in the policy to meet its future payment obligations.

Life insurance has become the vehicle of choice in this arrangement because the earnings on the cash value within the life insurance policy are not subject to current tax and thus grow on a pre-tax compounded basis. In addition, the cash value may be accessed on a tax-free cash flow basis by borrowing against the policy in future years to fund the retirement obligation of the company. Moreover, in the event of an early death of the participant, the policy provides a current death benefit to allow the company to meet its obligation and potentially recover its costs for the plan.

Notwithstanding the compelling need for companies to offer enhanced benefits to key executives and the substantial benefits derived by executives from participating in traditional NQDC arrangements, a number of drawbacks exist. From a company perspective, a traditional NQDC arrangement is quite expensive. While this type of plan has historically been sold on a "cost recovery basis", from the accountant's perspective it is difficult to ignore the flaw in limiting the cost analysis to one of recovery only.

It is a certainty that the company, as the owner of the life insurance policy, will eventually be entitled to receive the death benefit at some future date upon the death of the particular participant. Nonetheless, if the executive is currently 45 years old, the company may well have to wait 30 or more years to recover its cost.

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From a practical standpoint, a company should be focused on a shorter time horizon, for example 10 years, to evaluate the effective cost of any plan. With a traditional NQDC arrangement, since the company does not make a payment of compensation to the participant, but rather uses the same amount to pay the premium on an insurance policy that it owns, **the company is not entitled to a current deduction for the amount** (and therefore traditional NQDC plans are not often used in small closely held companies when the owners are looking "deferred" compensation plans).

The loss of the current deduction has a real, measurable cost in today's dollars. At the same time, the company loses the use of cash flow associated with the lost tax deduction, as well as the cash flow expended to make the premium payment. In the example above, the company forgoes the opportunity to deduct $100,000 in compensation. At a 40% tax rate, the company loses $40,000 in current deductions. Moreover, the company is unable to redeploy the $40,000 back into the business. Over a 10-year period, the cost is substantial.

In addition to the cost of the lost tax deduction and the opportunity cost of not having access to the cash flow, a company also incurs the cost of administering the NQDC plan and is required to record the future liability of the plan on its books.

	Deferred Compensation Plan			
Year	Executive Deferral	Plan Funding	Lost Tax Deduction at 40%	**Incremental Annual Outlay**
	[1]	[2]	[3]	**[4]=[1]+[2]+[3]**
1	$100,000	($100,000)	($40,000)	**($40,000)**
2	100,000	(100,000)	(40,000)	**(40,000)**
3	100,000	(100,000)	(40,000)	**(40,000)**
4	100,000	(100,000)	(40,000)	**(40,000)**
5	100,000	(100,000)	(40,000)	**(40,000)**
6	100,000	(100,000)	(40,000)	**(40,000)**
7	100,000	(100,000)	(40,000)	**(40,000)**
8	100,000	(100,000)	(40,000)	**(40,000)**
9	100,000	(100,000)	(40,000)	**(40,000)**
10	100,000	(100,000)	(40,000)	**(40,000)**
Totals:				**($400,000)**
Net Present Value at 6%:				**($312,068)**

The participant, on the other hand, also accepts some downside in the traditional NQDC arrangement. The single most significant risk factor for the participant is that of "creditor risk". Recall that a company's obligation to pay future retirement benefits is established by a contract between the company and the participant. While the company may have purchased an insurance policy to help it meet the future obligation, this policy is an asset of the company and may be liquidated by other priority creditors of the company.

The **participant is a general, unsecured creditor of the company** whose risk of nonpayment exists until the last retirement dollar is paid. High profile business failures, such as the Enron collapse, underscore this significant risk to participants in traditional NQDC arrangements.

Notwithstanding the drawbacks to traditional NQDC arrangements, they have been hugely successful principally due to the lack of meaningful alternatives and the substantial limitations on the level of participation by highly compensated employees permitted in qualified plans, like 401(K) and IRA plans.

American Jobs Creation Act of 2004

The burst of the Internet "bubble" and stock market demise at the end of the 1990's led to a number of high-profile business failures and an awareness of inappropriate compensation arrangements with some key executives. The awareness of such arrangements led to heightened scrutiny of executive compensation and benefits by the IRS, SEC, shareholders, and the public at large. Enactment of the Sarbanes-Oxley legislation (Sarbanes-Oxley Act of 2002 (P.L. 107-204) and the regulatory elimination of "old" split-dollar owned life insurance (Treas. Reg. §1.61-22) are two prior actions designed to substantially curtail perceived abuse in this area.

On October 22, 2004, the President signed the American Jobs Creation Act of 2004 (P.L. 108-357). This new law makes *dramatic* changes to the tax rules impacting virtually all NQDC arrangements for all amounts deferred there under on or after January 1, 2005. The new law is generally viewed as "tightening the noose" on traditional NQDC arrangements, foreshadowing possible future restrictions that will further eliminate the distinctions between qualified and non-qualified arrangements.

The Act created a new tax code section, IRC §409A. In sweeping fashion, the new law provides that all current and prior deferrals of compensation of any sort by anyone will be taxed if the terms of such plan under which the deferrals were made do not comply with the terms of the new rules. In particular, the new law creates limitations on payout elections, as well as creating greater restrictions in event of death, disability, termination and hardship. Significantly, the new law prohibits the ability to accelerate benefits as follows:

- No "haircut" or penalty provision permitting early withdrawal
- No petitions for early distributions

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- No contract renegotiations or benefits restructures
- No plan terminations or liquidations

The new law affects NQDC in a number of other ways, including the timing of deferral elections, the rules impacting changes in the time and form of payout, elimination of offshore trusts, elimination of financial/health triggers and, of course, an increase in IRS reporting requirements.

On December 20, 2004, the Treasury Department and the IRS issued Notice 2005-1 (the "Notice") providing guidance to companies with respect to the transition of existing NQDC plans, including the "freezing" or termination of such plans. Although the new legislation generally is effective for contributions made on or after January 1, 2005, the Notice extends the deferred compensation compliance deadline to December 31, 2005 to bring existing NQDC plans into compliance.

Significantly, the Notice provides that an employer has until December 31, 2005 to terminate an existing plan without inadvertently triggering the penalties otherwise prescribed by the Act. The extension set forth in the Notice provides a great opportunity for executive benefits advisors to assist clients in evaluating their deferred compensation options through the end of 2005.

Reaction to the Act

The reaction to the new law has been consistent – employers do not like it. They see the following problem areas:

- Our NQDC Plan is no longer attractive to key executives
- Increased IRS and SEC reporting requirements
- Increased shareholder scrutiny
- Increased Director and Officer potential liability
- No ability to terminate plan until the last participant's retirement is paid
- Looking for other retirement benefit alternatives

The reaction from employees has also been consistent – they do not like it. Many executives are expressing concern over the following:

- Long-term financial security of their employer
- Change in heart of management to continue the plan given the law change
- Change in control of company no longer represents a "trigger event"
- Retirement planning flexibility has been substantially reduced

- Possible need for early access is no longer an option
- Looking for other retirement/investment alternatives

Companies that currently provide traditional NQDC arrangements are struggling to determine the appropriate course of action in light of the new law. While the new legislation contemplates an ability to "grandfather" an existing plan, doing so will generally require "freezing" the current plan, thus prohibiting future contributions. Under such circumstance, a company is faced with either not offering a plan going forward or developing a new plan that complies with the new legislation. Alternatively, a company may choose to terminate an existing plan, choose not to form a new plan and instead leave retirement planning up the key employees, or find an alternative plan that does not come with the limitations, restrictions and costs associated with NQDC.

Options

- ❖ **Do Nothing**
- ❖ **Terminate Current NQDC Plan and Transition Future Deferrals to Alternative Plan**
- ❖ **Freeze Current NQDC Plan and Transition Future Deferrals to Alternative Plan**

Looking for Alternatives

Many employers are anxious to evaluate alternative arrangements that will provide a competitive executive benefits solution without the onerous requirements, limitations and inflexibility brought on by the Act. The remainder of this section will discuss two simple alternatives that are getting a lot of attention from employers and are well received by key executives.

- §162 Double Bonus Plan

The first alternative is the so-called §162 Double Bonus Plan. (Note that "§162" is merely a reference to IRC §162 that provides that a payment, in this case a bonus, is deductible as an ordinary and necessary business expense to the extent it is reasonable). This arrangement is a fundamental shift away from the traditional NQDC structure and contemplates that the executive will purchase a life insurance policy to fund his or her own future retirement needs. Consequently, the company is not the owner of the policy and, accordingly, the policy is not subject to the claims of the company's creditors. To enable the executive to purchase the policy, the company agrees to make an annual bonus sized on an after-tax amount necessary to pay the premium.

In order to accomplish the purchase, the company will essentially make two bonus payments. The first bonus is an amount equal to what would have been deferred in a traditional NQDC arrangement. However, since the company is making this payment to the executive currently, it is subject to current income

taxation. Consequently, the company makes a second bonus that will replace the taxes lost on the first bonus, after taking into account that the second bonus will also be subject to income tax.

Put another way, under a §162 Double Bonus Plan, the company simply makes a payment that is "grossed-up" to the executive such that the net after-tax payment is equal to a target amount. Recall that in a traditional NQDC arrangement, an executive who selected to defer $100,000 does not pay tax on that amount in the current year and the employer invests the entire $100,000 into an insurance policy on a post-tax basis.

The appeal of a §162 Double Bonus Plan is its simplicity and deductibility. Because the participant is paying taxes on the bonus, the plan operates outside the rules and regulations otherwise applicable to traditional NQDC and, in particular, the Act. From a participant perspective, this type of plan results in direct participant ownership of the retirement plan through ownership of the insurance policy and thereby eliminates the creditor risk present in traditional NQDC arrangements.

The primary drawback for use of the §162 Double Bonus Plan is the cash flow cost for the employer. Because the employer is expected to "gross up" the bonus to cover taxes, the plan is expensive and inefficient, from a tax perspective.

Plan Bonus	**(100,000)**
Tax Deduction	**40,000**
Net Cost of Bonus	**(60,000)**
Double Bonus	**(66,667)**
Tax Deduction	**26,667**
Net Cost of Double Bonus	**(40,000)**
Gross Cost:	**($166,667)**
After-Tax Cost:	**($100,000)**

For this reason, many employers have preferred historically to establish a traditional NQDC arrangement or provide no plan at all. Passage of the Act has caused companies to give the §162 Double Bonus Plan another look.

- §162 Leveraged Bonus Plan

In response to the limited options available to companies, the marketplace has produced a new alternative that provides similar benefits to traditional plans, but does so at a substantially reduced cost to the employer. A §162 Leveraged Bonus Plan ("LBP") works like a §162 Double Bonus Plan except that with LBP, rather than the company making a "grossed up" second bonus to cover the entire

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cost of taxes lost on the first bonus, the company makes a much smaller second bonus to cover the **interest cost of borrowing** an amount that replaces the taxes lost on the first bonus. That is, the participant borrows an amount equal to the tax paid on the first bonus (the participant may borrow an amount equal to a multiple of the taxes paid in order to create greater leverage and better performance of the retirement arrangement).

	§162 Bonus	LBP	LBP Savings
Plan Bonus	(100,000)	(100,000)	0
Tax Deduction	40,000	40,000	0
Net Cost of Bonus	(60,000)	(60,000)	0
Double Bonus	(66,667)	(4,000)	62,667
Tax Deduction	26,667	1,600	
Net Cost of Double Bonus	(40,000)	(2,400)	37,600
Gross Cost:	($166,667)	($104,000)	$62,667
After-Tax Cost:	($100,000)	($62,400)	$37,600

LBP is essentially an individually owned executive benefit program that is funded with universal life insurance. A portion of the premium is funded through a loan made by a third party finance company. Employers like LBP over traditional NQDC because LBP is not subject to deferred compensation-related regulation or the Act. Consequently, LBP allows an employer to maintain a flexible and selective fringe benefit for key executives without the administrative burden and long-term liability.

Most importantly, LBP is deductible to companies currently while substantially reducing the overall cash flow cost to the company. Employees like LBP because they own the retirement plan outright and are no longer subject to the general credit risk of the company for their future retirement cash flow. Moreover, unlike traditional NQDC, the future retirement benefits are paid tax-free if the policy is held until death. Lastly, LBP plans provide a current death benefit and may be designed to provide asset protection and/or estate tax planning flexibility.

LBP is unique in that a third-party loan is utilized to fund a portion of the premium due on the insurance policy. The loan should be non-recourse relying solely on the underlying insurance policy as collateral. Consequently, the executive participant should not provide a personal guarantee of any kind and should not pledge any other personal assets. Because there is no personal guarantee, the lender should not have a minimum net worth requirement and require no credit reporting or financial underwriting.

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A participant should expect to be offered a written commitment from the finance company to make a minimum of 5 annual loans. **Typically, the loan term is 10 years with automatic annual renewals and repayment is expected at the end of the 10th year from the cash value buildup within the policy**. (The lender will likely only lend on a universal life ("UL") insurance policy. A UL policy has a guaranteed minimum crediting rate and a higher "current crediting rate". Since the policy has a positive crediting rate and the employer is carrying the interest cost of the loan, it is generally not possible for a participant to lose value in the retirement plan due to market conditions or interest rate fluctuations). Depending on the lender, there may be a requirement that the insurance policy be held by a revocable trust until such time as the loan is repaid. Where this is required, the cost of trust formation, administration and trustee services are typically paid for by the lender.

Summary on NQDC and LBP

The American Jobs Creation Act of 2004 established a new set of rules and regulations governing the operation of every deferred compensation arrangement in the United States. The early consequence of the Act has been to take the "wind out of the sail" of traditional NQDC. Mounting scrutiny and complexity have reached a tipping point for many employers pushing them to explore alternative arrangements designed to provide competitive retirement benefits to key executives.

Alternative arrangements like the §162 Double Bonus Plan and the §162 Leveraged Bonus Plan provide current deductions, simplicity and minimal administrative expense. Moreover, these alternatives provide the retirement benefits key executives demand without the challenges presented by the Act and related regulation. Lastly, in the case of the §162 Leveraged Bonus Plan, by using the funds of a third-party lender, a company can provide competitive benefits at a substantial savings over other alternatives.

Conclusion on "Deferred Compensation"

Anytime there is a problem that can be solved, there is an opportunity for an advisor to generate new business IF the advisor has a solution to the problem.

For many medium to small business, income tax deferral and wealth building are very important issues and through the sale of receivables through payment via a deferred installment note (WealthBuilder® Annuity), clients can defer current income for up to 30 years. For advisors looking to grow their practice, there is not a topic that can be more useful than one that helps clients reduce their taxes and build wealth (all while not being involved in a qualified plan which would require significant funding for all employees).

For many advisors the Jobs Creation Act will be an opportunity to show current clients with traditional NQDC plans why they need to get out of those plans and the consequences if they do not. By learning about the Leveraged

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Bonus Plan, advisors can set themselves apart from ultimately what most advisors will be telling their client, which is the traditional “double bonus” plan.

By learning these techniques, advisors who have or would like to have high income clients will be better educated and more capable to help those clients than any other local advisor.

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