



Deductible Roth 401(k) Look-A-Like

by

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Ask a highly-paid executive this question: “*How much could you contribute to a deductible retirement plan if the retirement income is tax free?*” For those with an answer, you have a new prospect for a Deductible Roth 401(k) Look-A-Like.

Try this on a CEO: “*If you could help selected executives fund a deductible retirement account with tax free retirement income, would you like to see how it works?*” For each CEO with a positive reaction, you will likely provide a Deductible Roth 401(k) Look-A-Like for several executives.

What follows is not a casual read; however, your learning curve should increase rapidly. If the subject is interesting to you, take the time to study this article and its related reports.

Case Study #1 (for-profit organizations)

Arthur Lee, age 45, is a top executive with Ryder Manufacturing Co., Inc. with current compensation of \$400,000. Let’s see if we can convince him to redirect \$30,000 pre-tax a year for five years into a Deductible Roth 401(k) Look-A-Like.

Step 1: Arthur agrees to a compensation reduction of \$30,000 for five years. This costs him \$16,500 a year after tax (in his 45% marginal income tax bracket). This is a key step as the out-of-pocket results to Arthur are the same as if he made five deductible annual contributions of \$30,000 to his 401(k) plan -- hence the use of the word “Deductible” in Deductible Roth 401(k) Look-A-Like.

Step 2: Ryder retains the \$30,000 no longer paid to Arthur in each of the five years; however, it is no longer deductible by Ryder, thus it retains a net \$19,800 each year in its 34% tax bracket.

Step 3: Ryder loans Arthur \$30,000 a year for five years which he uses to fund \$750,000 of Indexed Universal Life via a loan-based split dollar arrangement. Ryder is out-of-pocket \$10,200 in each of the five years (split dollar loan to Arthur of \$30,000 for five years less the net \$19,800 retained for five years in Step 2.)

Step 4: Ryder carries the cumulative loan on its balance sheet as a loan receivable (secured by the life insurance policy).

Step 5: Arthur pays loan interest to Ryder at the current Applicable Federal Rate (“AFR”), and the April 2010 long-term AFR of 4.40% is illustrated. Ryder provides a gross-up bonus to Arthur to offset the loan interest Arthur owes. The bonus is deductible by Ryder, and the loan interest paid by Arthur is taxable to Ryder.

Step 6: Arthur repays the loan in year 20 via a withdrawal from the life insurance policy. The life insurance policy remains in force, but it is no longer subject to a split dollar arrangement.

Step 7: In year 21, Arthur makes loans on the policy of \$36,000 a year for the next 20 years producing total after tax retirement cash flow of \$720,000. This after tax cash flow is analogous to a Roth 401(k) -- hence the use of the phrase "Look-A-Like" in Deductible Roth 401(k) Look-A-Like.

Below is Ryder's net payment analysis. Note in Column (11) there is a negative cumulative charge to earnings for Ryder in all years, and a *negative value indicates a credit to earnings*. As you can see in year 20 of Column (4), the \$150,000 loan is scheduled to be repaid to Ryder via a policy withdrawal. At that time, Ryder locks in the credit to earnings of \$38,412, the policy is no longer subject to the split dollar arrangement, and Arthur is free to use cash flow from the remaining policy values to supplement his retirement.

	(1)	(2)	(3)	(4)	(5)	(6)	(7)	(8)	(9)	(10)	(11)	
	Compensation Adjustment by Executive	Employer's After Tax Gain from Compensation Adjustment	Loan to Executive	Loan Repayment from Executive	Loan Interest Received from Executive	After Tax Loan Interest Received from Executive	Bonus Paid to Executive	After Tax Cost of Bonus Paid to Executive	Employer's Net Payment*	Employer's Annual Charge to Earnings** (8) - (6) - (2)	Employer's Cumulative Charge to Earnings**	
Yr	Age	Executive	Executive	Executive	Executive	Executive	Executive	Executive	Executive	Executive	Executive	
1	45	30,000	19,800	30,000	0	1,320	871	2,400	1,584	10,913	-19,087	-19,087
2	46	30,000	19,800	30,000	0	2,640	1,742	4,800	3,168	11,626	-18,374	-37,462
3	47	30,000	19,800	30,000	0	3,960	2,614	7,200	4,752	12,338	-17,662	-55,123
4	48	30,000	19,800	30,000	0	5,280	3,485	9,600	6,336	13,051	-16,949	-72,072
5	49	30,000	19,800	30,000	0	6,600	4,356	12,000	7,920	13,764	-16,236	-88,308
6	50	0	0	0	0	6,600	4,356	12,000	7,920	3,564	3,564	-84,744
7	51	0	0	0	0	6,600	4,356	12,000	7,920	3,564	3,564	-81,180
8	52	0	0	0	0	6,600	4,356	12,000	7,920	3,564	3,564	-77,616
9	53	0	0	0	0	6,600	4,356	12,000	7,920	3,564	3,564	-74,052
10	54	0	0	0	0	6,600	4,356	12,000	7,920	3,564	3,564	-70,488
11	55	0	0	0	0	6,600	4,356	12,000	7,920	3,564	3,564	-66,924
12	56	0	0	0	0	6,600	4,356	12,000	7,920	3,564	3,564	-63,360
13	57	0	0	0	0	6,600	4,356	12,000	7,920	3,564	3,564	-59,796
14	58	0	0	0	0	6,600	4,356	12,000	7,920	3,564	3,564	-56,232
15	59	0	0	0	0	6,600	4,356	12,000	7,920	3,564	3,564	-52,668
16	60	0	0	0	0	6,600	4,356	12,000	7,920	3,564	3,564	-49,104
17	61	0	0	0	0	6,600	4,356	12,000	7,920	3,564	3,564	-45,540
18	62	0	0	0	0	6,600	4,356	12,000	7,920	3,564	3,564	-41,976
19	63	0	0	0	0	6,600	4,356	12,000	7,920	3,564	3,564	-38,412
20	64	0	0	0	150,000	0	0	0	0	-150,000	0	-38,412
		150,000	99,000	150,000	150,000	112,200	74,052	204,000	134,640	-38,412	-38,412	

Green columns = Ryder's Cash Flow in.
 Red columns = Ryder's Cash Flow out.
 Blue columns = Ryder's Net Payment and Charge to Earnings.

*Column (9) = (3) - (2) - (4) - (6) + (8)
 **A negative value indicates a credit to earnings.

[Click here](#) before proceeding to review the entire illustration for Arthur's Deductible Roth 401(k) Look-A-Like.

Case Study #1 - A Comparative Alternative for Arthur Lee

Arthur could decide not to reduce his compensation by \$30,000 a year for the next five years and invest the resulting \$16,500 in after tax funds each year in, let's say, an equity account.

[Click here](#) to review this strategy in illustrations from the Equity Account Calculator available on the InsCalc[®] tab in the InsMark Illustration System. We assumed a 7.5% yield and a 1.00% dividend to match the 8.50% illustrated with the Indexed UL. The equity account runs out of gas after only six retirement years when tasked with matching the after tax retirement cash flow results of \$36,000 a year from the Deductible Roth 401(k) Look-A-Like. If spread over 20 retirement years, the equity account produces only \$14,566 a year.

Case Study #1 - Retirement Cash Flow @ Age 65 and Residual Values @ Age 85

Deductible Roth 401(k) Look-A-Like: The life insurance policy underwriting the arrangement is illustrated to produce after tax retirement cash flow for Arthur of \$36,000 a year for 20 years (\$720,000 total) with residual cash value of \$406,266 wrapped in \$496,766 of policy death benefit. This is produced after a policy withdrawal is made from cash values of \$150,000 in the year prior to retirement to repay the split dollar loans due Ryder.

Equity Account #1: Starting at age 65, this account is illustrated to produce after tax retirement cash flow for Arthur of \$36,000 a year for 6 years plus \$346 in year 7 (\$216,346 total) with residual value of \$0 thereafter.

Equity Account #2: Starting at age 65, this account is illustrated to produce after tax retirement cash flow for Arthur of \$14,566 a year for 20 years (\$291,321 total) with residual value of \$28.

By loaning funds for the split dollar arrangement, Ryder uses its cash far more efficiently than, for example, a matching contribution to a formal defined contribution plan since, with a Deductible Roth 401(k) Look-A-Like, it ends up permanently enhancing its balance sheet -- in this case, by a permanent amount of \$38,412.

The equity account is no match for the life insurance policy once you account for all the items that retard the growth of an equity account such as management fees, income tax on dividends and short-term gains, and capital gains tax on long-term gains. These items are all reflected in the equity account illustrations discussed above.

Note: In addition to the Deductible Roth 401(k) Look-A-Like, Ryder could also schedule a one-time, pre-retirement severance benefit for Arthur equal to his realized compensation reductions, the cost of which would be partially offset by Ryder's negative charge to earnings. If such severance were added to the equity account arrangement, there would be no corresponding offset.

Case Study #2 (tax-exempt organizations)

The costs and benefits for an executive of a tax exempt organization are exactly the same as the costs and benefits for an executive of a for-profit organization -- including both the Deductible Roth 401(k) Look-A-Like and the equity alternatives. **A tax exempt organization's costs are different than a for-profit organization's costs, and the differences are highlighted in red below.**

Robert Huntington, age 45, is a top executive with Bay Area Medical Center with current compensation of \$400,000. Let's see if we can convince him to redirect \$30,000 pre-tax a year for five years into a Deductible Roth 401(k) Look-A-Like.

Step 1: Robert agrees to a compensation reduction of \$30,000 for five years. This costs him \$16,500 a year after tax (in his 45% marginal income tax bracket). This is a key step as the out-of-pocket results to Robert are the same as if he made five additional annual contributions of \$30,000 to his 401(k) plan.

Step 2: The Medical Center retains the \$30,000 no longer paid to Robert in each of the five years. **Since the Medical Center is not subject to income taxation, it retains the entire \$30,000.**

Step 3: The Medical Center loans Robert \$30,000 a year for five years which he uses to fund \$750,000 of Indexed Universal Life via a loan-based split dollar arrangement. **The Medical Center is out-of-pocket \$0 in each of the five years (split dollar loan to Robert of \$30,000 for five years less the \$30,000 retained for five years in Step 2.)**

Step 4: The Medical Center carries the cumulative loan on its balance sheet as a loan receivable (secured by the life insurance policy).

Step 5: Robert pays loan interest to the Medical Center at the current Applicable Federal Rate (“AFR”), and the April 2010 long-term AFR of 4.40% is illustrated. The Medical Center pays a gross-up bonus to Robert to offset the loan interest he owes. **The bonus is not deductible by the Medical Center nor is the loan interest paid by Robert taxable to the Medical Center.**

Step 6: Robert repays the loan in year 20 via a withdrawal from the life insurance policy. The life insurance policy remains in force, but it is no longer subject to a split dollar arrangement.

Step 7: At the beginning of year 21, Robert makes annual loans on the policy of \$36,000 a year for the next 20 years producing total after tax retirement cash flow of \$720,000.

Below is Bay Area Medical Center’s net payment analysis. Note in Column (9) there is a negative cumulative charge to earnings for the Medical Center in all years, and a *negative value indicates a credit to earnings*. As you can see in year 20 of Column (4), the \$150,000 loan is scheduled to be repaid to the Medical Center via a policy withdrawal. At that time, the Medical Center locks in the credit to earnings of \$58,412, the policy is no longer subject to the split dollar arrangement, and Robert is free to use cash flow from the remaining policy values to supplement his retirement. Note: In all years, the Medical Center’s credit to earnings in Column (9) is higher than Ryder’s corresponding numbers (caused by the Medical Center’s tax exempt status).

Bay Area Medical Center’s Net Payments Analysis										
Yr	Age	(1) Compensation Adjustment by Executive	(2) Employer’s Gain from Compensation Adjustment	(3) Loan to Executive	(4) Loan Repayment from Executive	(5) Loan Interest Received from Executive	(6) Bonus Paid to Executive	(7) Employer’s Net Payment*	(8) Employer’s Annual Charge to Earnings** (6) - (5) - (2)	(9) Employer’s Cumulative Charge to Earnings**
1	45	30,000	30,000	30,000	0	1,320	2,400	1,080	-28,920	-28,920
2	46	30,000	30,000	30,000	0	2,640	4,800	2,160	-27,840	-56,760
3	47	30,000	30,000	30,000	0	3,960	7,200	3,240	-26,760	-83,520
4	48	30,000	30,000	30,000	0	5,280	9,600	4,320	-25,680	-109,200
5	49	30,000	30,000	30,000	0	6,600	12,000	5,400	-24,600	-133,800
6	50	0	0	0	0	6,600	12,000	5,400	5,400	-128,400
7	51	0	0	0	0	6,600	12,000	5,400	5,400	-123,000
8	52	0	0	0	0	6,600	12,000	5,400	5,400	-117,600
9	53	0	0	0	0	6,600	12,000	5,400	5,400	-112,200
10	54	0	0	0	0	6,600	12,000	5,400	5,400	-106,800
11	55	0	0	0	0	6,600	12,000	5,400	5,400	-101,400
12	56	0	0	0	0	6,600	12,000	5,400	5,400	-96,000
13	57	0	0	0	0	6,600	12,000	5,400	5,400	-90,600
14	58	0	0	0	0	6,600	12,000	5,400	5,400	-85,200
15	59	0	0	0	0	6,600	12,000	5,400	5,400	-79,800
16	60	0	0	0	0	6,600	12,000	5,400	5,400	-74,400
17	61	0	0	0	0	6,600	12,000	5,400	5,400	-69,000
18	62	0	0	0	0	6,600	12,000	5,400	5,400	-63,600
19	63	0	0	0	0	6,600	12,000	5,400	5,400	-58,200
20	64	0	0	0	150,000	0	0	-150,000	0	-58,200
		150,000	150,000	150,000	150,000	112,200	204,000	-58,200	-58,200	

Green columns = Medical Center’s Cash Flow in.
 Red columns = Medical Center’s Cash Flow out.
 Blue columns = Medical Center’s Net Payment and Charge to Earnings.

*Column (7) = (3) - (2) - (4) - (5) + (6)
 **A negative value indicates a credit to earnings.

[Click here](#) before proceeding to review the entire illustration for Robert’s Deductible Roth 401(k) Look-A-Like.

Note: The Comparative Alternative discussed below is identical to Arthur's discussed above; however, it is repeated here for consistency purposes. (Bay Area Medical Center's tax exempt status does not affect Robert's personal numbers.)

Case Study #2 - A Comparative Alternative for Robert Huntington

Robert could decide not to reduce his compensation by \$30,000 a year for the next five years and invest the resulting \$16,500 in after tax funds each year in, let's say, an equity account.

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Deductible Roth 401(k) Look-A-Like: The life insurance policy underwriting the arrangement produces after tax retirement cash flow for Robert of \$36,000 a year for 20 years (\$720,000 total) with residual cash value of \$406,266 wrapped in \$496,766 of policy death benefit. This is produced after a policy withdrawal is made from cash values of \$150,000 in the year prior to retirement to repay the split dollar loans due the Medical Center.

Equity Account #1: Starting at age 65, this account is illustrated to produce after tax retirement cash flow for Robert of \$36,000 a year for 6 years plus \$346 in year 7 (\$216,346 total) with residual value of \$0 thereafter.

Equity Account #2: Starting at age 65, this account is illustrated to produce after tax retirement cash flow for Robert of \$14,566 a year for 20 years (\$291,321 total) with residual value of \$28.

By loaning funds for the split dollar arrangement, the Medical Center uses its cash far more efficiently than, for example, a matching contribution to a formal defined contribution plan since, with a Deductible Roth 401(k) Look-A-Like, it ends up permanently enhancing its balance sheet -- in this case, by a permanent amount of \$58,200.

The equity account is no match for the life insurance policy once you account for all the items that retard the growth of an equity account such as management fees, income tax on dividends and short-term gains, and capital gains tax on long-term gains. These items are all reflected in the equity account illustrations discussed above.

Note: In addition to the Deductible Roth 401(k) Look-A-Like, the Medical Center could also schedule a one-time, pre-retirement severance benefit for Robert equal to his realized compensation reductions, the cost of which would be partially offset by the Medical Center's negative charge to earnings. If such severance were added to the equity account arrangement, there would be no corresponding offset.

For tax exempt organizations, in order not to run afoul of IRC Section 457(f), severance should only be provided in the event of involuntary termination of employment or death; otherwise, it is likely that the amount of promised severance will be included in the covered executive's income immediately.

Note: The application that was used for the "Look-A-Like" Case Studies in this Marketing Alert (InsMark's *Leveraged Compensation System*) can illustrate an accompanying severance benefit, and the specimen document sets referenced under "Resources" below contains specimen severance documents for use by profit and tax exempt organizations.

Resources

Those licensed for Version 5.0 (or higher) of InsMark's *Leveraged Compensation System* can review the menu prompts by going to <http://insmark.com/WorkbookDownload/ConceptLibrary.html> and clicking on the Leveraged Compensation System Workbook listed under Deductible Roth 401(k) Look-A-Like. (We used the Leveraged 401(k) Look-A-Like module in Version 5.0 to prepare the illustrations associated with this article and customized the proposal heading on the Basic Data tab to correspond with that name.) Those licensed for Version 15.1 (and higher) of the *InsMark Illustration System* can review the menu prompts we used for the equity analysis for Arthur Lee and Robert Huntington by going to <http://insmark.com/WorkbookDownload/ConceptLibrary.html> and clicking on the InsMark Illustration System Workbook listed under Deductible Roth 401(k) Look-A-Like.

Version 19.0 (and higher) of InsMark's *Documents On A Disk*[®] and *Documents On The Net*[™] have specimen documents for the transactions discussed in this article. They are located in the Employer-Sponsored Split Dollar section of documents under the following headings:

- Leveraged Deferred Compensation using Loan Regime Split Dollar (for-Profit Organizations)
- Leveraged Deferred Compensation using Loan Regime Split Dollar (Tax Exempt Organizations)

For licensing information about any of the above Systems, please contact an InsMark Account executive at 1-888-InsMark (467-6275). Institutional inquiries should be made to David A. Grant, Senior Vice President - Sales, at 1-925-543-0513 or dag@insmark.com.

In closing, let me end with the two paragraphs from the beginning of this article:

Ask a highly-paid executive this question: *"How much could you contribute to a deductible retirement plan if the retirement income is tax free?"* For those with an answer, you have a new prospect for a Deductible Roth 401(k) Look-A-Like.

Try this question on a CEO: *"If you could help selected executives fund a deductible retirement account with tax free retirement income, would you like to see how it works?"* For each CEO with a positive reaction, you will likely have the chance to provide a Deductible Roth 401(k) Look-A-Like for several executives.

Important Note: This information in this article is for educational purposes only. In all cases, the approval of a client's legal and tax advisers must be secured regarding the implementation or modification of any planning technique as well as the applicability and consequences of new cases, rulings, or legislation upon existing or impending plans.

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