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ROCK OF AGES

The Arithmathean Pension Plan - Using the Pooled Income Fund for Non-Deferred Compensation Planning

The first article for professional publication that I wrote was an article about using offshore trusts in non-qualified deferred compensation planning. I called the article the Rastafarian Rabbi Trust. The article was published in Trust and Estate Magazine. Approximately five years later, I was working for Deloitte and Touche as an insurance consultant in their individual tax practice when I had the opportunity to meet Tom Brisendine who was a former practice leader at the IRS in the employee benefits area and part of Deloitte's National Tax Office.

When we met, he wanted to know if I was the same Nowotny who had written the Rastafarian Rabbi Trust article. The article was cited in a report on IRC Sec 409A to the Joint Committee on Taxation. Commercially, no one bought me a Diet Coke to discuss the idea, but apparently enough taxpayers used the idea for Congress to enact a tax law change. I have always felt since that at least Big Brother reads my articles.

The ERISA and tax rules make it difficult for a business owner to benefit key employees on a discriminatory basis while obtaining tax benefits for amounts set aside for the key employees. Many private and public companies have structured non-qualified deferred compensation (NQDC) plans for key employees. In private companies, these plans are either unfunded or partially funded using permanent life insurance. Frequently, these benefit programs provide a pre-retirement death benefit for the key employee using a Split Dollar arrangement. However, a negative factor in NQDC arrangements is the requirement that plan assets remain subject to the claims of the company's general creditors. A reversal of fortune in the business can destroy future retirement benefits since they remain subject to the claims of the business' creditors.

Consequently, the plan sponsor may suffer a reversal of fortune that endangers the assets of the NQDC plan. Frequently, a business owner would like to provide an economic benefit to a group of key employees upon the sale of the Company in gratitude for the years of loyalty and commitment to the business owner and the business. At a gesture of appreciation, the business owner would like to provide an annuity to share his good fortune with those who helped to make it happen.

The Arithmathean Pension Plan refers to Joseph of Arimathea, a wealthy disciple of Jesus, who asked Pontius Pilate for Jesus' body following the crucifixion so that he could provide a proper burial. Joseph provided his own tomb for the burial. We do not know much about Joseph of Arimathea except that he was a wealthy disciple of Jesus who sat on the Sanhedrin, the ruling council of first-century Judaism. While the apostles hid and ran for the hills, Joseph risked his own neck literally and politically by asking Pilate for the body to provide a proper Jewish burial instead of burial in a common grave. A business owner who simultaneously seeks to leave business assets for key employees and charity is worthy to be associated with the name of Joseph of Arimathea.

Lastly, regarding the title of the article, I have written previously about my enthusiasm for Latin music. Less well known is my enthusiasm for gospel music. I like the new R&B-styled gospel sound. I enjoy Kirk Franklin, Martha Moniz but Fred Hammond best of all.

I have written extensively about the Pooled Income Fund (PIF) and its Swiss knife-like planning utility. This article focuses on yet another planning application of a customized PIF for NQDC planning purposes following the sale of the business owner's company. This strategy is best amplified through a case study.

The Plan allows a business owner to allocate a portion of the sale to a PIF on a partially deductible basis to provide a lifetime annuity for key employee(s). The balance of PIF assets is left to the business owner's donor advised fund following the death of the last income beneficiary. Beyond this basis planning proposition, the funding of the PIF may be structured to provide tax-free distributions for the lifetime of the key employees.

Overview of the Pooled income Fund

A pooled income fund (PIF) is a Charitable Trust that is established and maintained by a public charity, i.e. 501(c)(3) organization. The pooled income fund receives contributions from individual donors that are commingled for investment purposes within the fund. Each donor is assigned “units of participation” in the fund that are based on the relationship of their contribution to the overall value of the fund at the time of contribution.

Contributions to pooled income funds qualify for charitable income, gift, and estate tax deduction purposes. The donor’s deduction is based on the discounted present value of the remainder interest. Donors can also avoid recognition of capital gain on the transfer of appreciated property to the fund. A cash contribution to a PIF is subject to an income tax deduction threshold of sixty percent of adjusted gross income (AGI). Appreciated assets are subject to the thirty percent of AGI threshold. Excess deductions may be carried forward for an additional five tax years. The taxpayer also receives a charitable deduction for gift tax purposes and the remainder interest is not included in the taxpayer’s taxable estate.

Each year, the fund’s entire net investment income is distributed to fund participants according to their units of participation. Income distributions are made to each participant for the lifetime, or multiple lifetimes, consecutively or concurrently. The taxpayer does not recognize gain or loss on the transfer of property to the PIF. If a pooled income fund has existed for less than three taxable years, the charity is able to use an interest rate in calculating the charitable deduction by first calculating the average annual Applicable Federal Midterm Rate. The rate for a hypothetical rate in 2021 tax year is 1.2 percent.

In practice, this feature makes pooled income funds ideal for use by persons who desire to dispose of highly appreciated, low yielding property free of capital gains tax exposure in favor of assets that will produce higher amounts of cash flow.

Summary of Pooled Income Fund Deductions Using a Hypothetical Rate of 1.2% for 2021 Tax Year

AGE	2021 PIF CONTRIBUTION
40	63.6
45	67.1
50	70.7
55	74.3
60	77.9
65	81.

Case Study #1 Fact Pattern

Yosemite Sam is the owner of Acme Inc. Sam has recently closed on the sale of the Company to its long-term customer Wile E. Coyote for $50 million. Sam would like to share a portion of the sales proceeds with five of his key employees - Dick Dastardly (65), Foghorn Leghorn (60), Pepe LaPew (55) and Speedy Gonzalez (50). He would like to provide each of them with an equal share of the income for their lifetime.

Solution

Sam creates a new Pooled Income Fund which is administered by Alianza Charitable Programs. He contributes $5 million to the PIF in 2021 which creates a tax deduction of $3.89 million which may be used up to 60 percent of AGI with a carryover of any unused deductions for an additional five years. His five key workers are all designated as income beneficiaries concurrently for their lifetimes. Sam is deemed to have made a taxable gift of $1.11 million for which he will use a portion of his estate and gift tax exemption. The projected income from the PIF portfolio is $200,000 from which each income beneficiary will receive $25,000 per year until the death of the beneficiary.

The funds within the PIF are managed within an LLC that is wholly owned by the PIF. The definition of income within the PIF trust document includes short term capital gain income and allows the trustee the discretion to allocate some long-term capital gains income to trust income.

Case #2 Fact Pattern

Wile E Coyote, age 65 is the owner of Acme, Inc., Acme is structured as a S corporation. He would like to provide a discriminatory deferred compensation arrangement for his key employee, Muttley, age 50. However, Wile E. would like to obtain some partial tax relief for the contribution and provide the funds from any business reversal of fortune which might subject the Plan funds unnecessarily to the claims of creditors. In Acme had a great year and would like to make a single contribution to the Plan of $750,000.

Solution

Wile E creates a new Pooled Income Fund which is administered by Alianza Charitable Programs. He contributes $750,000 to a PIF in 2021. The assumed interest rate for calculating the tax deduction rate is 1.2 percent. Wile's deduction is $530,000. The PIF provides for a customized investment fund that is invested in a life insurance policy insuring a key employee within Acme (but not Muttley!). The policy is funded on a non-MEC basis. The projected value of the policy at age 65 is $2.4 million assuming an eight percent growth rate.

At that point, the trustee will tax-free distributions and make payments each to Muttley as the income beneficiary. The Plan is captured in an agreement between Acme and Muttley. The projected tax-free annual payments are $125,000 per year. Wile E is deemed to have made a $220,000 taxable gift to Muttley. Wile E allocates a portion of his estate and gift tax exemption equivalent to the transfer. The payments continue until Muttley's death.

Summary

One of the criticisms of NQDCs is that the employer's contributions use after-tax dollars. Another complaint is the requirement that the corporate plan assets remain subject to the claims of the company's creditors. The use of the PIF as an alternative provides an interesting result and improvement. The owner's contribution is partially tax deductible at a high level relative to the contribution. Second, the assets are outside of the reach of corporate creditors. Third, depending upon the investment considerations, future payments can be structured on a tax-free basis to the income beneficiary.

One potential negative is the fact that the transfer of the income interest to the employee is a taxable gift. This is the part where the witness or testimony of Joseph of Arimathea comes in. To whom much is given, much is expected! The low interest rate environment reduces the level of the gift. If the business owner does not have a taxable estate, the exemption equivalent is available to use so that no check is ever written to the government. This idea is outside of the box of normal planning but is a particularly useful idea. You heard it here first!