EQUITABLE

Planning perspective

The BATL Plan®

Bonus and Tax Loan (BATL)

It can be argued that a business's most valuable assets are its employees, the talented people who are committed to making "it" happen — day in and day out.

Attracting, retaining and rewarding key people is instrumental to the success of any business.

Since key employee benefits are provided by most competitive businesses, many talented and highly compensated executives are searching for other ways to defer current income in favor of augmenting funds available at retirement.

There are several employee benefits common to most businesses:

- **Social Security**
- **Health and medical insurance**
- **Life and disability insurance**
- **Traditional qualified retirement plans, such as 401(k) or SIMPLE IRAs**

Lost deferral opportunity

The Section 401(k) plan has become a popular plan to set aside income for retirement, but government regulations limit maximum annual contributions for highly compensated employees.

As of 2020, employee contributions to 401(k) plans are limited to $19,500 ($26,000 for ages 50 and older) even if the executive wants, can and needs to defer more. Contributions may be limited even further if the rank and file employees are not making deferrals.

The restrictions placed on traditional 401(k) plans have contributed to a form of reverse discrimination.

Although they allow an average employee an opportunity to protect a significant portion of his or her current income, they are significantly inadequate in protecting the compensation of key employees, including the business owners. In effect, a significant gap exists between the portion of income a highly compensated employee can protect versus an average employee. The ratio can be as high as 1 to 3, which means the highly compensated employee ends up protecting ⅔ less compensation than the average employee.

How does reverse discrimination affect key employees' retirement income?

Consider the savings disparity between an employee earning $50,000 a year (Mr. Smith) and a key employee earning $350,000 (Mr. Jones). Here is what they could both save in a 401(k) plan (we will assume both are age 45):

	Smith	Jones
Total compensation	$50,000	$350,000
401(k) deferral opportunity (assume $19,500 maximum contribution)	39%*	5.57%*
Company match $.25 on the dollar, up to 3% of salary	3%	1.39%
Potential deferral opportunity (with match)	42%	6.96%
Lost deferral opportunity (protection gap?)	0	-17.14%

* Limited by a $19,500 maximum contribution limit in 2020. These amounts could be limited further depending on nondiscrimination rules. This comparison does not take into consideration the possibility of the executive making after-tax contributions to the 401(k) plan.

Employers with traditional pension plans in place already have taken a good step in showing they value their employees' commitment. Unfortunately, this may not be enough to help retain key people. A retirement income gap could drive some of the best talent to take positions with competitors offering retirement programs that better meet their needs.

The result: Employers suddenly find that the financial success they have worked so hard to achieve is not so secure with the loss of experienced staff members.

Methods for overcoming 401(k) deferral limits

Highly compensated executives whose retirement savings goals have been affected by the 401(k) plan deferral limits have generally had two ways to try to overcome this problem. First, executives with the discipline to do so may accumulate the net after-tax amounts they would have deferred in personally held investments. A personal retirement savings program is far more effective than spending the net after-tax income, but it does have its drawbacks:

- Since the compensation received is currently taxable income, there is less money to invest for retirement savings.
- Taxes on earnings will further erode retirement savings.
- Unlike qualified plans, the money saved for retirement can be reached by the executive's personal creditors.

Other executives — with employers who are willing to participate — will defer the income on a nonqualified basis. This can also be an effective strategy, but it too has some disadvantages:

- The executives' deferral accounts are subject to the claims of the employer's creditors as well as their own. Their funds could be lost if the employer runs into financial problems.
- Rules under IRC §409A place stringent requirements for in-service withdrawals, making it difficult for participants to access those funds in case of a financial "emergency."
- There are costs involved for the employer if the full amount of the deferrals are to be accumulated for the executives' benefit,[1] since no compensation deductions are allowed until the compensation is paid or otherwise made available to the executive.

1 Fees charged by plan administrators are also typically borne by the employer. However, these fees are usually modest in nature.

An innovative alternative: The BATL Plan®

The BATL Plan® is an arrangement between the employer and the executive that involves a combination loan and bonus. The employee purchases a cash value life insurance policy and pays the premiums with bonuses from the employer. The bonuses themselves will be subject to income tax, but the employer loans the employee the funds to cover the additional tax amounts. As a result, the entire bonus can be used to pay premiums, providing a way to maximize the tax-deferred cash value accumulation in the life insurance policy. The policy cash values will be used to supplement retirement income.

Advantages to the employer

- Selective: The employer can pick and choose the executives
- Ties key executives to the business
- Majority of cost is tax-deductible
- Control of the plan rests with the employer
- No IRS approval needed
- Easy to establish: Minimal setup and administrative costs

Other considerations for the employer

- Insurance policy is portable for employee; as such, the “golden handcuffs” on employee are not as strong as with other nonqualified plans
- Publicly traded companies cannot participate due to Sarbanes-Oxley Act

Advantages to the employee

- Supplemental retirement benefits and death benefit protection
- Income tax-free survivor benefits[2]
- Potential tax-deferred cash value growth
- Possible access to CSV over time (subject to agreement) and portable
- Generally protected from creditors[3]
- Potential for plan to become self-completing in the event of disability[4]

Other considerations for the employee

- Even though income taxes on the bonus are covered with loans from the employer, the employee at some point may be pushed into a higher tax bracket. This can create a taxable consequence for the employee who is not covered by the loan.
- Must carefully structure any income disbursements from the policy to avoid unintended tax consequences.

2 IRC 101(a).

3 State law controls creditor protection.

4 Requires purchase of disability rider.

Case study

To see how the BATL Plan® may help a highly compensated executive, let's use "Mr. Jones" from the example. Using the BATL Plan®, a bridge over the deferral gap can be created.

In a typical bonus arrangement, the employee would have to pay the taxes on the bonus from his or her own income, or net the taxes and pay a lower premium for a policy with a lower amount of death benefit protection. With the BATL Plan®, the employee can apply the full bonus to the premiums without having to use any personal funds to pay taxes.

Meet Mr. Jones

Do you have clients like Mr. Jones with a need to lower their taxable income?

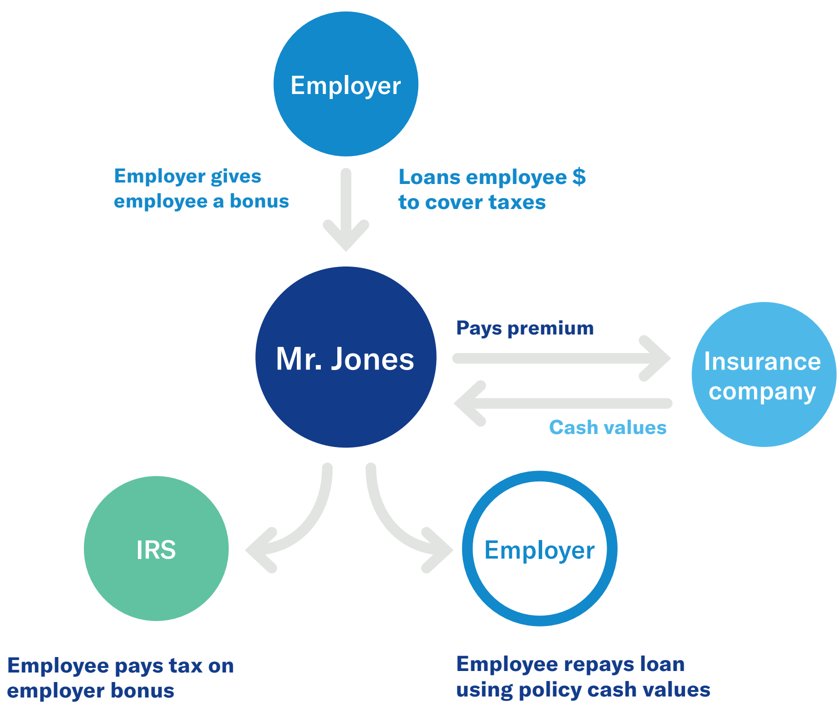
- Nonsmoker in good health
- Highly compensated individual in a 35% marginal income tax bracket
- Each year, he will receive annual bonus compensation of $50,000, which would result in an additional $17,500 of income taxes

Over the first 7 years

A series of seven annual bonuses are planned in order to take advantage of maximum cash value accumulation potential under the "7-Pay Test" required by Internal Revenue Section 7702A.
For our case, we will assume interest is accrued. See the graphic below for the hypothetical results.

- The full amount of each bonus will be applied to a life insurance policy.
- The employer will lend the employee the tax amount associated with each bonus for 7 years.
- Any interest due on prior years' tax loans and any future interest after the first 7 years can be paid by the employee out of pocket.
- Or, if the employer is willing, the employee can accrue future interest and add it to the loan balance.[5]

The buy-sell plan



5 The loan interest rate charged by the employer should be at least equal to the Applicable Federal Rate (AFR) in effect at the time of the loan. Interest-free or below-market (i.e., AFR) interest rate loans are subject to §7872, which imposes taxes on imputed "forgone interest."

Prior to retirement

- The employee receives a bonus of $50,000 each year. The cumulative total will be $350,000 in bonus compensation.
- The employee borrows $126,000 over the course of the plan to pay his taxes and another $82,623 in accrued loan interest, based on a 3% loan interest rate.

Note: The policy premium and death benefit amounts used for this case are only intended to help demonstrate the planning concept discussed and not to promote any specific product. The rates are broadly representative of rates that would apply for a policy of this type and size for insureds of good health at the ages noted in the example. Assumes corporate tax rate of 20% and employee individual tax rate of 36%. To determine how this approach might work for you, individual illustrations should be prepared or requested for your review.

Pre-retirement	Age	Cumulative premiums/bonuses from employer	Cumulative loans from employer	Cumulative loan interest accrued	Loan owed to employer	Death benefit net of loan	After-tax cost of bonus	Annual loan to employee	Annual after-tax outlay
Year	**Employee**						**Employer**		
1	46	**$50,000**	$18,000	$540	$18,540	$1,358,083	$40,000	$18,000	$58,000
2	47	$100,000	$36,000	$1,636	$37,636	$1,387,998	$40,000	$18,000	$58,000
3	48	$150,000	$54,000	$3,305	$57,305	$1,420,588	$40,000	$18,000	$58,000
4	49	$200,000	$72,000	$5,564	$77,564	$1,455,976	$40,000	$18,000	$58,000
5	50	$250,000	$90,000	$8,431	$98,431	$1,494,357	$40,000	$18,000	$58,000
6	51	$300,000	$108,000	$11,924	$119,924	$1,535,938	$40,000	$18,000	$58,000
7	52	**$350,000**	**$126,000**	$16,062	$142,062	$1,580,941	$40,000	$18,000	$58,000
							Total:	**$126,000**	**$406,000**
		Annual bonus	Cumulative bonus	Employer loan					

At retirement

The employee begins taking annual withdrawals and loans from the life insurance policy.

- Withdrawals and/or policy loans will be taken for 15 years, and $16,967 of each year's withdrawal/loan will be applied as installment payments to repay the employer. (This amount is calculated to repay the loan balance over that 15-year period.)
- Assuming the policy will support annual withdrawals or loans of $98,497 a year for a 15-year period,[6] this would leave $81,530 each year, or more than $6,700 each month for retirement income.
- For a taxpayer in a 36% marginal tax bracket, this would equate to a before-tax distribution from a 401(k) plan or other qualified plan of more than $110,000 per year for 15 years.

Not only does the BATL Plan® help bridge the retirement income shortfall, but over the life of the plan, the cumulative net after-tax cost to the employer for providing this benefit is only: $177,200

6 Loans and partial withdrawals will decrease the death benefits and cash value or your life insurance policy, and may be subject to policy limitations and income tax. In addition, loans and partial withdrawals may cause certain policy benefits or riders to become unavailable and may increase the chance your policy may lapse. If the policy lapses, is surrendered or becomes a MEC, the loan balance at such time would generally be viewed as distributed and taxable under the general rules for distribution of policy cash values and may also be subject to an additional 10% premature distribution penalty prior to age 59½, unless certain exceptions are applicable.

Post-retirement

Note: The policy premium and death benefit amounts used for this case are only intended to help demonstrate the planning concept discussed and not to promote any specific product. The rates are broadly representative of rates that would apply for a policy of this type and size for insureds of good health at the ages noted in the example. To determine how this approach might work for you, individual illustrations should be prepared or requested for your review.

Post-retirement	Age	Annual loans and/or withdrawals from policy	Annual loan payments to employer	Annual after-tax outlay	Death benefit net of loan	After-tax loan interest received	Loan principal repayment	Annual after-tax outlay
Year	Employee					Employer		
21	66	$98,497	$16,967	-$81,530	$1,427,101	$4,600	$11,217	-$15,817
22	67	$98,497	$16,967	-$81,530	$1,340,157	$4,331	$11,553	-$15,884
23	68	$98,497	$16,967	-$81,530	$1,253,560	$4,053	$11,900	-$15,953
24	69	$98,497	$16,967	-$81,530	$1,167,114	$3,768	$12,257	-$16,025
25	70	$98,497	$16,967	-$81,530	$1,079,664	$3,473	$12,625	-$16,098
26	71	$98,497	$16,967	-$81,530	$991,091	$3,170	$13,004	-$16,174
27	72	$98,497	$16,967	-$81,530	$901,384	$2,858	$13,394	-$16,252
28	73	$98,497	$16,967	-$81,530	$810,533	$2,537	$13,795	-$16,332
29	74	$98,497	$16,967	-$81,530	$718,526	$2,206	$14,209	-$16,415
30	75	$98,497	$16,967	-$81,530	$625,352	$1,865	$14,636	-$16,500
31	76	$98,497	$16,967	-$81,530	$531,000	$1,514	$15,075	-$16,588
32	77	$98,497	$16,967	-$81,530	$435,459	$1,152	$15,527	-$16,679
33	78	$98,497	$16,967	-$81,530	$338,717	$779	$15,993	-$16,772
34	79	$98,497	$16,967	-$81,530	$240,764	$395	$16,472	-$16,868
35	80	$98,497	$16,967	-$81,530	$141,590	$0	$16,967	-$16,967
40	85	$0	$0	$0	$104,787	$0	$0	$0
45	90	$0	$0	$0	$98,409	$0	$0	$0
55	100	$0	$0	$0	$16,804	$0	$0	$0
Total:		**$1,477,455**	**$254,505**	**-$1,222,950**			**Total:**	**$177,200**

It is obvious that the BATL Plan® can be an effective way to reward key people and tie them to the employer in a cost-efficient manner. For further information or to see how this strategy may fit your specific circumstances, contact your financial professional.

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