FRINGE BENEFITS: ESSENTIAL TOOLS IN FINANCIAL PLANNING[1]

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Abstract. The area of fringe benefits is an important and integral part of total financial planning. No matter what form and no matter what tax and economic characteristics the benefits may have, they must be coordinated with the other areas of planning, i.e., accumulation planning (income and investment planning), business continuation planning and estate planning. Only then can a coordinated financial plan be properly implemented.

Fringe benefits assume many different forms, some with tax advantages and some with little if any tax advantage. But no matter what form they assume they are critical tools in financial planning. The purpose of this paper is to provide the reader with an overview of certain types of fringe benefits and the attributes of each. The emphasis will be on fringe benefits provided by a corporate employer so whether you're an owner-employee or an employee with no corporate ownership it is important to be cognizant of these concepts. The benefits to be discussed are qualified plans (pension/profit-sharing plans), non-qualified deferred compensation plans, medical expense reimbursement plans and educational benefit plans; as mentioned, there are many other types of fringe benefits but these four are important and popular due to their tax and economic attributes.

Qualified plans. Pension and profit-sharing plans that are tax qualified (i.e., contributions are deductible and there is tax-free accumulation of investments) under the Internal Revenue Code (IRC) continue to be extremely important tools in the planning process. Some view them as the ultimate tax shelter based upon the certainty that surrounds them pursuant to legislation and case law. Legislation has been extremely important in the history of qualified plans and the Tax Equity and Fiscal Responsibility Act of 1982 (TEFRA) made some significant changes in the treatment of contributions, benefits and taxes. Some have referred to TEFRA as "mini-ERISA"; ERISA was the landmark legislation passed in 1974 that completely changed pension and profit-sharing plans.

In the area of contributions and benefits, the defined benefit level (type of plan where the benefit is defined) has been reduced from $136,425 to $90,000 and in the case of a defined contribution plan (type of plan where the contribution is defined and includes profit-sharing plans) the maximum annual addition was reduced from $45,475 to $30,000. Corporate deductions for years beginning after December 31, 1982 will be limited to those amounts required to fund the lower limits provided by TEFRA; i.e., no deductions will be allowed for contributions or benefits provided on behalf of an employee which exceed the new limits for such plans. This Act also generally eliminates distinctions in the law between qualified plans of corporations and those of self-employed individuals (under Keogh plans) so that contribution and benefit levels are now the same. Two additional changes in the law of significance are the limitations on loan transactions and the $100,000 cap on the estate tax exclusion for benefits payable to a beneficiary of a deceased employee under a qualified plan.

Prior to TEFRA there were few restrictions on loans from qualified plans. However, under the Act, a loan from a qualified plan which is repaid within five years is treated as a distribution *only* to the extent that the amount of the loan (when added to the outstanding loan balance of the employee under all other loans from such plan) exceeds the *lesser* of (1) $50,000 or (2) ½ of the present value of the employee's nonforfeitable accrued benefit under such plans but in any event, not less than $10,000. This rule applies to

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loans, assignments, or pledges made after August 13, 1982. Present rules requiring that a plan loan bear a reasonable rate of interest, provide a reasonable repayment schedule and be made available on a nondiscriminatory basis still apply.

Also prior to TEFRA, there was an unlimited estate tax exclusion for plan payouts due to a participant's death. The Act has placed an aggregate limit of $100,000 on the estate tax exclusion for such payouts [IRC Section 2039(g)].

Despite periodic and major changes in the qualified plan area, this fringe benefit continues its important role. It is in fact, an ultimate tax-sheltering tool.

Non-qualified deferred compensation. A deferred compensation arrangement is one in which an employer promises to pay an employee in the future for services rendered currently. This is done pursuant to a contractual arrangement and the deferred compensation will eventually be paid to the employee upon the earliest of the following three events: retirement, death or disability. It is non-qualified (unlike pension/profit-sharing plans) in that employer contributions are nondeductible and accumulations in the plan are currently taxable to the employer. However, the employer may select which employees may participate as opposed to pension/profit-sharing plans where stringent anti-discrimination rules apply.

The main reasons for establishing a deferred compensation plan are the following:

- It can be an effective income tax strategy to defer receipt *and* recognition of income until post-retirement years when, presumably, the recipient is in a lower income tax bracket.
- It can be a fringe benefit, augmenting or supplementing existing qualified plans (the plan can also be in lieu of a qualified plan whenever warranted especially in light of the lower limits under TEFRA).
- The arrangement can serve as a set of "golden handcuffs" to encourage select (anti-discrimination rules don't apply) and valued employees to remain with the company
- The employer can attract talented individuals from competitors by offering a plan to make up for benefits that will be lost by leaving the competitor.

From the employee's perspective, the primary attribute of such a plan is the personal income tax savings from the deferral of income to later years. Again, we presume that the employee will be in a lower income tax bracket post-retirement but even if that is not the case the accumulation or "forced savings" aspect of the plan can be beneficial. Also, the contractual arrangement and the funding mechanism for the plan "guarantees" that the employer will be able to meet that payment obligation.

From the employer's perspective, even though the contributions to the plan are not deductible until paid out, the arrangement offers a highly flexible planning tool. Again, the employer is able to select which employees will participate and in a family business the plan can retain certain key employees until children are in a position to run the business.

There are numbers of ways to fund the employer's obligation but the four most common methods are through internal funding from earnings, life insurance, annuities and mutual funds. An analysis of the funding media is outside the scope of this article but considering the contractual obligation and the concern of the employee that the employer is able to meet that obligation, funding from earnings is probably the least attractive method.

Medical expense reimbursement plans. An employer may provide medical benefits for employees and their dependents. The benefits may include payment or reimbursement of medical expenses or payment or reimbursement for premiums for medical insurance. The amounts paid or reimbursed by the employer may be tax-free to the employee and tax deductible by the employer. This is especially valuable to the employee since medical expenses paid by the employee are deductible only to the extent that they exceed five percent of his or her adjusted gross income. Regarding the tax treatment of medical expense benefits to employees, there is a significant distinction between insured plans (benefits provided pursuant to insurance contracts) and self-insured plans (those where the employer pays the expenses or reimburses the employee without insurance coverage).

Self-insured plans are subject to rules under IRC Section 105(h) forbidding discrimination in favor of employees who are officers or shareholders or are highly paid. There are certain classes of employees that may be excluded such as those who have not completed three years of service, have not attained age 25, are part-time or seasonal employees, are union employees (and accident/health benefits were the subject of good-faith bargaining) or are nonresident aliens. If a plan is considered discriminatory, the amount reimbursed to the favored individual is includible in his or her income so it is important to avoid discrimination or in the alternative provide benefits pursuant to an insurance contract (i.e., an insured plan).

Educational benefit plans. It is possible to use a corporate employer's pre-tax earnings to pay college expenses of employees' children. Considering the ever-increasing cost of college and the cost to the employee of using his or her own after-tax dollars to pay the child's expenses, such plans are extremely attractive in fringe benefit planning.

A corporation may establish an educational benefit plan and trust to pay college expenses incurred by children of the firm's employees. The corporation deducts the contribution to the plan as a business expense under Reg. Section 1.162-10 and the amount contributed is not taxable to the employee *until* the subsequent benefits are paid. Thus, from a personal tax standpoint, the plan is merely a form of deferred compensation. The employee receives an economic benefit since the tax liability based on the contribution is less than the college expenses would cost the employee using after-tax personal dollars.

To qualify for this favorable tax treatment, the plan must meet the following standards.

- The corporation cannot retain control over the funds in the trust nor can any of the funds revert to the corporation
- The plan must be concerned with employee welfare (e.g., education of the employees' children)
- The plan must provide equivalent benefits to all employees (not just shareholders and/or key employees)
- The benefits must not be linked to salary or be a substitute for one's salary. *Greensboro Pathology Associates, PA.*, (1982, CA Fed Cir) 698 F2d 1196.

Summary. We have reviewed just four types of fringe benefits amongst the varied and myriad forms of fringe benefits that are available. We have focused on benefits provided by a corporate employer that have significant tax and economic advantages to both employer and employee. These benefits and others are critical tools and they must be coordinated in a strategy of total financial planning.

At this writing, the House Ways and Means Subcommittee on Select Revenue Measures is holding hearings on H.R. 3525 — the Permanent Tax Treatment of Fringe Benefits Bill of 1983. The Bill would establish permanent rules for the federal tax treatment of fringe benefits and the effect, if passed in its present form, would subject many of the now tax-favored fringe benefits to tax. It is imperative to monitor such legislation to take advantage of the most economic and tax-favored benefits.

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