Best Ways to Pay for College (Part 1)

Both 529 plans and 409A plans can be used to pay for college.

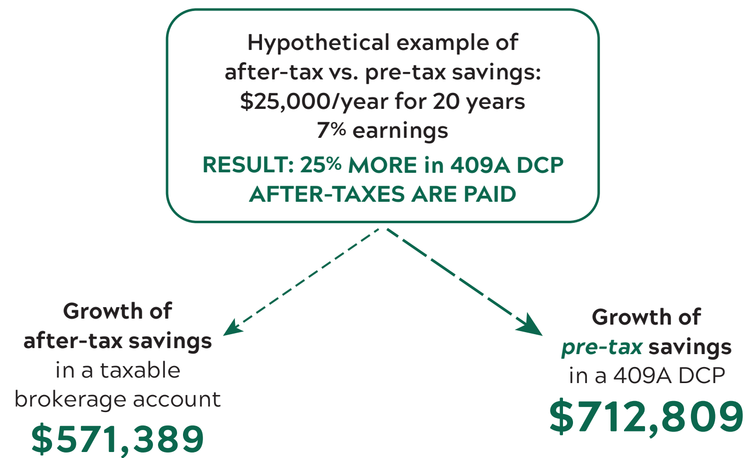
By Timothy Drake and John Sanford for PSCA's NQDC Committee

There are many articles comparing various ways to effectively save for college education (or any other educational pursuits). This article, in two parts, compares the top educational savings plan, the 529 plan, to the nonqualified deferred compensation plan, the 409A plan. Part 1 will focus on 409A plans and how they may be used to pay for college, and Part 2 (to be published in the Spring 2021 edition of *Defined Contribution Insights*) will focus on 529 plans. Plan sponsors may consider their plan design and communication material to stress the advantages of using a 409A to allow plan participants to fund college education for their children.

What is a 409A Nonqualified Deferred Compensation Plan (409A DCP)?

A 409A DCP is a company-sponsored program that allows key employees to defer pre-tax cash compensation, have the money grow tax-deferred, and then receive the taxed balance at a defined later date. There are no dollar limits on the amount that can be deferred. These plans are designed to provide tax-advantaged, supplemental retirement savings opportunities. Employees are limited to what they can save in qualified 401(k) plans, so a 409A DCP provides additional pre-tax deferral opportunities for key employees.

Exhibit 1: Advantages of Pre-Tax Contributions and Tax-Deferred Growth



Other assumptions: 27% blended tax (income/capital) for taxable brokerage account, 35% income tax (federal, state, local) on 409A DCP distributions.

The compounding concept is hypothetical and for illustrative purposes only and is not intended to represent performance of any specific investment, which may fluctuate. It is possible to lose money by investing in securities.

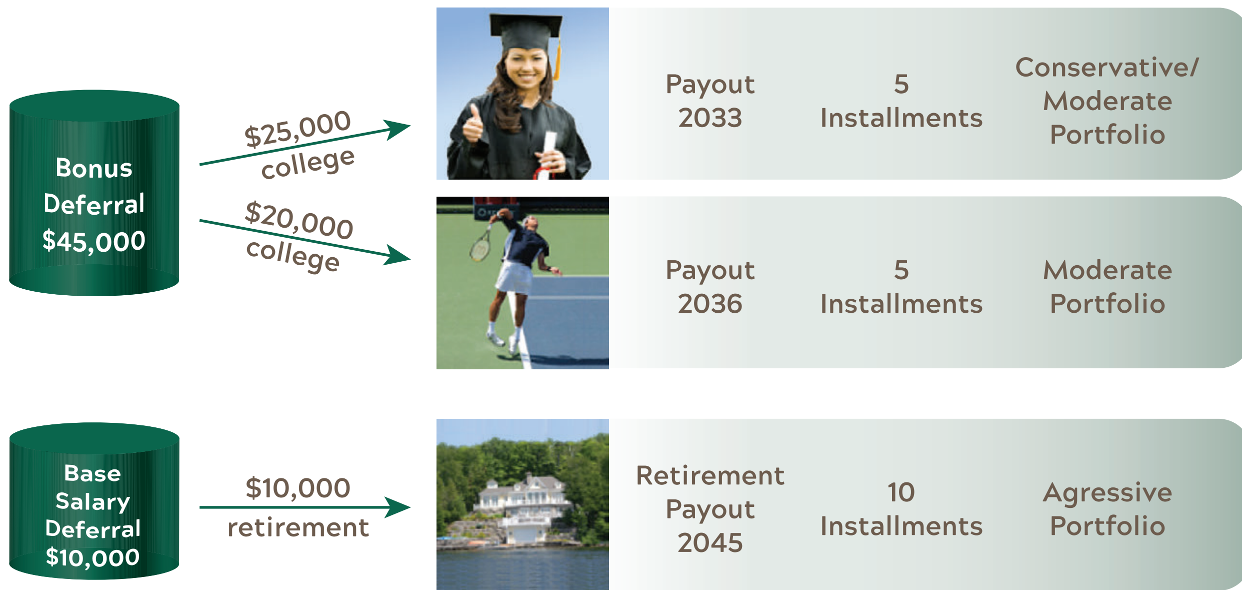
There are significant tax-advantages of a 409A DCP. Exhibit 1 illustrates the advantages of pre-tax savings and tax-deferred compounding.

How can a 409A DCP be used to fund college education?

409A DCPs are not just for retirement. They can meet both short-term and mid-term future cash needs as well. There is no minimum deferral period in the regulations, but typical plan designs require a minimum of two to three years after the year of deferral. However, payment commencing at a specified future date, like the year after a child's high school graduation, and paid over a 5-year period is allowed.

For example, a 40-year-old eligible executive employee earning $150,000 in salary and $50,000 in bonus could elect to defer $10,000 of salary and $30,000 of bonus. Distribution can be set up for a future year, like 2030, and be paid over 5 years; or a future event, like termination of employment, and be paid over 15 years. As a comparison, the key employee's maximum 401(k) contribu-

Exhibit 2: Example of How 409A DCP Distributions Work



tion would be limited to $19,500 in 2020 and could be further restricted due to qualified plan rules. Because 401(k) account balances are generally only available without penalty starting at age 59.5, they are rarely advertised as college education savings vehicles.

How does a 409A DCP work?

An enrollment takes place each year, usually around October/November, for calendar year plans. The election to defer salary and/or bonus is generally made prior to the compensation being earned. During enrollment, the key employee decides how much to defer and for how long. Deferral periods range from two years to 30 or more years. Distributions are usually paid in a lump sum or in annual installments of up to 15 years.

Each annual enrollment can have a different election and may allocate deferrals to different distribution events, or "accounts."

For example, the same key employee from the above example has two kids, a five-year-old daughter and a two-year-old son. This employee decides to set up an account/distribution event for each child. The daughter's account will start payments in 13 years (age 18 is a typical college entry age), and the son's account will start payments in 16 years. Both accounts will be paid over a five-year period, as elected.

Each year, the key employee can redetermine how much to defer into each account. Since the daughter's account has fewer years to grow, the employee may allocate an additional amount into that account.

For example, a few years later, the key employee is now earning $160,000 and expecting a $60,000 bonus. Bonus deferral elections can be $25,000 into the daughter's account and $20,000 into the son's account. See Exhibit 2 for a visual example of how this 409A DCP distribution would work.

Each year, a decision can be made as to how much is needed to go into each account to meet the goal. The employee may also establish additional accounts, like a retirement account or accounts for a future trip or second home purchase.

Continuing with the previous example, let's say that this employee is doing well and elects to defer $10,000 of next year's salary into a retirement account. Now there are three accounts: daughter's college account, son's college account, and employee's retirement account. Because there are different time periods, each account can have its own investment allocation. The retirement account is longer term and may have a portfolio mix of a higher percentage of equities versus fixed income. Investment changes are usually available on a daily basis in most 409A DCPs. Investment changes are not taxable because the account grows tax-deferred. So rebalancing, dollar-cost averaging, and adjusting the portfolio mix as the event gets closer are simple processes.

Deferrals into a 409A DCP can also lower current income taxes. The employee in our example is now earning $220,000 ($160k salary plus a $60k bonus). After deferrals into all three accounts and maximizing the 401(k), the employee's taxable income is only $145,500 [$220k (salary + bonus) – $19.5 (401k) – $25k (daughter's college account) – $20k (son's college account) – $10k (employee's retirement account)].

In this example, the key employee reduced current federal and state income tax and saved for future events

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Exhibit 3: 2020 Federal Income Tax Brackets* Married Filing Jointly

Purpose	Percentage
10%	$0 – 19,750
12%	$19,751 – $80,250
22%	$80,251 – $171,050
24%	$171,051 – $326,600
32%	$326,601 – $414,700
35%	$414,701 – $622,050
37%	$622,051 or more

*Add State Income Tax Rates as applicable

on a pre-tax basis. This is very efficient savings for future needs. Deferring current income can also help with your future college student qualifying for financial aid, since current income plays an important role in determining financial aid eligibility. Financial aid applications usually request retirement/savings account information, but those accounts may be less important than current income.

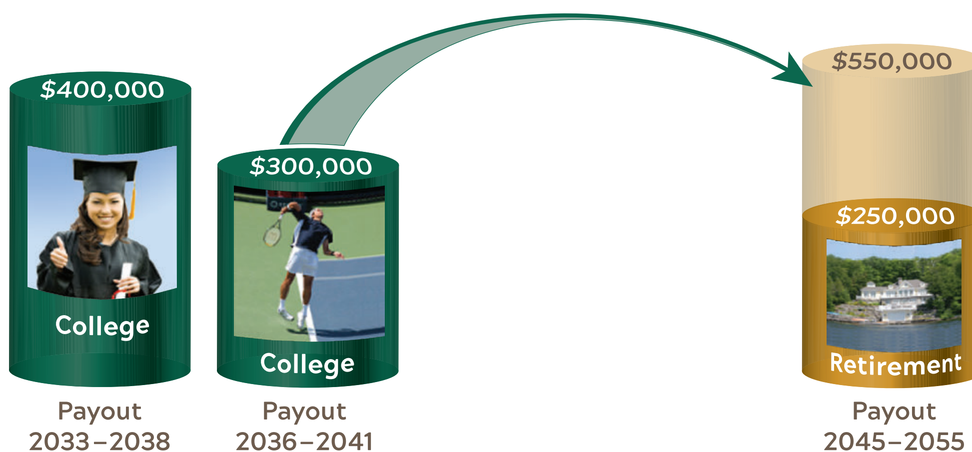
Contingencies! What happens if plans change?

Let's talk about flexibility and contingencies. You are going to hear a lot about qualified and nonqualified educational expenses under the 529 plan. None of that applies here. The future distributions of a 409A DCP can be used however is needed — there are no restrictions. The money can be used to pay for tuition at any college or educational system anywhere in the world. It can be used for room and board, or to pay for expenses associated with commuting, grocery shopping, technology, vocational education, gap year travel, starting a new business, or buying a car. And, there is much less paperwork. With a 409A DCP, there is no need to track receipts to prove that the expenses "qualify" as deductible and penalty free expenses as you will see in 529 Plan regulations.

Let's fast forward in our example: the key employee has been deferring, the balance has been invested and earning tax-deferred gains, and now all three accounts have the following balances: $400k (daughter's college), $300k (son's college), and $250k (retirement). The daughter is now 18 and ready to attend college this fall. The account has grown to $400k and distributions of about $80k per year have begun. Remember, none of this money has been taxed — yet. It was deferred pre-tax and has grown tax-deferred. But now, ordinary income tax will become due upon receipt of each payment. So, in a 35 percent tax bracket (combined federal and state tax rates), the key employee will have an additional $56k after-tax to supplement income and help with college expenses ($80k (distribution) – $28k (taxes @35 percent) = $52k).

In the same year, the son is now 15 and is a nationally-ranked tennis player. The son's account has grown to $300k. Colleges are already making overtures, and a scholarship seems to be on the horizon. In this case, the distributions may not be needed. The account distribution date can be changed to a later future date, or the account be combined with the retirement account.

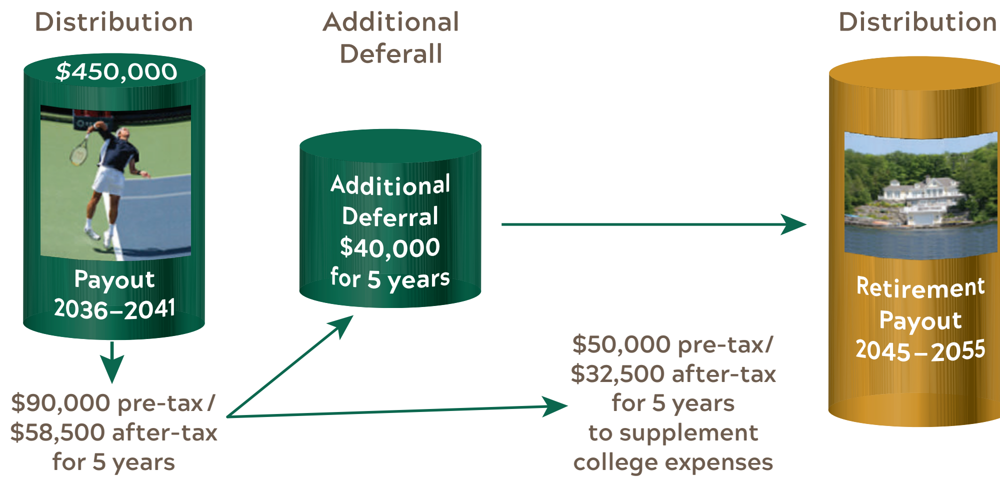
Exhibit 4: 409A DCP Flexibility: Changing Distribution Elections(s) and/or Increasing Deferrals in the Year of Payout



Changing distribution election(s):

- Request: at least 12 months in advance of original scheduled payment date
- Delay: at least 5 years after original scheduled payment

Exhibit 5: 409A DCP Flexibility: Increasing Deferrals in the Year of Payout To Offset Schedule Distributions That Are No Longer Needed



The $300k from the son's account can be added to the retirement account of $250k, enhancing that account balance to $550k, as seen in Exhibit 4. Simple and easy. There is no reason to find another relative to use the leftover balance. Instead, redeploying the balance towards retirement provides ultimate flexibility. However, there is a rule here that must be mentioned. The distribution has to be changed at least one year prior to payments commencing in that account. If not combining with the retirement account, the payment has to be pushed out at least 5 years. But the employee can decide to postpone the scheduled distribution now (3 years until the son reaches 18), or wait a couple more years to see what transpires with the tennis career. Even if things change last minute and the one-year advanced notice is not achieved, the employee may be able to just increase deferrals to offset the additional income that is not needed, as Exhibit 5 illustrates.

The employee distributions are scheduled to start in 6 months — which is too late to postpone. The son waited for his preferred college, and now, at last, has a 75 percent scholarship offer. At this time, the son's account is now worth $450k and five annual distributions of about $90k pre-tax will commence. But, what if only $50k pre-tax is needed to supplement what the scholarship doesn't cover? The key employee can increase deferrals by $40k for each of the next five years and apply that money to the retirement account.

$90k pre-tax distribution — $50k ($32.5k after-tax at a 35 percent combined tax rate) = $40k additional deferral out of salary/ bonus to offset the income taxes on some of the distribution — leaving only what is needed and redeferring the rest.

409A DCPs are usually described as supplemental retirement plans, and only groups of highly compensated employees or a select group of management are eligible. Your employer has to offer such a plan, but 409A DCPs are usually considered to be shareholder/ owner friendly. Since the plan balance is subject to general creditor status during an employer bankruptcy, a shorter timeframe may be a wise choice. If the plan is managed correctly and has assets set aside to pay the benefits down the road, adverse consequences can be mitigated but not eliminated.

These plans sometimes offer minimum rates of return ranging from one percent to four percent; check with your employer for a list of available fund options.

Conclusion

Planning and saving for college expenses as early as possible is key to meeting future needs. A 409A DCP is a pre-tax contribution with tax-deferred growth and ordinary income taxes being paid upon distribution, so there is more focus on future income tax rates.

The 409A DCP has no restriction on contributions and total flexibility over how distributions are used. And if needs change, the distribution can be postponed and/or redirected into another account. This flexibility can facilitate saving for retirement with unused college education accounts.

There are other benefits of 409A DCPs such as attracting, retaining, and motivating key employees. Additional benefits include aligning participant incentives with meeting specific goals and the ability for participants to arrange distributions in order to reduce or avoid paying state income tax.

John Sanford is Principal at Mullin Barens Sanford Financial & Insurance Services and a member of PSCA's Nonqualified Deferred Compensation Committee.

Timothy Drake is Director of Wealth Management at Chamberlin Group.

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