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Client Conversations – Winter 2022

In this installment of *Client Conversations*, we explore the unique benefits of nonqualified defined contribution plans, look at options for covering healthcare costs in early retirement, and provide some insights on surging home prices and the drivers behind them.

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Nonqualified deferred compensation plans can be an effective way to boost retirement savings, but the decision to participate depends on your personal financial circumstances. For example, you should think twice about participating if you are not already taking full advantage of your company’s 401(k), including maxing out your contributions (plus a catch-up contribution, if you’re eligible). You might also want to fully fund your health savings account (HSA), if you have access to one, before you start nonqualified plan contributions.

Of course, with today’s tight labor market, you probably wouldn’t want to participate if you think you might leave your company since these plans are for long-term savings—and that would likely trigger a distribution. But if your 401(k) and HSA are maxed out and you want to defer more pre-tax dollars, it’s worth a look. Let’s talk nonqualified deferred compensation plans.

A nonqualified deferred compensation plan is an arrangement between an employer and employee that allows the employee to defer receipt of currently earned compensation. Employers can also make contributions to participant accounts. Because these plans are not required to comply with many of the rules that govern qualified plans—like 401(k) plans—they can offer appealing options in terms of contribution amounts, investment options, and distribution options.

Unlike cash compensation that is taxed in the current year, deferred compensation plans generally aren't subject to federal income taxes until you begin receiving distributions from the plan. So, contributing can both reduce your current tax bill and boost your savings.⁴⁰

So far, that sounds pretty good, right? What's the downside?

Probably the biggest consideration is that, unlike your 401(k) account, the compensation that you defer into the plan is not your money. This means that, when it comes time for you to receive the compensation you deferred, your employer may be unwilling or unable to pay the amount or that a creditor may seize the funds through foreclosure, bankruptcy, or litigation. Typically, employers set aside funds deferred, but they remain part of the general assets of the company, subject to the claims of creditors.

That said, your employer may also take steps to help make you comfortable that your funds (plus earnings) will be there when you need them, including setting assets aside to pay your future benefits and securing them in a rabbi trust. An irrevocable rabbi trust, adequately funded, can help provide you with the assurance that your benefits will be paid in all events other than the insolvency or bankruptcy of your employer.

Nonqualified deferred compensation plans offer unique benefits and come with some important considerations, so they are not right for everyone. As always, you should speak with your financial and tax advisors about your company's plan and your personal financial situation before you make any decision to participate.

Q: I am thinking about retiring early. How can I cover healthcare costs if I retire before I am eligible for Medicare at age 65?

Congratulations! If you're considering early retirement, hopefully this means that your years of saving and investing well have resulted in a nice nest egg that—combined with Social Security and other income sources—will allow you to maintain your lifestyle without career work.

Given the cost of health care and the growing need for medical care as you age, it's important to have some form of health insurance coverage. And, if you retire before age 65, you'll want a plan to cover medical costs until Medicare kicks in.

If you are being offered an early retirement package from your employer, check to make sure that it includes post-retirement medical coverage. Often, these packages provide medical coverage until you reach age 65 and become eligible to receive Medicare.

If your package does not include post-retirement coverage—or if you're just plain retiring early—you will have several options for health insurance. One easy option: If you're married and your spouse is still working, you may be able to secure coverage through his or her employer.

Otherwise, you can explore coverage through the Consolidated Omnibus Budget Reconciliation Act (COBRA) or private health insurance to close the gap to Medicare eligibility age. COBRA only provides temporary benefits—up to a maximum of 18 or, in some cases, 36 months—but that may be enough for you. And private health insurance premiums can be expensive, depending on factors such as your age and health status. You may also be able to find and purchase an individual health insurance policy through either a state-based or federal health insurance Exchange Marketplace.

Once you have found coverage, remember that money that you have saved in an HSA can be used to

pay insurance premiums and other qualified medical expenses tax-free. Tapping into those funds, if you have them, could close—or at least narrow—the gap if you need private insurance for a year or two.

Lastly, while working during your early retirement may not be part of your plan, taking a different or part-time job to keep health insurance might be an option.

Q: Home prices in my area have been booming. Why is this happening, and do you expect it will continue?

This question is on the minds of many Americans—partly because of the prevalence of home ownership in the U.S. and partly because it's hard not to notice surging home prices.

On average, U.S. home prices have climbed 4.1 percent on an annual basis since 1987, according to Fortune magazine. However, in its latest forecast, Fannie Mae indicated that it expects median home prices to rise 7.9 percent between the fourth quarter of 2021 and the fourth quarter of 2022—twice the long-term average.

There are several drivers of this phenomenon. But, as always, market behavior comes down to supply and demand. There has been too much demand for the supply of available homes.

The housing supply has been low for more than a decade. The housing crash in the late 2000s devastated the construction industry, and a variety of factors, including labor shortages, tariffs, limited land, and restrictive permit processes, have kept the supply of new homes below historical averages. This placed more pressure on existing homes to meet demand from prospective buyers.

More recently, with the shift to remote work and education and low interest rates, many people looked for more space. This increase in demand happened as pandemic-induced labor shortages, supply-chain issues, and rising raw material costs stymied construction of new homes.

At the same time, homeowners who might have seen high prices as an opportunity to sell were hesitant to do so because of economic uncertainty and the high cost of moving to another home. Refinancing to lower mortgage payments or cash out kept some homeowners in place. And government mortgage forbearance programs have kept families from losing their homes through the pandemic but also kept homes that might have otherwise been foreclosed on off the market.

The pandemic also made it less appealing to have strangers entering a home for an open house. And older people who might have moved into assisted living or other senior facilities were more likely to stay in their homes.

Taken together, these factors produced a perfect storm of low supply and high demand that drove already high prices to dizzying levels and created desperation among buyers.

In fact, prices are so high some buyers are backing off. But demand remains strong and will outstrip housing supply for the foreseeable future. Near-term relief might come if high prices inspire more homeowners to sell and if the end of government programs puts more foreclosed homes on the market.

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