WHITE PAPER

Advantages to Pre-Tax Deferral of Income in an Uncertain Tax Environment

By Steve Broadbent and Chris Nyland
A NEW TREND IS UPON US ...

Employees who once routinely deferred compensation are now rethinking those habits as they consider updates to their financial plans. Among the concerns is whether it might be better to take income today because of the uncertainty of tax increases in the future. While many of the temporary tax rates are now permanent following the recent “fiscal cliff” negotiations, we read on an almost daily basis about new Congressional proposals for future “revenue enhancements,” which is nothing more than a new tax under the proverbial sheep’s clothing. This article shows how you should consider recent and future tax rate changes and investment returns when analyzing whether to participate in your company’s nonqualified deferred compensation plan (DCP).

ADVANTAGES
TO PRE-TAX DEFERRAL OF INCOME
IN AN UNTACERTAIN TAX ENVIRONMENT

Steve Broadbent and Chris Nyland

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A CHALLENGE TO CURRENT THINKING ON INCOME DEFERRAL

The new conventional wisdom reverses the time-honored thought that one should tuck away income in deferred accounts now to pay lower taxes in retirement later.

But is the conventional wisdom correct?

A study by Fulcrum Partners LLC suggests that in all but a few scenarios, even if taxes do rise in the years ahead while working or during retirement, the accumulated savings that may be achieved over the long term through deferral of income and related taxes under an DCP plan are still greater than the amount that could be accumulated through after-tax investing in a personal investment account.

Propelling the new conventional wisdom of "don't defer" are the following factors:

- DCP participants now anticipate a change in federal tax policy that will cause an upward shift in their marginal tax rates with no prospect for tax rates to decline during retirement.
- At the same time, the provisions of Internal Revenue Code (IRC) Section 409A that govern all income deferred after January 1, 2005, have decreased participant flexibility in certain respects regarding timing of deferral elections and distributions.
- DCP accounts lack the security of qualified retirement plans such as a 401(k) account; therefore, many participants have decreased or even stopped deferring income into a DCP because of the financial uncertainty of their employer.

The combination of these factors has caused the DCP liabilities in my companies to level off in recent years as compared to the significant growth in DCPs prior to 2008.
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BASIC TRUTHS STILL HOLD

While basic truths still hold, the wisdom of crowds may change soon. Here’s why:

Two of the factors causing a decline in participation will fade away with time. Plan sponsors and plan participants have gained more experience in the effective management of deferred compensation under the Section 409A regulations. While the regulations do impose some restrictions on you, the effective operation of a DCP under these new regulations merely requires some additional planning.

Limited recovery from the recent recession is underway and you are no longer bombarded with bad economic news almost every day. The slow economic recovery has created new optimism among DCP participants about their employers and their individual financial plans.

Will Taxes Rise?

Immediately following the 2012 Presidential election, we witnessed a contentious battle in Congress over the “fiscal cliff” issues, which in the end brought us a higher capital gains rate and an increase to the top marginal income tax rate. In the coming months, we will see debates over the debt ceiling and the so-called “Grand Bargain” which will attempt to provide a combined solution to the debt ceiling, reducing the nation’s debt, tax reform, and an outline for future Federal budgets. These debates will create additional pressure for more increases to both capital gains and income tax rates.

On top of the fiscal issues cited above, executives are enduring a new 3.8% tax on investment income for individuals with a modified adjusted gross income in excess of $200,000 for single filers and $250,000 for joint filers. As you consider pre-tax investing in a nonqualified DCP versus an after-tax alternative it is important to remember this tax does not apply to investment gains in a DCP.

The focus of our study examines the impact of an immediate increase in tax rates while contributing to a DCP and an increase in tax rates while taking distributions from a plan during retirement. The impact of the timing of these tax increases is compared to the after-tax investment alternative.
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Despite the new certainty on tax rates in the near-term, the long-term tax policy impact on well-planned retirement savings plans is also impossible to predict. Taxes could be higher when distributions are made in retirement, or when scheduled or in-service distributions are made five or ten years from now. It is also possible, although unlikely, that they could be lower.

So there is still a very good chance taxes will go up—and stay up—for a significant portion of your retirement planning time horizon.

DEFERRAL WITH HIGHER TAX RATES AHEAD

We think that having higher income and higher tax rates in the future does not automatically lead to the conclusion, which many have made, that it makes no sense to defer income now if taxes may be higher when you receive distributions in retirement, or when scheduled or in-service distributions are received five or ten years from now. Here is how we went about the study.

Variables and Assumptions

With a split Congress, it is all but impossible to predict the outcome of the continuing budget and tax negotiations. To compensate for this uncertainty, we created a large number of scenarios to compare (1) after-tax investing in a personal investment account (i.e. a regular taxable brokerage account) outside your employer's benefit plans to (2) the pre-tax deferral of income into an employer-sponsored DCP. The important variables for the analysis are:

- Personal investment accounts are taxed as 100% long-term capital gains. (In reality, a diversified personal investment account typically would be taxed as a combination of capital gains and ordinary income; however, this assumption was selected to provide the best advantage to personal investment accounts.)

- Deferred compensation is taxed as 100% ordinary income at the time of distribution.

- While the long-term capital gains rate is currently 20%, we examined the impact of both the previous 15% capital gains tax rate and the current 20% rate.

- Marginal federal and state income tax rates are examined at 34%, 37%, 41%, and 45%. (These rates are based on the recent increase in the top rate from 35% to 39.6%. At the time this analysis was completed, an increase in the next tier from 33% to 36% was expected; therefore, this marginal rate is included as well. An
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additional 5% was added to the above rates as the average top marginal state income tax. FICA (Social Security and Medicare) taxes were not factored into this analysis as all compensation, whether deferred into a qualified (e.g., 401(k) plan) or nonqualified plan, or taken into income, is taxed for FICA at the time the compensation is earned, not when it is distributed.

Pre-tax earnings rates are 3%, 7%, or 10%.

Investment horizons of 10 and 20 years.

Distributions occur either in lump sum or in installments over a 10-year period.

For simplicity in presentation, this analysis assumed that a single amount of $10,000 was invested in either a personal investment account or a DCP account in all scenarios. The amount used for the after-tax investing in your personal account is $10,000 minus the income tax owed in the year earned. The single deposit of $10,000 was then tested in approximately 75 scenarios using the variables listed above. The analysis compared the value of the personal investment account to the DCP after capital gains or ordinary income taxes were paid. The personal investment account was taxed at the capital gains rate at the end of each calendar year (the study assumed non-tax managed mutual funds with a high asset turnover) and the DCP account was taxed at ordinary income rates when distributions were received from the plan.

**DCP Does Better**

In almost all scenarios, the DCP provided superior results. The only scenarios favoring the personal investment account are based on the highest wage earners who are willing to settle for a meager 3% pre-tax return and invest their income over a short 10-year period. In all other scenarios, a DCP account provided an advantage—in terms of the total amount accumulated after taxes are paid—ranging from a low of 1.75% to 47.75%. Obviously, the recent increase in capital gains rates from 15% to 20% provides an additional advantage to a DCP ranging from 3% to 15% depending on the rate of return and length of the investment.

The following chart provides an example of pre-tax versus after-tax investing. This scenario assumes a 45-year-old defers $10,000 per year for five years on a pre-tax basis, and leaves these funds in a deferred compensation account until retirement at age 65. The DCP participant then receives annual installments from the DCP account over a period of ten years, each taxed at a 37% tax rate for ordinary income. The pre-tax deferral of income is compared to investing the after-tax equivalent of $10,000 ($6,600 after a 34% combined marginal federal and state tax rate) per year for five years. Again, these funds remain in the account until age 65 and are taxed annually at either a 15% or a 20% capital gains tax rate. The participant withdraws equal sums from the investment account over ten years starting at age 65. In all scenarios, the investments are earning a pre-tax rate of 7%.
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Deferred Compensation vs Personal Investment Alternative
Deferral or Investment of $10,000 Pre-Tax for 5 years Starting at Age 45
10 Annual Distributions Starting at Age 65
Graphs Provides End of Year Account Balance

- Personal Investment Account with 20% Cap Gains Tax (Annual After-Tax Distribution = $11,141)
- Personal Investment Account with 15% Cap Gains Tax (Annual After-Tax Distribution = $11,989)
- Deferred Compensation Plan (Annual After-Distribution = $14,232)

Assumptions
Current Age - 45, Retirement Age - 65, 5 Annual Deferral or Investments - $10,000, Pre-Tax Credit Rate - 7.00%
Personal Tax Rate in Year of Deferral or Investment - 34%
Personal Tax Rate in Years of Account Distributions - 37%
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LOWER RATES NOW DO NOT MATTER

What can you take away from this chart? DCP plans continue to be advantaged over time even if income tax rates rise again in the coming years. The assumption of the capital gains rate is important, as the 20% capital gains rate (as opposed to the previous 15% rate) makes the DCP look even better. The compounding of pre-tax money will always beat after-tax investing, assuming equal pre-tax rates of return on the investments.

If taxes are lowered during your retirement, the advantage of a DCP does not change. The following chart assumes a 37% marginal income tax rate during the deferral or investment years, and a 34% rate during retirement. The results do not look substantially different from those shown on the previous chart.

(SEE CHART NEXT PAGE)
ADVANTAGES OF PRE-TAX DEFERRAL OF INCOME IN AN UNCERTAIN TAX ENVIRONMENT

Deferred Compensation vs Personal Investment Alternative
Deferral or Investment of $10,000 Pre-Tax for 5 years Staring at Age 45
10 Annual Distributions Starting at Age 65
Graphs Provides End of Year Account Balance

- Personal Investment Account with 20% Cap Gains Tax (Annual After-Tax Distribution = $10,635)
- Personal Investment Account with 15% Cap Gains Tax (Annual After-Tax Distribution = $11,444)
- Deferred Compensation Plan (Annual After-Distribution = $14,910)

Assumptions:
Current Age - 45, Retirement Age - 65, 5 Annual Deferral or Investments - $10,000, Pre Tax Crediting Rate - 7.00%
Personal Tax Rate in Year of Deferral or Investment - 37%
Personal Tax Rate in Years of Account Distributions - 34%
ADVANTAGES OF PRE-TAX DEFERRAL OF INCOME IN AN UNCERTAIN TAX ENVIRONMENT

The following chart compares after-tax investing at both a 15% and 20% capital gains tax rate to pre-tax deferral of income in a DCP, assuming a 7% pre-tax rate of return on the deferred income or investment. The pair of percentages represents the marginal income tax rate at the time of deferral/investment and at the time of distribution, respectively. The percentages in the deferral for 10 and 20 years columns represent the advantage of the DCP over the personal investment account—in terms of the total amount accumulated after all taxes are paid.

Example: A participant defers $10,000 for 20 years and takes a lump sum payment following the twentieth year. If the participant's tax rate at the time of deferral is 34% and at distribution is 37%, the advantage of a DCP over an after-tax investment of the same $10,000 ($6,600 after-tax @ 34% tax rate) is 24.22%.

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<th>Income Tax Rates While:</th>
<th>7% Earnings</th>
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<td>Age 65</td>
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<td>Lump Sum</td>
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<td>Contributing to a DCP</td>
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<td>20% Capital Gains</td>
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<td>34%</td>
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<td>Taking Distributions from a DCP</td>
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<td>37%</td>
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<td>37%</td>
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<td>41%</td>
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<td>15% Capital Gains</td>
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The data is created using the following: personal investments account taxed as 100% long-term capital gains; deferred compensation taxed as 100% ordinary income; long-term capital gains rate: 15% or 20%; income tax rates: 34%, 37%, 41%, and 45%; earnings rates: 7%; retirement age: 55 and 65; lump sum distributions vs. 10-year installment distributions. The performance data is hypothetical based upon the stated assumptions and should not be considered indicative of future performance.
ADVANTAGES OF PRE-TAX DEFERRAL OF INCOME IN AN UNCERTAIN TAX ENVIRONMENT

DEFERRED COMPENSATION PLAN PROVIDES ADVANTAGES OVER PERSONAL INVESTMENT ACCOUNT AS TAXES RISE

The pre-tax investment rate of return is a significant factor in the comparison of DCP to after-tax investing. Taxable investment will continue to perform worse in comparison to a DCP account as you raise the marginal tax rates. The DCP will be further advantaged if income tax rates increase immediately instead of gradually over a few years. The assumption of the recent increase in the capital gains rate from 15% to 20% is also important to this analysis as demonstrated above. Additionally, the Affordable Care Act, otherwise known as Obamacare, includes a 3.8% Medicare surtax on investment income. Distributions from DCPs are treated as ordinary income, not investment income. While not included directly into this analysis, the Obamacare Net Investment Income surtax on investment income will further improve the advantage of pre-tax deferrals.

SECURITY CONCERNS AND INVESTMENT CHOICES

The recent turbulence in the economy is a reminder that our investment portfolios should be well diversified. Some people eligible for a nonqualified DCP will continue to reject the DCP if they are taking a low-risk/low-return approach, are concerned about the near-term illiquidity of their DCP account, or worry about the credit risk to their employer. However, assuming a normal risk threshold and minimal security concerns, pre-tax deferral of income is a sound investment strategy when ordinary income tax rates are changing.

Liquid funds in money market accounts are an important part of everyone’s financial plan and a well-diversified portfolio. However, the money market investments are best held outside of an employer-sponsored DCP, as low-yielding accounts do not reap a significant advantage from being inside a pre-tax DCP. If all of your investing is in a low-return style, then DCP is not for you. However, those who look long-term and assume “normal” equity returns over time will clearly win with a Deferred Compensation Plan.
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