Advantages to Pre-Tax
Deferral of Income in An
Uncertain Tax Environment:
2018 Updates

A White Paper Report from
Fulcrum Partners LLC

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by Steve Broadbent and Chris Nyland

This article was originally written in 2013 and has been revised to
reflect today’s economic and tax considerations.

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Alert: A new trend may be upon us. Employees who once routinely deferred compensation may be rethinking that habit as they consider updates to their financial plans. One of the concerns is if it might be better to take income today because of uncertainty about tax increases in the future. This article explains how you should consider recent and future tax rate changes when analyzing whether to participate in your company’s nonqualified deferred compensation (NQDC) plan.

A Challenge to Current Thinking on Income Deferral

Conventional wisdom would lead employees to tuck away income in deferred accounts now so that they can pay lower taxes in retirement later.

However, is the conventional wisdom correct?

A study by Fulcrum Partners LLC suggests that in all but a few scenarios, pre-tax deferral is still an effective strategy. Even if tax rates do rise while you are working or after your retirement, the accumulated savings that may be achieved over the long term, through deferral of income and related taxes under an NQDC plan, are still greater than the amount that could be accumulated through after-tax investing in a personal investment account.
Propelling the conversation to “don’t defer” are the following factors:

- NQDC participants remain concerned about future changes in federal tax policy causing an upward shift in their marginal tax rates during retirement.
- Likewise, Internal Revenue Code (IRC) Section 409A, which governs all income deferred after January 1, 2005, has decreased participant flexibility in certain respects regarding timing of deferral elections and distributions.
- NQDC 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 NQDC plans because of the financial uncertainty of their employer.

The combination of these factors has caused the NQDC participation in many companies to level off in recent years.

**Basic Truths Still Hold**

While basic truths still hold, the wisdom regarding two of the above factors has changed for plan participants in recent years:

- Plan sponsors and plan participants have gained significant experience in the effective management of deferred compensation under Section 409A regulations. While the regulations do impose some restrictions on sponsors and participants, the effective operation of NQDC under these new regulations merely requires some additional planning.
The recession of 2008 and 2009 is now old news, and we are witnessing a strong economy, albeit with significant market volatility. As a result, many NQDC participants are regaining optimism about their employers and their individual financial plans.

**How often will tax rates change in the future?**

Immediately following both the 2012 and 2016 Presidential elections, we witnessed contentious battles in Congress over both corporate and personal taxes, budget deficits, and debt ceiling limits. As we approach the 2018 midterm elections and look ahead to the 2020 Presidential election, we will undoubtedly see continuing debates on both fiscal and tax policy issues.

Future changes to the control of the U.S. House of Representatives, U.S. Senate, and the White House will create political pressures and provide opportunities within each of the major political parties to use tax policy to achieve social engineering objectives or to solve the ever-growing national debt. As you consider pre-tax investing in an NQDC plan versus an after-tax alternative, you should remember that current tax changes do not apply to investment gains in NQDC accounts until such time that your distributions begin.

The Fulcrum Partners study examines both the impact of an increase in tax rates while contributing to an NQDC plan 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.

Given the great divide in today's politics, the long-term changes of tax policy on well-planned retirement savings plans is impossible to predict. Tax rates 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 may be lower.

The only certainty in tax rates over your retirement-planning time horizon is change.

**Deferral with Higher Tax Rates Ahead**

We think that having higher income 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.

The following pages explain how we went about the study.
The Fulcrum Partners Study

Variables and Assumptions

To compensate for the uncertainty on future tax policy, 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 with (2) the pre-tax deferral of income into an employer-sponsored NQDC plan. 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 top long-term capital gains rate is currently 20%, we examined the impact using both 15% and 20% capital gains rates.
- Marginal federal and state income tax rates are examined at 34%, 37%, 41%, and 45%, even though today’s top rate is 37%. FICA (Social Security and Medicare) taxes were not factored into this analysis, for all compensation, whether deferred into a qualified, such as 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.
We used investment horizons of 10 and 20 years.
Distributions occur either in a 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 an NQDC 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 NQDC 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 NQDC account was taxed as ordinary income when distributions were received from the plan.

NQDC Does Better

In almost all scenarios, NQDC provided superior results. The only scenarios favoring the personal investment account involve high wage earners willing to settle for a meager 3% pre-tax return and invest their income over a short 10-year period. In all other scenarios, an NQDC 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%. Additionally, a capital
gains rate of 20%, as compared to 15%, provides an additional advantage to an NQDC plan. This advantage ranges from 3% to 15%, depending on the rate of return and the length of the investment.

The following chart (Chart 1) 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 NQDC participant then receives annual installments from the NQDC account over a period of ten years, each taxed at a 37% tax rate for ordinary income.

**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

Graph Provides End of Year Account Balance

<table>
<thead>
<tr>
<th>Deferral Period</th>
<th>Distribution Period</th>
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<tbody>
<tr>
<td>$180,000</td>
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<tr>
<td>$160,000</td>
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<td>$0</td>
<td></td>
</tr>
<tr>
<td>-$20,000</td>
<td></td>
</tr>
</tbody>
</table>

- 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 Crediting Rate - 7.00%,
- Personal Tax Rate in Year of Deferral or Investment - 34%
- Personal Tax Rate in Years of Account Distributions - 37%
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 the person is 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%.

What can you take away from this chart? NQDC 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, given that a 20% capital gains rate, as compared to 15%, makes the NQDC look better. Assuming equal pre-tax rates of return on the investments, compounding of pre-tax money will always beat after-tax investing.

If taxes are lowered during your retirement, the advantage of NQDC does not change. The following chart (Chart 2) 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 2, next page)
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
Graph Provides End of Year Account Balance

CHART 2

- $20,000
- $0
$20,000
$40,000
$60,000
$80,000
$100,000
$120,000
$140,000
$160,000
$180,000

Distribution Period

Deferral Period


- 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%

(Read more, next page)
The following chart (Chart 3) compares after-tax investing at both a 15% and 20% capital gains tax rate to pre-tax deferral of income in an NQDC plan, 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 NQDC 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 20th year. If the participant’s tax rate at the time of deferral is 34% and at distribution is 37%, the advantage of NQDC over an after-tax investment of the same $10,000 ($6,600 after-tax at the 34% tax rate) is 24.22%.

**Advantage of the Pre-Tax Deferral of Income over the Equivalent After-Tax Alternative using various Capital Gains and Federal Income Tax Scenarios**

<table>
<thead>
<tr>
<th>Income Tax Rates While:</th>
<th>7% Earnings</th>
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<tbody>
<tr>
<td></td>
<td>Age 65</td>
</tr>
<tr>
<td></td>
<td>Lump Sum</td>
</tr>
<tr>
<td>20% Capital Gains</td>
<td></td>
</tr>
<tr>
<td>Contributing to a DCP</td>
<td>34%</td>
</tr>
<tr>
<td></td>
<td>37%</td>
</tr>
<tr>
<td></td>
<td>41%</td>
</tr>
<tr>
<td>15% Capital Gains</td>
<td></td>
</tr>
<tr>
<td>Contributing to a DCP</td>
<td>34%</td>
</tr>
<tr>
<td></td>
<td>37%</td>
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<tr>
<td></td>
<td>41%</td>
</tr>
</tbody>
</table>

The data is created using the following: personal investments account taxed at 100% long-term capital gains; deferred compensation taxed at 100% ordinary income; long-term capital gains rate: 15% or 20%; income tax rates: 34%, 37%, 41%, and 45%; earnings rate: 7%; retirement age: 55 and 65; lump sum distributions vs. 10-year installment distributions.
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 NQDC to after-tax investing. Taxable investments will continue to perform worse in comparison to NQDC as you raise the marginal tax rates. NQDC will be further advantaged if income tax rates increase immediately instead of gradually over a few years. As demonstrated above, the assumption on future long-term capital gains rates is also important to this analysis. Higher capital gains rates provide future advantage to NQDC.

Final Thoughts

The recent volatility in the markets is a reminder that personal investment portfolios should be well diversified. Some people eligible for NQDC plans will continue to reject NQDC if they are taking a low-risk/low-return approach, are concerned about the near-term illiquidity of their NQDC 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.
ABOUT FULCRUM PARTNERS LLC:

Fulcrum Partners LLC (https://fulcrumpartnersllc.com) is one of the nation’s largest executive benefits consultancies. A wholly independent, member-owned firm, Fulcrum Partners is dedicated to helping organizations enhance their Total Rewards Strategy. Founded in 2007, today the company has 13 nationwide offices and more than $6B in assets under management. Learn more about the Fulcrum Partners executive benefits advisory team at Fulcrum Partners Managing Directors nationwide directory.

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ABOUT STEVE BROADBENT:

Managing Director Steve Broadbent’s skill in analyzing and collaborating on the design, funding, and security of nonqualified benefit programs for publicly traded or large, privately held corporations is always in high demand. At Fulcrum Partners, he works attentively with each client, carefully designing effective benefits programs to enable organizations to attract and retain key executive talent while building shareholder value. Steve has over 20 years of targeted financial industry experience, including 11 years as an Executive Benefits Consultant for Clark Consulting.

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ABOUT CHRIS NYLAND:

Managing Director Christopher H. Nyland has more than 30 years of in-depth experience in the executive benefits industry. He has been instrumental in successfully developing nonqualified benefit plans for many Fortune 1000 companies from the financial services industry to healthcare, engineering, high-tech, manufacturing, and utilities corporations.

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