



Deferred Compensation: *Pre-Tax or After-Tax Savings?*

An educational white paper for EBS clients and prospects
interested in retaining more retirement income

William L. MacDonald, Managing Director

Executive Benefit Solutions

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“Our new Constitution is now established, and has an appearance that promises permanency; but in this world nothing can be said to be certain, except death and taxes.” ----- Benjamin Franklin

While death and taxes are unavoidable, you do have control over how you manage and prepare for taxes at death. If you do not prepare properly, you can pay more to the government than necessary and end up with less for your retirement or your heirs.

We all recognize that income taxes cannot be avoided, only deferred and minimized. By understanding how tax-efficient strategies affect your retirement, you retain more of your savings for yourself.

Qualified (401(k)) and nonqualified retirement plans typically include either pre-tax or after-tax accounts or both. Pre-tax contributions help increase savings in your pre-retirement years, while after-tax contributions help reduce your tax burden during retirement. You may also save for retirement outside of a retirement plan, such as in an investment account, however, a 3.8 percent [Net Investment Income Tax \(NIIT\)](#) applies to individuals, estates, and trusts that have net investment income above applicable threshold amounts. Qualified and nonqualified deferred compensation (NQDC) plans, as well as life insurance, are not subject to NIIT.

Your retirement income should come from three buckets of money and taxed various ways (capital gains, ordinary income, tax-free). This paper discusses the risks associated with taxes, reviews the three money buckets and gives you a high-level overview of several possible strategies for you and your financial advisor to consider.

Risk of Tax Rates

Most economists agree that tax rates will change in the future. Few dare to predict when and how much. The likelihood that top federal income tax rates will change in 2017 and beyond seems probable, based on collective statements by Hillary Clinton and Donald Trump.

Clinton said, ***“The wealthiest pay too little in taxes while middle class needs more relief. I’m going to fix that. I’ll close corporate loopholes and make sure millionaires and billionaires can’t pay lower rates than middle-class families. And I’ll give tax relief to working families who are struggling with costs from college to health care.”***

Her plan was to create a four percent “surcharge” on high-income taxpayers (over \$5 million), which effectively adds a marginal rate of 43.6 percent for taxable income over \$5 million and 24 percent top marginal tax rate for qualified dividends and long-term capital gain income (long term defined as six years). Capital gains for one year of holding would be 43.4 percent. At \$415,050 married and filing jointly, the federal rate proposed is 39.6 percent. And then her “Buffett Rule” applies, which would establish a 30 percent minimum tax on taxpayers with adjusted gross income (AGI) over \$1 million.

Now the election is over, and we have a Trump White House. His plan is to cut corporate taxes from 35 to 15 percent, collapse the current seven tax brackets for individuals, which range from 10 to 39.6 percent, into three brackets of 10 percent, 20 percent, and 25 percent and to leave dividends and capital gains at 20 percent. He intends to repeal the 3.8 percent Obamacare tax on investment income, as well as the alternative minimum tax. These two positions represent quite a contrast, further adding to the unpredictability of future tax rates.

If you knew rates would drop in 2018 and beyond under Trump, at least in a four to eight-year window, you would plan your elections today and take distribution during these lower tax years. Conversely, if you thought the rates would be higher as proposed by Clinton, you would take a much different approach. However, we don’t have a crystal ball. We do know the current rate and what Trump proposes. ***How can we use this information to our advantage?***

Take a glance at Chart I for a historical perspective on U.S. top income tax rates. We at EBS have learned the history of income tax rates from the chairman of our advisory board and partner, Dr. Arthur Laffer.

History of Tax Rates: 1913 – 2014



Chart I Source: Bradford Tax Institute

Let's take a little history lesson on taxation. The top tax rate rose from 15 percent in 1916, to a whopping 67 percent the following year. In 1918, the rate peaked at 77 percent, before slowly declining to 73 percent in 1920. As most of us realize, the 1920s were a major boom period in America. You might say it was a huge bubble which burst when the Great Depression hit. Note that during the 1920s income tax rates fell to a low of 25 percent in 1925, which helped fuel strong economic growth.

Taxes usually rise during periods of war, as was the case during WWII. In fact, the top marginal bracket hit 94 percent in 1945 and remained at or above 90 percent for the next 19 years, until President Kennedy got his wish for lower taxes in the early 1960s. The top marginal tax rate was lowered to 50 percent in 1982 and eventually to 28 percent in 1988 under Ronald Reagan. It slowly increased to 39.6 percent in the 1990s, then was reduced to 35 percent for the period 2003 until 2012.

In 2012, "The American Taxpayer Relief Act of 2012" increased the highest income tax rate to 39.6 percent. The Patient Protection and Affordable Care Act added 3.8 percent on to this rate, making the maximum federal income tax rate 43.4 percent. What's more, many states raised their tax limits, too.

From this history, and our experience working with deferred compensation plans for 30-plus years, we draw this conclusion: **Wealth accumulation should not be dependent on a single asset or assumption.** Many financial planners do preach diversification in contribution and accumulation vehicles. But not until recently did they begin to focus on the more problematic need to create diversification for an executive's future distributions.

Benefit Security Impact

On top of the tax risks discussed above, executives must also be aware of the “general creditor risks” associated with NQDC plans.

Four major events could negatively affect a participant's NQDC benefits:

1. Change in control of the sponsoring employer;
2. Change in financial condition of the sponsor, short of bankruptcy;
3. Change of heart of management, where participant has a dispute;
4. Bankruptcy of the sponsoring employer.

In all cases except bankruptcy, a “funded” [rabbi trust](#) protects the participant.

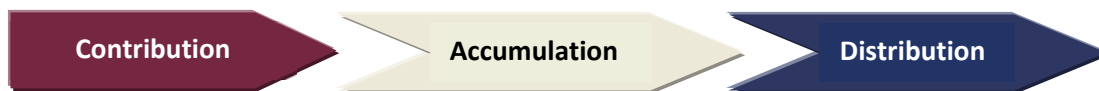
Due to this uncertainty post-retirement, we see a major share of executives taking lump-sum distributions due to concerns over benefit security, with the unwelcomed consequences of pushing retirement distributions into the top tax bracket.

As mentioned above, a number of states in the last few years also raised income taxes, which makes lump-sum distributions expensive from a tax standpoint. It is difficult not to take advantage of the tax deferral offered by an NQDC, even in light of the creditor risk. However, you should consider some diversification in how you accumulate. One of the major advantages with NQDC is the avoidance of state income tax under [the Pension Source Tax Act of 1996 \(P.L. 104-94\)](#) on distributions that are ten years or longer. One must weigh the security risk with the tax benefits.

Today, it is important to consider both diversification of your investments and distribution of income. To understand the importance, and to plan effectively, let me walk you through the three phases of your money so you can see how to set up your buckets.

The Three Phases of Your Money

To fully appreciate the value of various strategies or a different approach to wealth accumulation, and better prepare for retirement planning, we need to examine closely the three phases or movements of money and how they impact the three buckets.



Contribution Phase

Simple enough, this is the phase when you make contributions to your various plans. The question is, **“should you save pre-tax or after tax or both?”** We have always been led to believe that a pre-tax investment, like an NQDC plan, is always better than an after-tax investment, but is that true?

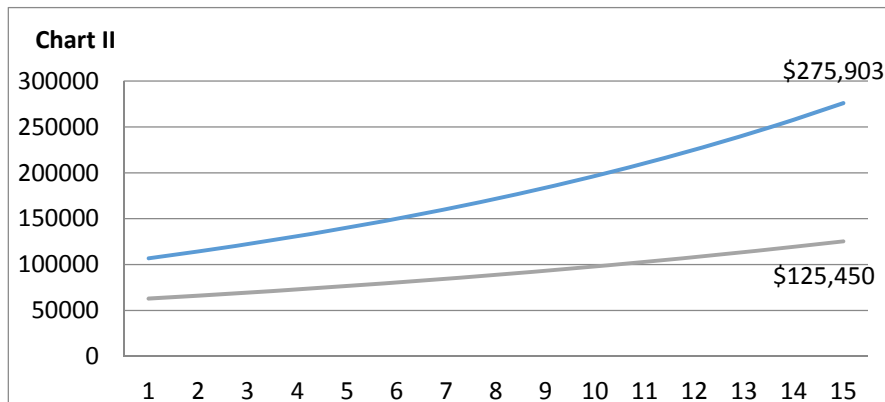
Take your investment in your personal residence, for example. Most of us purchased our home with after-tax dollars. When the home appreciated (the accumulation stage), it grew tax deferred. When we sell it (the distribution phase), we pay capital gains tax versus ordinary income. In fact, the government “gives” us a \$500,000 exemption when filing jointly ([current tax law](#)), if it is our primary residence.

Then, isn't it the **accumulation phase** and the **distribution phase** that make this investment a valuable one? Another good example is the Roth IRA. Make an after-tax contribution. However, the investment grows tax-deferred, and the income is tax-free.

Accumulation Phase

When designing any retirement strategy, the highest return on your investment determines success. Most people follow modern portfolio theory, diversify their investment strategy, and invest in mutual funds. The objective of this phase is **“tax-deferred accumulation,”** or, at least, minimize your taxes during the accumulation. NQDC plans, Roth Plans, as well as the company's 401(k) plans, give us this advantage. As we see later, many executives use individual life insurance policies for tax deferred and, in many cases, tax-free growth and distribution.

Chart II below shows how \$100,000, growing taxed deferred at seven percent, versus being subject to tax on the accumulation at 40 percent and 28 percent. Deferring a portion or all your taxes during this phase can make a significant difference.



By deferring taxes on the returns of an investment, the investor benefits from tax-deferred growth: Instead of paying tax on the returns of an investment, the tax is paid only at a later date, leaving the investment to grow unencumbered.

In the words of Albert Einstein:

“Compound interest is the eighth wonder of the world. He who understands it, earns it . . . he who doesn’t . . . pays it.”

Distribution Phase

The final phase defines how you withdraw or distribute your money at retirement; ostensibly, the most important phase of your retirement planning. Of course, ***it is not how much you accumulate in these plans; it is how much you keep.*** By selecting the right vehicles, you minimize or even eliminate taxes on the distribution.

True diversification offers varying distribution sources with varying tax treatments, as illustrated in Chart III below. Notice how an increase in the top tax rate from 35 to 50 percent reduces your distribution assumptions by roughly 25 percent per year in your taxable accounts.

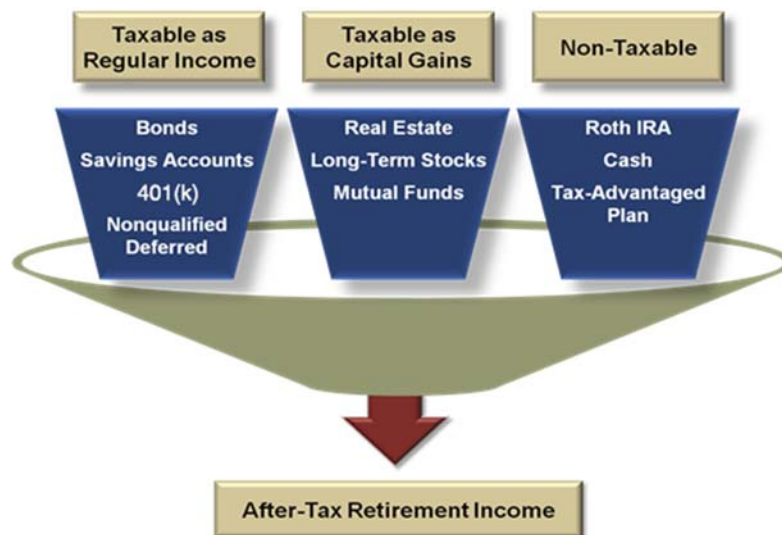
That is why timing is everything.

Example:						
Age 50 deferring \$50,000 pre-tax (\$30,000 after-tax) until age 65 (15 years) at 7% pre-tax (5.25% after-tax)						
Traditional Pre-Tax Deferral Plan				After-Tax Deferral Plan		
Pre-Tax Deposit	7% Investment Earnings	Account Balance	Year	After-Tax Deferral	5.25% Net Earnings	Account Balance
\$50,000	\$3,500	\$53,500	1	\$37,500	\$1,260	\$39,469
\$50,000	\$7,245	\$110,745	2	\$37,500	\$2,573	\$81,010
\$50,000	\$11,252	\$171,997	3	\$37,500	\$3,941	\$124,731
\$50,000	\$15,540	\$237,537	4	\$37,500	\$5,367	\$170,749
\$50,000	\$20,128	\$307,665	5	\$37,500	\$6,852	\$219,182
\$50,000	\$48,358	\$739,180	10	\$37,500	\$15,269	\$502,265
\$50,000	\$87,952	\$1,344,403	15	\$37,500	\$25,608	\$867,881
Amount Distributed		\$1,344,403		Amount Distributed		\$867,881
50% Tax		\$672,202		Tax		\$0
Net Distribution		\$672,202		Net Distribution		\$867,881

CHART III Demonstrates outcome when you defer at 25 percent and take distribution at 50 percent

And why it is important to have three buckets of money, taxed differently (Chart IV). You should have a portion of the investment allocated to a non-taxable bucket, designed to provide a hedge against future higher tax rates, and free from your employer's creditors in traditional NQDC plans.

Three Tax Diversification Strategies: Buckets of Money chart IV



These three phases illustrate why it is important to rethink your strategy for wealth accumulation and retirement savings.

Tax Diversification: How to Keep More of Your Money

Contribution Phase	Accumulation Phase	Distribution Phase
<ul style="list-style-type: none"> - Pre-Tax or After Tax or Both? - Qualified Plans have limits - We're told pre-tax is better, but not always the case. Real estate investing is done with after-tax dollars and accumulates tax deferred and pays out under capital gains. - After-tax strategies are designed for participant control and creditor protection. 	<ul style="list-style-type: none"> - ROI (return on investment) directly impacts retirement lifestyle. - Modern Portfolio Theory states that investment diversification is key. - Mutual funds: a common form of diversification. - Objective tax-deferred accumulation. 	<ul style="list-style-type: none"> - Typically three buckets are available during distribution. <ul style="list-style-type: none"> . Taxable at regular income . Taxable as capital gains . Non-Taxable - Just as you diversify during accumulation, you should diversify during distribution. - Certain vehicles like life insurance are designed to pay out in a tax-advantaged manner.

With tax diversification, you will learn how you can keep more of the money you have earned by ensuring your investments are as tax efficient as possible. These three tax diversification strategies (buckets) can work together to help you gain control. There are several alternatives available, some of which you may not have considered in the past and some which may be new to you. Review the chart below with your tax advisor and spend time with an EBS consultant to design the right strategy for you.

An in-depth financial analysis will be needed to look at the economics. EBS has built a financial modeler that you and your advisor can use to examine various assumptions. Contact EBS for access to the modeler. For purposes of this paper, we will focus on six vehicles:

- Traditional Pre-tax Nonqualified Deferred Compensation
- After-Tax Nonqualified Mutual Funds
- Executive Bonus Plan with After-Tax life insurance
- Rabbicular Trust
- Restricted Property Trust
- Qualified Cash Balance Pension Plan

Traditional NQDC Plan

An NQDC plan or agreement simply defers the payment of a portion of the employee's (participants) compensation to a future date (established in the agreement). Amounts held back (deferred) while the employee works for the company, pay out to the employee when he or she separates from service, elects an in-service distribution, becomes disabled or passes away.

Participants in NQDC plans can tax defer compensation (salary, bonus, restricted stock), accumulate investment earnings (basket of mutual funds), deferring the tax until a future date. Many plans today allow participants to elect "in-service" distributions so they can plan for life events, like college cost for children and take distributions while they are still working.

One of the advantages of an NQDC is to elect distributions at retirement over a period, say 10, 15 or 20 years, with tax-deferred earnings on the unpaid balance. Upon distribution, executives can plan payouts to avoid paying state income taxes under [the Pension Source Tax Act of 1996 \(P.L. 104-94\)](#) discussed above. For more information on NQDC plans see our guide on "[Designing NQDC Plans to Competitive Advantage.](#)"

Executive Bonus Plan with After-Tax Life Insurance

An executive bonus plan (IRC Section 162) enables business owners or companies to provide supplemental benefits to key employees or executives of their choice. This addition usually includes death benefits from a life insurance policy, as well as cash value accumulations, which can be used to supplement retirement income.

With an executive bonus plan, the business can selectively use tax-deductible company funds to provide valued benefits to key people. An executive benefit plan, used effectively, can be a valuable tool to attract and retain key executives.

Simple in design and easy to implement, executive bonus plans work as follows:

- The company provides the key executive with a bonus (could be employee or employer money or combination) that is taxable as income to the participant. The bonus is a deductible business expense for the company.
- The key employee may choose to use the bonus to purchase a whole life or universal life insurance policy that builds cash value and grows tax deferred. Most companies adopting these plans use a high-cash-value/low-death-benefit policy to focus more on cash accumulation.
- The life insurance policy, if properly structured, may provide an attractive benefit to the participant in the form of cash-value growth. Any cash value accumulation will grow tax deferred and may be accessed by the participant income tax-free through withdrawals and policy loans. The policy's cash value can be used to supplement retirement income or for any other financial need.
- If the key executive dies, in most cases, the heirs will receive the death benefit proceeds tax-free from the life insurance policy.

New Rabbicular Trust

A Rabbicular trust was a hybrid of the Rabbi and Secular trusts used to provide participants with benefit security. The trust, before 409A, was designed as a Rabbi trust until the occurrence of an event indicating the financial difficulty of the employer (short of bankruptcy), such as a stipulated decline in debt-equity ratios, net worth, gross sales, or earnings per share. When the event occurs, the trust becomes a Secular trust and the executive receives the right to withdraw benefits.

A Rabbi trust protects the assets from the claims of the employer's creditors if events occur which make insolvency likely; however, you want to take advantage of the tax deferral and ERISA exemptions until that time. These trusts are no longer used post adoption of 409A which prohibits "trigger events."

However, EBS has resurrected the Rabbicular trust (New Rabbicular Trust), with the combination of a rabbi and secular trust, denoting the name rabbi-secular. Under this arrangement, different from the original and 409A compliant, participants make an after-tax contribution to the secular trust (like the after-tax executive bonus), and the sponsoring employer credits all earnings to the rabbi trust (like traditional NQDC). Therefore, the participant's deferrals are not subject to

creditor claims for their contributions and, in later years, not taxed on those contributions when withdrawn. Earnings represent the only amount subject to creditor claims. The participant will be taxed on the earnings, like an NQDC, when he receives the benefits.

Restricted Property Trust (RPT)

The Restricted Property Trust (RPT) enables highly taxed business owners to mitigate income taxes and grow assets. The RPT plan allows for substantial pre-tax contributions (tax-deductible savings), tax-deferred growth, and tax-free distributions. Any corporate entity, other than a sole proprietor, is eligible and only shareholders/partners are allowed to use the RPT.

Because the RPT is not subject to ERISA, participation and contribution limits do not apply. A minimum funding period of five years requires a minimum annual contribution of \$50,000. Further plan funding, if desired, must be accomplished in additional five-year increments. The maximum contribution is based on what's "reasonable and customary" for the level of income earned.

For multiple shareholders/partners, each may elect their contribution levels, or even elect not to participate in the plan. Plan contributions are 100 percent tax deductible to the business entity, while the participant is required to report as income up to 30 percent of the contribution. Assuming a maximum 50 percent tax bracket, the effective tax cost on the plan contribution would be 15 percent. At plan termination when the funds distribute, the tax-deducted portion is then taxed. However, the 30 percent initially taxed, along with growth attributable to that amount, is received entirely income tax-free—equal to 45 to 50 percent or more of the amount distributed.

Certain conditions must be followed to receive these benefits. One should consult his tax advisor and those knowledgeable on the subject of RPT. The RPT is a good vehicle for those who seek tax deductibility, tax-free income and have a need for tax-free life insurance. At plan termination, the policy transfers to the participant and the tax liability is paid by the tax-free portion of the policy cash values. The participant may then continue to hold the policy and the cash values will continue to grow tax-deferred (without any further contributions). The policy cash values can then provide tax-free income for a specified period, or be taken in a lump-sum, tax-free payment. Each participant may choose his personal income preference.

Qualified Cash-Balance Pension Plan

Cash-balance plans are like traditional qualified defined-benefit pension plans with a 401(k) twist. As in a traditional pension plan, investments are professionally managed, and participants are promised a certain benefit at retirement. The promised benefit is stated as a 401(k)-style account balance, rather than as a monthly income stream.

Retirement savers may see the plans as a blessing or a bane, depending on how they have fared with 401(k)s or traditional pension plans. Those currently relying on 401(k)s may find that the addition of a cash-balance plan slashes their tax bills and pumps up a sagging nest egg. Those who depend on generous traditional pension plans are less enthusiastic.

Many older business owners are turning to these plans to turbocharge their retirement savings. Cash-balance plans have generous contribution limits that increase with age. People 60 and older can sock away well over \$200,000 annually in pre-tax contributions. In 401(k)s, total employer and employee contributions for those 50 and older are limited to \$57,500.

The following table highlights each one of these strategies.

Comparison of Vehicles

	Pre-Tax NQDC Plan	After-Tax NQDC mutual funds	After-Tax Executive Bonus Plan- Life Insurance	Rabbinical Trust	Restricted Property Trust
Tax Consequences on Contributions:					
To Participant	Not Taxed as income	Taxed as income	Taxed as income	Taxed as income	Only small portion currently taxed ⁽¹⁾
To Company	No current tax deduction	Tax Deductible	Tax Deductible	Tax Deductible	Tax Deductible ⁽¹⁾
Tax Consequences of Investment Accumulation before Distribution:					
To Participant	Not taxed as income	Investment earnings taxed as income ⁽²⁾	Investment earnings not taxed as income ⁽³⁾	Investment earnings not taxed as income	Investment earnings not taxed as income ⁽³⁾
To Company	Not tax deductible	Not tax deductible	Not tax deductible	Not tax deductible	Not tax deductible
Benefit Security in the event of:					
Change in control of sponsor	Yes	Yes	Yes	Yes	Yes
Bankruptcy of Sponsor	No	Yes	Yes	Yes on deferrals, No on investment earnings ⁽⁴⁾	Yes
ERISA Requirements:					
Reporting and Disclosure	Yes			Yes	No
Funding	No			No	No
Participation	No			No	No
Vesting	No			No	No
Fiduciary	No			No	No
ERISA Enforcement	No			No	No
Contribution maximums:	No Limit	No limit	No limit	No Limit	Minimum \$50,000 no max
Life Insurance Benefits	Not unless designed into plan	NO	Yes	Not unless designed into plan	Yes
Taxation on Distribution of income	Taxed as income	Not taxed as income unless unrealized gains distributed	Tax-free (5)	Contributions not taxed, investment earnings taxed as income	Tax-Free (5)

- (1) Plan contributions are 100% tax deductible to the business entity, while the participant is required to report as income up to 30% of the contribution.
- (2) A 3.8 percent Net Investment Income Tax (NIIT) (<https://www.irs.gov/uac/newsroom/net-investment-income-tax-faqs>) applies to individuals, estates, and trusts that have net investment income above applicable threshold amounts.
- (3) The inside build-up of the cash value of a life insurance contract is not subject to income taxation before distributions. Of course, if the cash value is held in the contract until the death of the insured, the entire death proceeds, including the cash value immediately before death, will be excluded from gross income under Section 101(a).
- (4) The rabbinical trust is both a secular and rabbi trust. Those dollars in the secular are protected (contributions), and those in the rabbi are subject to creditor claims (earnings).
- (5) When you begin to withdraw cash from the policy, the amount of withdrawals up to your basis in the policy will be tax-free. Your basis is the amount of premiums you have paid into the policy. Normally anything in excess of basis would be taxed, however, if withdrawals are from policy loans there is no taxation.

Rethinking Your Wealth Accumulation

Historically, NQDC plans with rabbi trusts have delivered a fairly reliable answer to wealth accumulation for highly compensated executives and business owners. They provided a vehicle to tax defer dollars and insulate executives against a company's refusal to pay out benefits in a change of control, change in financial condition or change of heart situation. However, the greatest risk of nonpayment arises out of a company's insolvency and the unknown future tax rate at distribution.

No perfect vehicle exists that would allow for **tax-deferred contributions, tax-deferred accumulation, and tax-free distribution**. One needs to balance the plans available in the three money buckets and plan accordingly. In our opinion, the ideal arrangement gives participants needed flexibility and pays benefits under the three tax scenarios at distribution: capital gains, ordinary income and tax-free.

In recent years, a decline in annual deferrals in NQDC plans has taken place while after-tax strategies have risen. Roth-type accumulation vehicles, such as the ones discussed above have become more prevalent. We may see more of these arrangements under Trump's tax proposal with personal income tax rates capped at 25 percent. However, with corporate rates at 15 percent, traditional deferred compensation plans become less expensive.

A window may open in 2017, with corporate rates at 35 percent, for plans that offer tax deductibility, and with personal income tax rates proposed to drop during distribution to 25 percent. All this complexity, mixed with perceived opportunities, requires you to spend ample time with your advisors as you educate yourself on the new realities of deferred compensation.



ABOUT EXECUTIVE BENEFIT SOLUTIONS, LLC

EBS is an independent executive benefits consulting firm which provides total plan management services with respect to programs specifically designed for key employees and professionals. Those services include:

- Consulting with respect to plan design,
- The structuring of related financing and benefit security arrangements,
- The design and management of the participant communication, education and enrollment processes,
- Management of any informal funding assets and,
- On-going plan administration and technical support.

More information about the firm can be found at: www.executivebenefitsolutions.com.

CONTACT INFORMATION:

EBS-Boston

20 Park Plaza, Suite 1116
Boston MA 02116
Phone: **617.904.9444**
Fax: 866.903.9927

Christopher Rich

Managing Director
crich@ebs-boston.com

Chris Wyrzten

Managing Director
cwyrzten@ebs-boston.com

Robert Flood

Managing Director
rflood@ebs-boston.com

National Administration

801 E. Plano Parkway,
Suite 216
Plano, TX 75704
972.422.8298

Bonnie Barnes

Vice President of Plan
Administration
bbarnes@ebs-boston.com

EBS-West

1902 Wright Place, Suite 200
Carlsbad, CA 92008
760.788.1321

William L. MacDonald

Managing Director
858.759.8637
wmacdonald@ebs-west.com

Don Curristan

Managing Director
760.788.1321
dcurristan@ebs-west.com

Trevor K. Lattin

Managing Director
949.306.5617
tlattin@ebs-west.com

EBS-Milwaukee

601 Genesee Street
Delafield, WI 53018
262.853.7755

Robert Birdsell

Managing Director
bob.birdsell@ebs-milwaukee.com

EBS-Richmond

3801-A Westerre Parkway
Richmond, VA 23233
804.317.9670

Hugh Carter

Managing Director
hcarter@ebs-richmond.com

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