Deferred Compensation in a Rising Tax Environment

An analysis of the relative advantage of deferral under multiple tax, timing, and return scenarios

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This article examines the impact of changing tax rates on nonqualified deferred compensation plans. To do this, we use historical tax rates and other factors that impact the viability of deferred compensation. We also discuss the impact on plan sponsors and the steps they should take to inform and educate their employees.
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Deferred compensation plans have long been the primary company-sponsored retirement vehicle for the highly compensated employee. These plans are popular vehicles due to limitations in qualified retirement plans and the fact that pre-tax deferral and tax deferred growth are generally thought to be more efficient than after-tax investing and after-tax investment returns.

With the scheduled expiration of Bush-era tax cuts and tax increases near, many employers are asking whether deferring in a rising tax environment makes sense. Answers to this question vary and often depend on whether they come from the press, a savings vehicle, or other sources.

This paper examines the impact of changing tax rates on nonqualified deferred compensation plans by addressing all of the quantifiable factors that can complicate an analysis. For example, tax rates at deferral and distribution are examined in addition to the impact of tax rates between these two points in time. This paper does not incorporate any qualitative factors that may make deferred compensation more or less attractive as a retirement vehicle. The intent is to answer the question of whether deferred compensation in our current tax environment can be advantageous and highlight certain influencing factors.

In addition, the modeling in this paper is meant to be as complete as possible while remaining understandable. Certain factors that should not impact the end result have therefore been minimized. Examples of such factors include the increasing prevalence and impact of tax-managed funds and the fact that payout duration can greatly influence state taxes.

Finally, this paper does not account for the Alternative Minimum Tax. While some employees will be subject to this tax, a uniform rate would be difficult to apply in a single hypothetical situation.

Overview of Deferred Compensation

A deferred compensation plan typically looks very similar to a 401(k) plan. Absent any further limitations imposed by nondiscrimination testing, the Internal Revenue Code currently places a $16,500 limit on the amount that an employee can annually contribute to a 401(k) plan.

Nonqualified deferred compensation plans offer employees at higher income levels the opportunity to defer income in excess of the $16,500 limit. In a nonqualified plan, the employee elects to defer receipt of compensation until retirement or another pre-selected date. This enables the employee to avoid immediate taxation (other than FICA) on income they would otherwise invest on an after-tax basis.

At the time of deferral, the employee selects the year and method of payment. The company then credits earnings to the employee’s deferred compensation account balance based on hypothetical investments selected by the employee or a fixed rate of return. The earnings grow tax-deferred until benefits are paid.
Current Tax Rates

Current tax rates, coupled with prognostication of future rates, provide the backdrop for most deferral decisions. To begin to understand the implications of these decisions, it is important to understand a few points about the current tax rules:

- The maximum rate for federal income tax is 35%, but the limitation on itemized deductions for high income earners increases the effective marginal rate to nearly 40%.

- State income tax ranges from 11% in Hawaii to 0% in several other states.

- Short-term capital gains (held for one year or less) are taxed at ordinary income rates.

- Long-term capital gains and qualified dividends are taxed at 15%, but they are scheduled to increase to 20% at the end of 2010.

The Financial Results of Deferred Compensation

The key advantage of deferred compensation is the delay of taxation. This delay allows for the pre-tax compounding of investment returns. The ability to invest more initially and reinvest 100% of earnings without an income tax drain until the ultimate distribution yields higher returns.

When comparing the relative merits of deferring compensation, there are three distinct tax phases to consider:

1. **Taxation on deferral**: Avoiding tax prior to investing means more money invested and earned. Investing $100,000 on a pre-tax basis will result in a larger after-tax benefit after the first year than investing $60,000 on an after-tax basis.

2. **Taxation during deferral period**: Taxes during the deferral period are relevant for the after-tax investing scenario. Income and capital gains are subjected to tax on an annual basis. Therefore, changes to capital gains tax rates and ordinary income tax rates over time impact the overall merits of one scenario compared to the other.

3. **Taxation on distribution**: Taxes at distribution are relevant for deferred compensation balances because neither the principal nor investment gain have been taxed up until the point of distribution. The entire distribution is therefore subject to full ordinary income tax. By contrast, in an after-tax investment scenario, the entire balance has already been subjected to income tax and capital gains taxes prior to distribution. No additional taxes are due at the time of distribution other than for recognition of previously unrecognized capital gains.
This example illustrates the potential advantage of tax-deferred growth available in deferred compensation plans. In our base case, an employee making typical deferrals will have a payout at retirement that is approximately 52% larger after taxes than what he or she would have earned with personal after-tax investments. This scenario assumes taxes remain constant with the highest current effective marginal rate.

Higher tax rates at the point of deferral increase the advantages of deferred compensation. Conversely, lower taxes decrease the advantages.

**The Impact of Change During the Deferral Period**

Changing some of the key assumptions from the base case described earlier shows how the advantages of deferred compensation can fluctuate. Isolating the impact of a prolonged spike in tax rates during the deferral period is a good example. If effective tax rates increase by 5% for 15 years and then decrease back to current rates prior to retirement, the advantage of deferring is even greater. The graph below illustrates a 5% effective tax rate increase and decrease for 15 years respectively, and then a return to current rates at retirement.
The Impact of Change at Retirement

Another common situation worth examining is a jump in tax rates at retirement in isolation. The graph below illustrates the effective tax rate increasing by 5% for five years before retirement and staying elevated through retirement. The deferral scenario is still more advantageous personal investing but to a lesser degree than our base case scenario.

Note that this increasing tax rate scenario results in a deferral advantage of 42%, while a decrease of 5% in the effective tax rate at retirement results in a 62% advantage for deferring.

Summary of Results

As shown above, the advantage of deferred compensation is impacted by changing tax rates. Although it may seem counter-intuitive, a long-term increase in tax rates during the deferral period actually provides the greatest relative advantage for deferred compensation. On the other hand, a tax rate increase at retirement still results in deferred compensation providing the larger benefit, although it does begin to reduce that benefit.

<table>
<thead>
<tr>
<th>Assumptions</th>
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<tbody>
<tr>
<td>$40,000 annual deferrals for five years</td>
<td></td>
</tr>
<tr>
<td>Current age 45 and retirement age 65</td>
<td></td>
</tr>
<tr>
<td>8% investment return</td>
<td></td>
</tr>
<tr>
<td>40% income tax rate now and at retirement</td>
<td></td>
</tr>
<tr>
<td>15% capital gains rate now and at retirement</td>
<td></td>
</tr>
<tr>
<td>After-tax investments taxed at a blended rate of 31%</td>
<td></td>
</tr>
<tr>
<td>Portfolio of 60% equity and 40% bonds</td>
<td></td>
</tr>
<tr>
<td>50% equity turnover and 2% dividend rate</td>
<td></td>
</tr>
<tr>
<td>Immediate lump sum distribution at retirement</td>
<td></td>
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</tbody>
</table>
History of Federal Taxation

While it may seem possible to predict where tax rates will be in the next five years, historical analysis shows that long-term fluctuation makes it hard to predict what the top tax rate will be in 20 years. For example, in the last 30 years, the top rate has been as low as 28% and as high as 70%. In the 30 years before that, the top tax rate was as high as 90%. The following graph shows the top marginal tax rate in the United States from 1913 to 2010:

Top Marginal Rate

As we move into a new decade, there are many drivers that suggest increasing tax rates are likely. However, it is difficult to predict whether these increases, if they occur, will be long-term. Most deferred compensation decisions must take into account a fairly long horizon. With retirement dates being pushed back later and later, it is likely that the next administration or even the one after that will have more impact on payouts from deferrals that are being considered right now. Indeed, as illustrated, higher tax rates in the short-term may actually contribute to the relative advantage of deferring.

Other Quantitative Influencing Factors

There are several other assumptions in addition to taxes that can influence the attractiveness of deferred compensation. Two key considerations are 1) how long deferrals will grow and 2) the interest rates assumed on those deferrals.

Deferral Period

Deferral length will have an effect on the advantage a deferred compensation plan will have over taxable alternatives. The longer a participant is able to keep deferrals in the plan to take advantage of the tax shield, the more valuable the plan is to the participant. Given the increased risk associated with a longer investment horizon, one should expect a greater reward.
**Assumed Investment Returns**

Assumed rates of return can have a significant effect on the attractiveness of deferred compensation. When a higher rate of return is assumed, the advantage of tax deferred investing grows exponentially. Again, the primary advantage of deferred compensation is in the tax deferred compounding of investment returns. The greater those returns are, the greater the appeal of deferred compensation.

With this in mind, employees must consider their personal investment strategy when evaluating whether to defer. Employees should also consider the impact of tax-deferred compounding when setting asset allocation strategies among tax-deferred and taxable investments.

**Incorporating All Factors**

It is important to understand the mechanics of these influencing factors both individually and collectively because there will be certain situations in which they will combine to make a compelling argument for or against deferral.

Combining the various elements that influence the relative advantages of pre-tax deferring or after-tax investing into a few scenarios shows the complications of generalizing the impact of higher taxes. Below are two tax scenarios:

**Scenario 1:** This starts with higher tax rates over the next 15 years and then gradually declines, similar to the late 1980s and early 1990s.

**Scenario 2:** Taxes remain level for several years, gradually decline, and then jump up.
The table below combines the two tax scenarios above with three individual investment and age scenarios:

<table>
<thead>
<tr>
<th></th>
<th>Executive A</th>
<th>Executive B</th>
<th>Executive C</th>
</tr>
</thead>
<tbody>
<tr>
<td><strong>Age</strong></td>
<td>60</td>
<td>52</td>
<td>45</td>
</tr>
<tr>
<td><strong>Deferral Amount</strong></td>
<td>$40,000 per year</td>
<td>$40,000 per year</td>
<td>$40,000 per year</td>
</tr>
<tr>
<td><strong>Deferral Period</strong></td>
<td>5 Years</td>
<td>10 Years</td>
<td>15 Years</td>
</tr>
<tr>
<td><strong>Investment Return</strong></td>
<td>4% grading down to 5% close to retirement</td>
<td>7% grading down to 5% close to retirement</td>
<td>8%</td>
</tr>
<tr>
<td><strong>Distribution Period</strong></td>
<td>Lump sum</td>
<td>10 Years</td>
<td>5 Years</td>
</tr>
</tbody>
</table>

The graph below shows the relative advantage and disadvantage for each individual under the two tax scenarios:

The graph shows that personal circumstances are the primary driver of the deferral advantage. While the different tax scenarios can cause slight fluctuation in the advantage of deferrals, it is the individual employee’s deferral period, age, and distribution period that cause the results to vary greatly.
Impact on Plan Sponsors

Because deferred compensation decisions can have a huge impact on the retirement of key employees, companies that sponsor such plans should strive to help employees make the best decisions possible. Three ways to assist employees include:

1. **Focus on education:** Deferral decisions can be complicated, and it is important to provide education and communication to help employees understand the variables that may impact their decisions. An informed population will better use the plan and perceive more value from it.

2. **Utilize technology:** There are a variety of planning tools available, including custom modeling of all the variables discussed in this paper. These tools can help quantify retirement needs and plan benefits.

3. **Avoid knee-jerk reactions:** Plan sponsors should realize the hazards of overreactions, such as cancelling the plan due to speculation of increasing rates. While there may be some that do not benefit from deferring, cancelling a deferred compensation plan can negatively affect the majority of the participants. In addition, plan termination is governed by strict rules that can have a long-reaching impact on the company’s ability to offer competitive benefits.

Conclusion

The question of whether to defer is influenced by many factors. While increasing tax rates have an effect, they are only one piece of a large equation with many variables. Participants can control some of these variables, but others are impossible to predict. Regardless, at the end of the day, employees must decide whether to defer by weighing the benefits and risks determined by their individual circumstances. While there are situations in which forgoing deferrals is reasonable, the majority will find significant benefit from deferred compensation. To help key employees plan for their financial future, plan sponsors should have a well-considered strategy to educate them and provide the tools necessary to make informed decisions.
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