THE TODD ORGANIZATION®

Executive Benefit Plans: Has the Pendulum Swung Too Far?

A Series Examining the Changes and Growing Challenges in Executives' Retirement Plans -- and How to Address Them

Regardless of Tax Rate Changes, Deferred Compensation Will Remain Important

The benefits of tax-deferred investing and tax-deferred compounding have long been a hallmark of successful retirement planning. This applies to both qualified and non-qualified supplemental retirement plans.

With federal budget deficits large and 2013 a non-election year, there is speculation that tax rates, especially on high earners could rise in the near future. Some worry that the benefits of executive retirement plans would be significantly reduced by deferring income into a higher tax environment, where taxes at the time of distribution would be higher. Yet, a statistical analysis and review of other important tax factors indicates that deferral will still make compelling sense.

Currently, the federal tax rate is 35 percent above $388,350, for those who are married and filing jointly. To illustrate the impact on deferred compensation plans of potentially higher federal taxes, The Todd Organization compiled the table below comparing pre-tax and post-tax net amounts, based on the following assumptions.

- A one-time investment of $10,000
- The participant is currently in the highest federal tax rate – 35 percent
- The top federal tax rates increases after one year to 39 percent
- The investment earns 8 percent each year.

TAX RATE INCREASES TO 39%		
	After Tax Net Amount	
Distribution	Pre-Tax Contribution	Post-Tax Contribution
2 years	$6,696	$6,838
3 years	$7,232	$7,177
4 years	$7,810	$7,533
5 years	$8,435	$7,907

As the chart shows, even by deferring into a higher tax environment, the executive will have higher proceeds, in this case a modest $55 at the end of three years. At the end of 5 years, however, the executive will have over $500 more. The gap will continue to grow as time passes, further minimizing the impact of the increased tax rate.

The most significant drawback of higher taxes is when a decision is made to withdraw the contribution shortly after the higher rate goes into effect. Yet, federal regulations already require a minimum of two years before a deferred compensation distribution is allowed for the original election.

As the preceding chart shows, the longer the deferral period the higher the differential from the non-qualified deferral plan versus strictly after-tax investing, even with a future tax increase.

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> The basic principle of deferral investing – having more money to invest initially on a tax deferred basis – results in increasingly more significant returns than by beginning an identical investment with after-tax funds.

There are other fundamental factors and planning strategies that will make deferred compensation plans compelling, even if there are significant future increases in federal taxes. These include the following.

Specifics of Who is Impacted by Higher Federal Taxes. Much of the discussion about higher taxes focuses on those currently in the two highest tax brackets, the 33 and 35 percent federal tax brackets. Yet, the 28 percent federal tax bracket, which currently goes up to $217,450 for those who are married and filing jointly, might remain unchanged in such a tax code change. Today, many middle managers, including some earning more than $115,000 (the government's definition for highly compensated) participate in non-qualified deferred compensation plans. In fact, deferred compensation plans are very important for many executives earning less than $300,000 annually.

Likely Lower Tax Rate at Retirement. Most individuals expect to have significantly lower federal tax rates at retirement, as their income will be lower. As such, the returns through deferring pre-tax results in even greater gains.

For additional information on deferred compensation and related tax deferral issues, contact your Todd Consultant or visit our website at www.toddorg.com.

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