

# The Taxes are Coming! The Taxes are Coming!

## *The Case for Deferred Compensation Plans*

by Kevin Novak

*With higher tax rates imminent, deferred compensation plans offer executives an opportunity to mitigate tax burdens and increase long-term savings.*



### A tax hike warning

Spread the alarm! For some time now, members of the financial and political communities have predicted tax hikes are on the horizon. Why is this? The lingering recession has driven tax revenue down to record lows. At the same time, government spending continues to grow, with more than \$1 trillion spent in stimulus aid alone. The result is an advancing federal deficit totaling close to \$14 trillion.

As the government begins to address our nation's mounting debt, tax increases are a likely resolution. But in what form will these higher taxes come? Instead of Paul Revere's famous, "One if by land, two if by sea," perhaps we'll be warned of higher taxes with "One if by expiring Bush tax credits, two if by healthcare reform legislation."

In fact, many tax increases are already in the pipeline. The following tax law changes have already been enacted, effective beginning with the 2013 tax year:

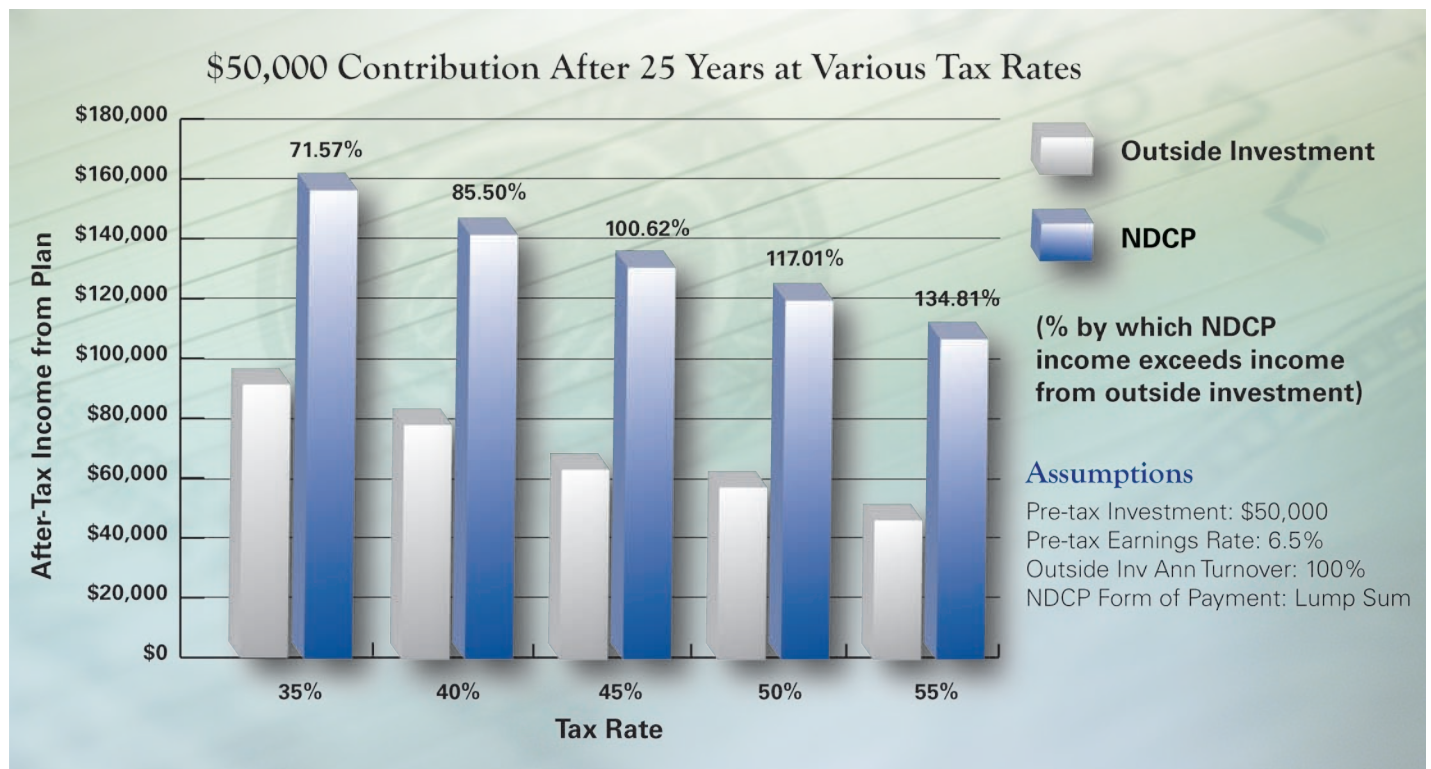
- Increased hospital insurance tax on high-income taxpayers
- Medicare contribution taxes on unearned income
- Limitations on health flexible spending arrangements

In addition, the current administration is set to raise the top 2 income tax rates to pre Bush-era levels for individuals with income over \$200,000 and couples earning more than \$250,000 (after deductions). This change will increase the top marginal tax rate from 35% to 39.6% and the rate in the second-highest bracket from 33% to 36%.

### Deferred Compensation Plans to the rescue

Nonqualified Deferred Compensation Plans (NDCPs) offer management and key employees an opportunity to defer income and avoid income taxes on their earnings while benefiting from tax-deferred growth. Furthermore, participants in NDCPs can contribute without concern to qualified plan limits. These features are important to high-income earners, who are affected the most by qualified plan limits and are likely to face the highest tax increases.

Because of the tax-deferred nature of NDCP contributions, participants can invest more and generate greater earnings than in a similar outside taxable investment. In fact, the higher the effective tax rate, the greater the advantage of NDCPs. The following chart shows the after-tax value of a single \$50,000 contribution after 25 years at a 6.5% earnings rate, considering various tax rate scenarios. The stated tax rates are assumed to be constant over the 25-year period.



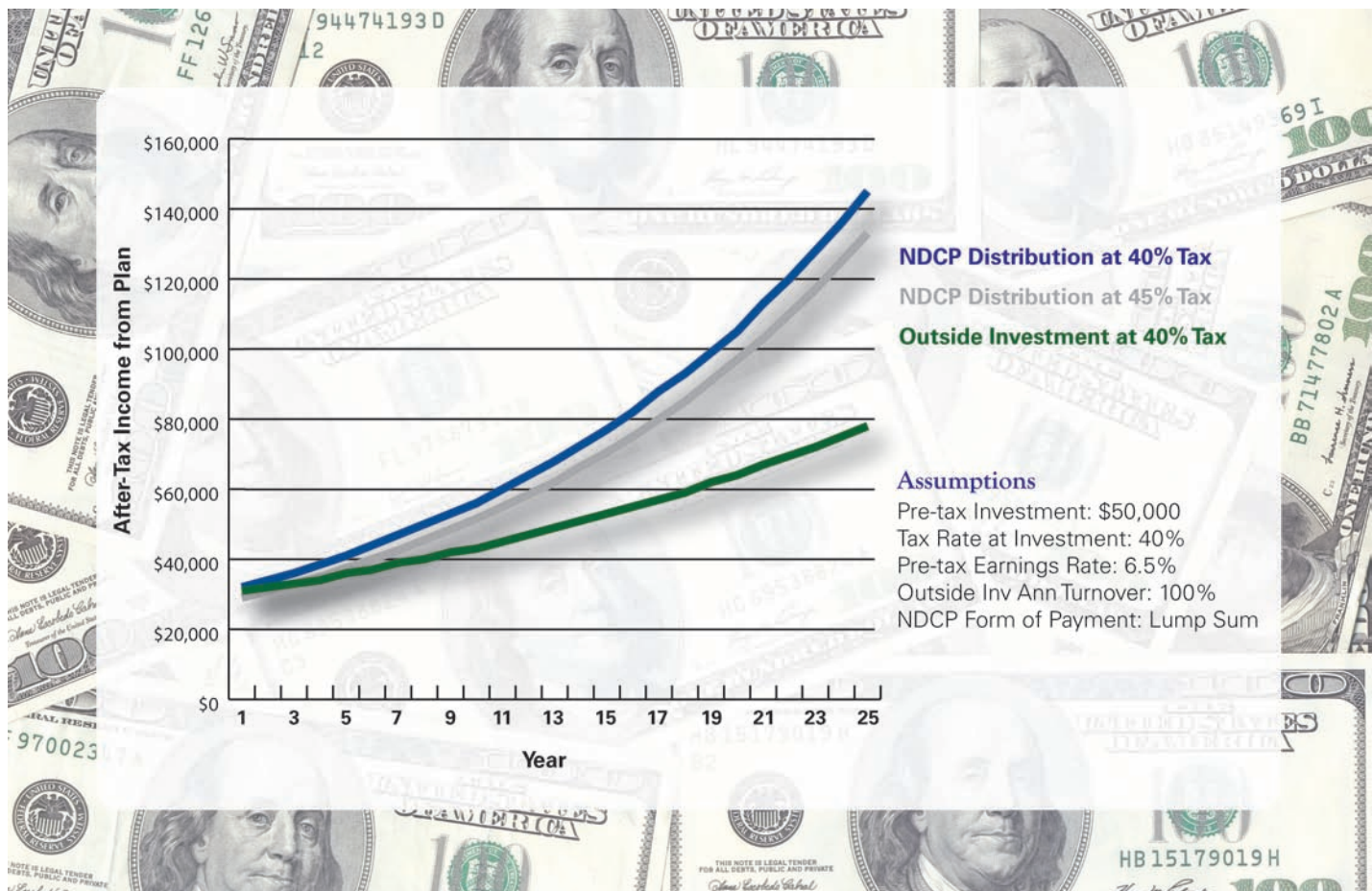
While higher tax rates eat into the value of both accounts, the key statistic is the percentage by which NDCP income exceeds income from the outside investment. As this measure shows, the advantage of the NDCP goes up with every increase in the tax rate, allowing participants in deferred compensation plans to come out significantly ahead of those in taxable investments.

### Timing considerations

Similar to a traditional IRA, balances in NDCPs are taxable at ordinary income rates at the time of distribution. A cause of concern for NDCP participants could be the negative impact of a possible tax increase at the end of the deferral period.

A worst-case scenario could occur in the event a participant defers income while tax rates are low, but must pay taxes when the rates are higher.

Consider the following example: the same \$50,000 contribution is made in an NDCP and an outside taxable investment. If the tax rate remains constant at 40%, the NDCP has a clear advantage. But what if the tax rate increases to 45% at the time of distribution, leaving the entire NDCP balance subject to the higher rate? As it turns out, the advantage of tax-deferred growth in the NDCP is so great that it more than makes up for the higher tax rate at distribution, as long as the contribution accumulates a minimum of four years.



As you can see, over the long-term the NDCP still outperforms a comparable fully taxable investment, even when subject to a worst-case scenario of higher taxes at distribution.

### Act now!

In the current environment of rising taxes, the ability to mitigate taxes and increase savings has become even more

important. Corporations that utilize a Nonqualified Deferred Compensation Plan enable their executives to prepare for the tax hikes on the horizon. The professionals at SilverStone Group possess the knowledge and experience necessary to guide clients in a direction that will allow them to reap the greatest benefits from a Nonqualified Deferred Compensation Plan.