

Tax Effective Wealth Accumulation

Understanding the sources and impact of taxes can make a difference.

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Taxation, in reality, is life. If you know the position a person takes on taxes, you can tell his whole philosophy. "The tax code, once you get to know it, embodies all the essence of life: greed, politics, power, goodness, charity." Those were the words of Sheldon S. Cohen, Former Internal Revenue Service Commissioner.

Having an understanding of how taxes affect investment returns as they can have a major impact on your final results is essential. Taxes have been a permanent part of the social-political landscape in the United States since the Sixteenth Amendment to the Constitution was ratified in 1913. Soon after the ratification, President Woodrow Wilson approved the form of federal income taxation that we know today. Initially affecting only the wealthy, it was not until after World War II that the federal income tax began to have a significant impact on the economic well-being of the average citizen.

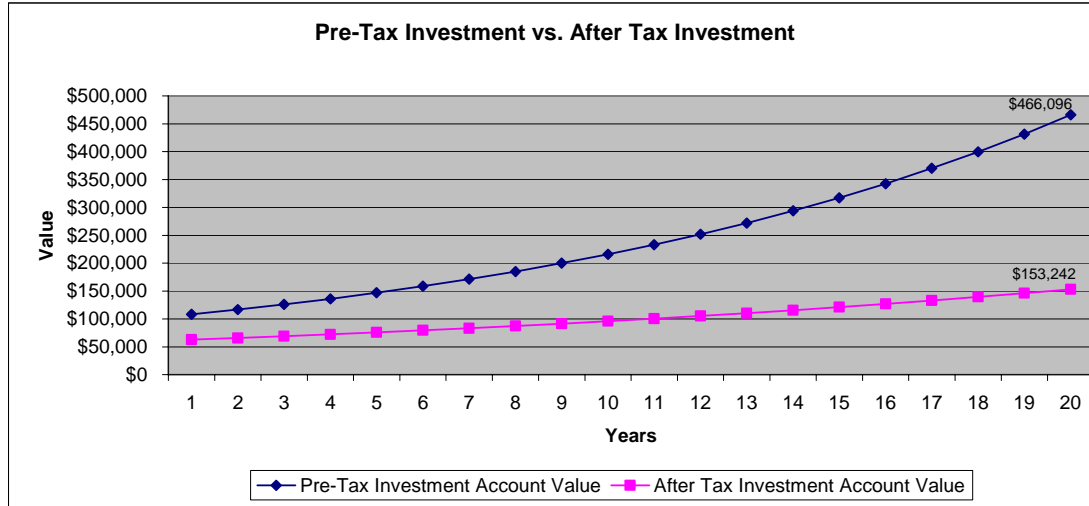
Nonqualified deferred compensation plans give executives the tools for optimal results in planning wealth accumulation for later retirement. These plans are not established to avoid the payment of taxes through questionable accounting or estate planning or simply the attempt to pay no tax. Rather the plan is to maximize what is available today in the tax system to optimize the overall results. For example, if an executive has the choice between accumulating money on a pre-tax or after-tax basis, with similar investments, it is foolish not to consider the impact of deferring those dollars pre-tax in a nonqualified plan. Chart I illustrates that point on a one time \$100,000 deferral.

If the executive receives a higher after-tax return through effective tax-aware investment management, the consulting firm makes a reasonable profit, the government collects its revenues on distribution, then we have achieved the best of all worlds - everyone involved in the process has gained something of value.

Today, 90% of the Fortune 1000 offer their executives nonqualified deferred compensation plans. Participation in these plans varies from company to company, but you would think executives who are saving dollars for future lifestyle events such as retirement would take full advantage of this opportunity. The lack of attention to taxes in the investment management process is so severe that most professionals in the investment management industry are unaware or unwilling to suggest the accumulation in nonqualified plans, maybe

because they lack the tools within their organization to design and manage these plans.

Pre-Tax Investment vs. After-Tax Investment



Assumptions	
Executive Age:	45
Deferral:	100,000
Deferral Duration:	1 Year
Crediting Rate:	8%
Individual Tax Rate:	40%

Chart I

Introduction of Nonqualified Plans

In 1974, the Employees Retirement Income Security Act, known as ERISA, was passed into law. The Act was intended to regulate the activities of employers as related to their handling of retirement pension and savings plans. As one might imagine, prior to ERISA some companies mishandled retirement benefit funds, causing thousands of workers to be left out in the cold when it became time for them to retire.

ERISA was enacted to protect the rank and file from potential abuses by senior management, and in that regard it has been a success. As with other government regulations, ERISA places restrictions on how retirement benefit plans must be structured, prohibits an employer from discriminating and adds cost and complexity to the administration of such plans.

As part of ERISA adopted in 1974, plans could be exempted from the filing, reporting and fiduciary responsibility if they were designed for, “a select group of highly-compensated and/or management personnel.” These plans are referred

to as nonqualified, versus qualified (such as your 401(k)) that must follow government regulations.

As opposed to “qualified” retirement savings, nonqualified plans must be “unfunded.” This means that the money deferred by the executive goes into the company’s general account and cannot be set aside to *guarantee* the plan’s future obligations. Should the company sponsoring such a plan become insolvent, the amounts deferred are considered part of the company’s assets and are therefore subject to the claims of creditors. (In a 401(k)/qualified plan, this is not the case.)

This feature is what gives the nonqualified deferred compensation plan its tax-deferred status. The thinking is that since the participant is placing money into a plan that he or she may never receive or benefit from, the amounts contributed are considered to be tax-deferred until such time as the participant actually receives the cash from the plan.

This risk, that amounts deferred may never be received, is also why only those who are “highly-compensated” may participate. The Department of Labor (DOL) believes that those highly-compensated individuals are capable of understanding the risks associated with participation in such a plan and therefore don’t need ERISA’s protection.

This article doesn’t go into the detail, but sponsoring companies have structured trust arrangements, known as Rabbi Trusts, to protect the assets against change in control, change of heart, and change in the company’s financial condition short of bankruptcy.

How Much Do You Need For Retirement?

Will you have enough for retirement? We answer emphatically: It depends!

The next logical question is: On what does it depend?

Put simply, it depends on you. It depends on when you want to retire and the lifestyle you wish to have when you retire. Equally important, it depends on how diligently you can save, how well you can invest, and if you understand what investments are right for you. Also, believe it or not, it depends where you reside when you retire. One of the hidden features of nonqualified plans is that I get 100% tax deferral while I’m deferring. This tax deferral includes state income taxes. If I live in a high-income tax state while deferring and then move to a low or no income state, as long as I take the distribution over 10 years, I never pay the higher taxes of the state where I deferred. The tax savings from the lower or no taxes state may result in savings of 10-12% plus investment earnings for my retirement accumulations.

Perhaps the biggest mistake people make when planning for retirement is to think that what is “enough” for the first year of retirement will be enough for each successive year. They underestimate their retirement expenses, and, more importantly, they overestimate how fast their nest eggs are growing, forgetting to account for taxes and inflation. Nonqualified plans have the advantage over other devices for helping to manage the taxes. Chart II illustrates the advantage of taking a distribution over 10, 15, and 20 years with the balance continuing to grow tax-deferred.

Pre-Tax Investment					
Account Balance At Retirement	Lump Sum	Payments Over 10 Years	Payments Over 15 Years	Payments Over 20 Years	
\$466,096	Pre-Tax	\$466,096	\$64,317	\$50,420	\$43,956
	After Tax	\$279,658	\$38,590	\$30,252	\$26,374
	Total	\$279,658	\$385,902	\$453,780	\$527,472

After-Tax Investment					
Account Balance At Retirement	Lump Sum	Payments Over 10 Years	Payments Over 15 Years	Payments Over 20 Years	
\$153,242	Pre-Tax	\$153,242	\$18,753	\$13,897	\$11,535
	After Tax	\$153,242	\$18,753	\$13,897	\$11,535
	Total	\$153,242	\$187,530	\$208,455	\$230,700

Pre-Tax Advantage	82%	106%	118%	129%

Assumptions	
Executive Age:	45
Deferral:	100,000
Deferral Duration:	1 Year
Crediting Rate:	8%
Individual Tax Rate:	40%
Retirement Age:	65

Chart II

How Fast Does an Investment Really Double In Value?

You may have heard about the “miracle of compounding” and the “rule of 72”. Briefly this means that by reinvesting your interest and/or dividends continually at the same rate, or by growth in the value of your initial investment, the value of your investment doubles in the number of years equal to 72 divided by your investment return.

Let's look at an example. Let's assume you defer \$100,000 at a growth rate of 8% annually. In 9 years - 72 divided by 8 - you will have \$200,000; this is due to compounding of investment return. For most investors, the one big catch is taxes!

If the executive who participates in the nonqualified deferred compensation plan is in a 40% tax bracket, and if he invested outside of a tax-sheltered plan, he would earn only 4.8% (8.0% minus 40% tax). Not only would he be investing after-tax dollars (Chart I), but it would take him 15 years to double his investment. This gives the nonqualified deferred compensation plan a major advantage.

One additional advantage; another vehicle for the executive that allows him to defer *unlimited amounts* of compensation *pretax* is not available. The 401(k) plan, also sponsored by his employer caps his contribution at \$15,000 (2006 limit).

Assumed rates of growth are hypothetical and not intended to represent a specific or typical type of investment.

The rule of 72 is a mathematical concept and does not guarantee investment results or function as a predictor of how an investment will perform. It is simply an approximation of the impact of a targeted rate of return would have. Investments are subject to fluctuating returns and there is no assurance that any investment will double in value.

Investing the Deferred Compensation Dollars

Having the ability to tax-defer unlimited amounts of compensation is a major advantage over other types of savings vehicles, however, if you don't invest wisely you will lose some of the advantage.

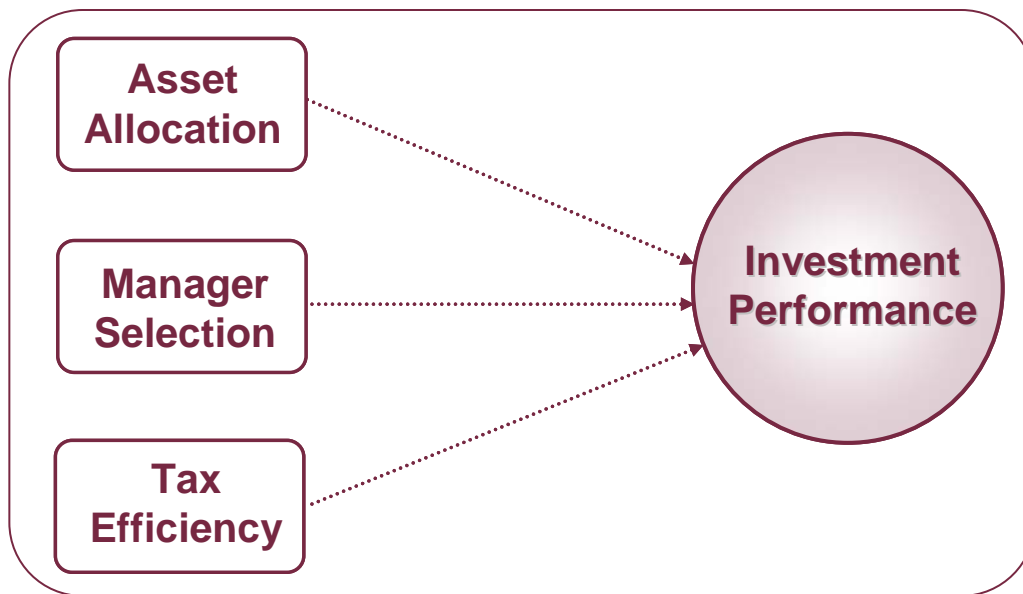
Most nonqualified plans give participants an investment menu of mutual funds similar to the company's 401(k) plan. This may not be the best platform for the executive's nonqualified money. The 401(k) plan, in many cases, is composed of much smaller account balances and spread among thousands of employees, verses nonqualified plans where the balances are much larger. Also, many 401(k) providers increase fees to help subsidize plan administration.

As we saw earlier, maximizing your returns can make a big difference, so spending another 40 or 50 basis points for un-needed services takes away from your returns.

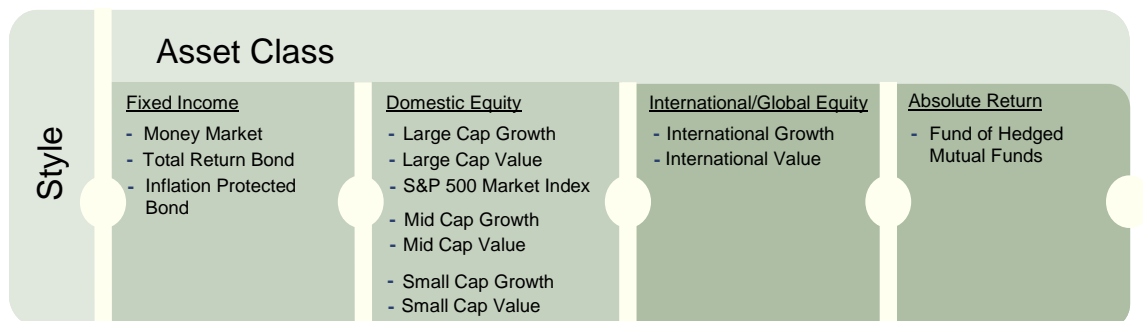
Investment Menu Construction

The single most important design decision of a nonqualified deferred compensation plan is the construction of the investment menu. The investment menu decision not only impacts an executive's deferred compensation balance, it also impacts the company's cost.

Three factors drive investment performance in a nonqualified plan.



Your employer should construct a "menu" with a well-diversified set of asset classes and styles.



The menu should have all of the asset classes from fixed income to international. The plan also should allow the participants to customize personal risk exposure,

or have available well-diversified, model portfolios that have been constructed by professionals.

Because most executives don't have the time to manage their portfolios, best practice plan designs today are adding asset allocation portfolios. When these portfolios are made available, over 60% of executives take advantage of them. These portfolios use the assets from the investment menu, and the portfolios typically range from conservative to aggressive (Chart III).

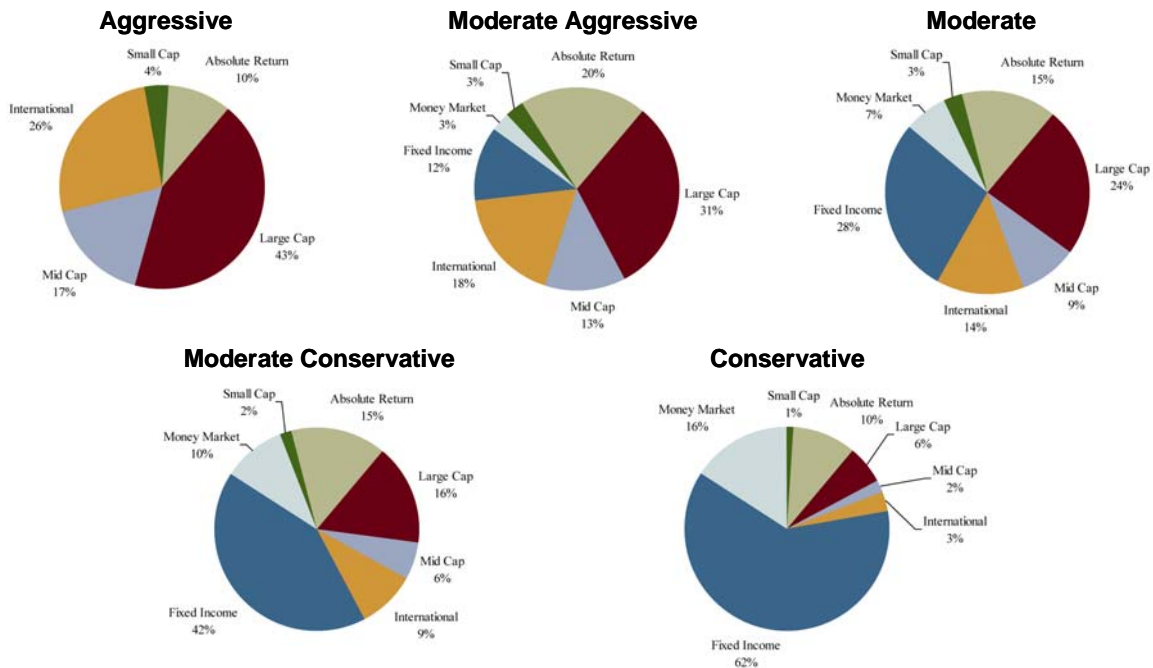


Chart III

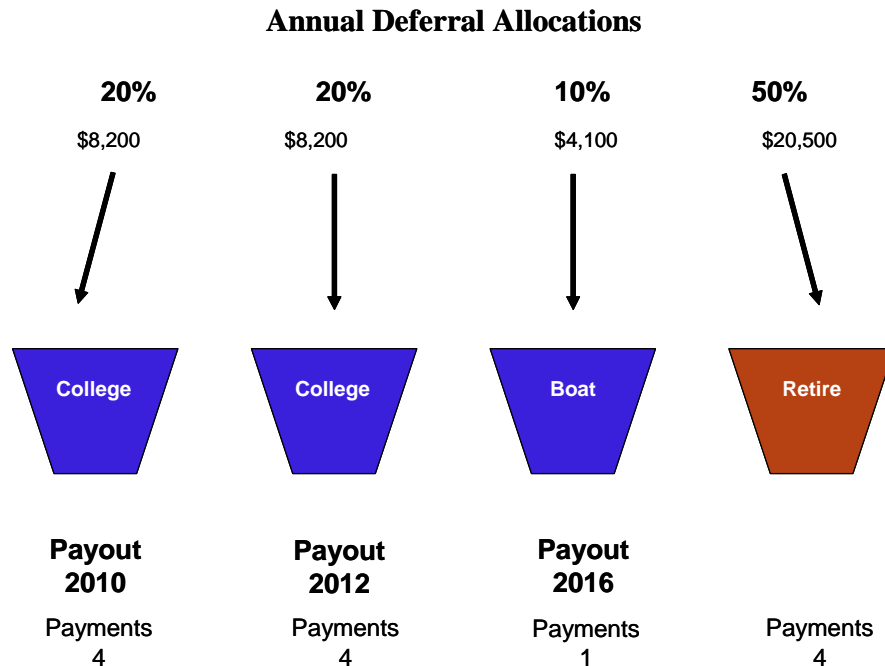
The executive can simply use a friendly risk tolerance questionnaire that helps the professional determine which portfolio meets the executive's needs. These portfolios are much different than life style funds in 401(k) plans being monitored and automatically rebalanced.

Nonqualified Plans Are Not Just For Retirement

Unlike 401(k) plans, most nonqualified deferred compensation plans allow the executive to manage his lifetime needs, both short and long term. A typical deferred compensation plan allows a participant to elect to defer all or a part of his compensation in what is known as short-term distribution features. As an example, a 40-year old executive could defer part of his bonus compensation for 5 years, for his daughter's college education. The new deferred compensation

tax laws (409A) would give him the ability to re-defer that money if at the time it's not needed.

A well-designed deferred compensation plan gives you more flexibility on planning these lifetime events. As an example, one could break up his deferrals into "buckets" setting aside deferrals for not only the event (i.e. child's college) but also the timing of distribution (i.e. over four years). Each bucket could also have its own asset allocation as described above.



Summary

Nonqualified plans are an excellent vehicle for an executive's wealth accumulation. In today's environment, no other alternatives allow for 100% tax-deferred compensation, and the ability to plan for life events and manage your own portfolio. If your company has a deferred compensation plan, it might be time to look into participating. The impact of compounding money on a tax deferred basis can be significant and have a major impact on your retirement income.