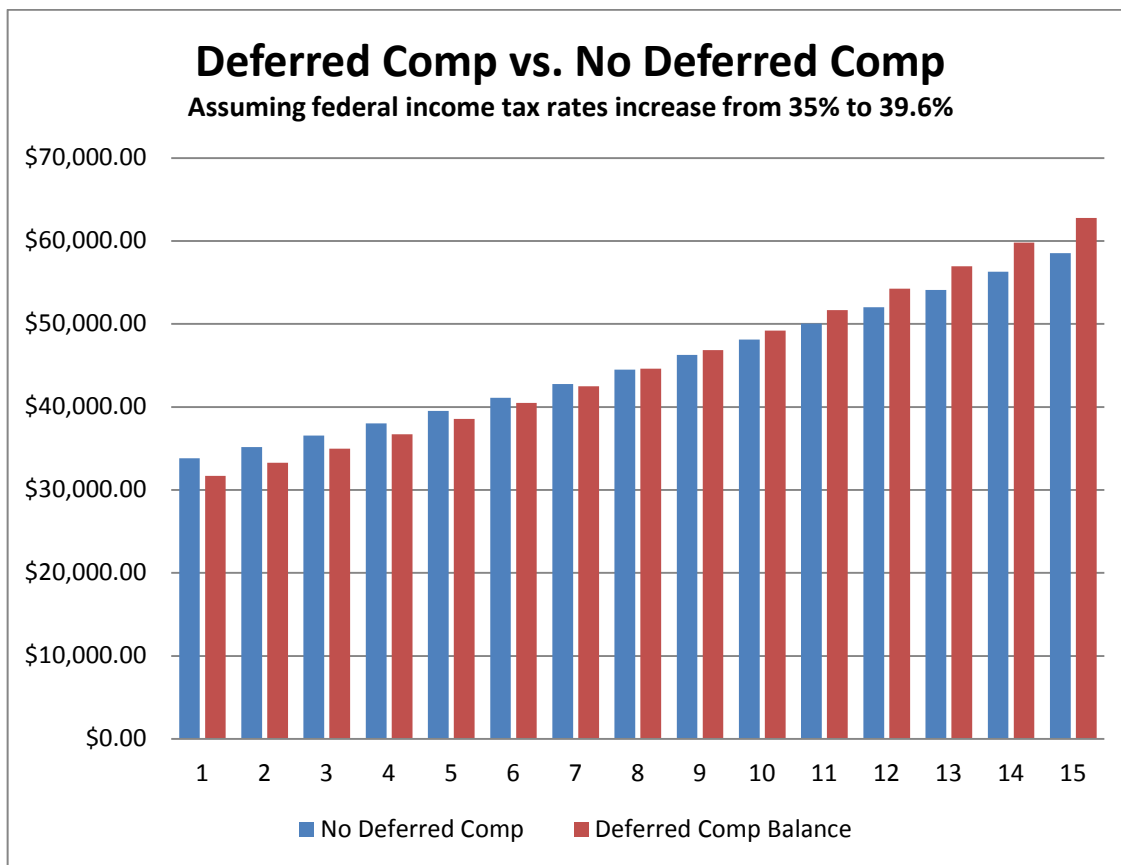


To Defer or Not to Defer: Does it make sense to participate in your deferred compensation plan?

In theory, participating in deferred compensation can make sense given the advantage of deferring taxes on any potential growth in the plan. However, current tax rates are set to expire in 2013, and if nothing is passed between now and then, the highest marginal federal income tax rate rises from 35% to 39.6%. In effect, you could very well be deferring income into a higher tax bracket. The key is you have to defer long enough for the tax deferral to make up for the potential increase in tax rates. Figure 1 illustrates a hypothetical after-tax investment of \$50,000 versus deferring \$50,000. (This also assumes no company match, which can shorten the time to break even.) It also assumes you can earn a higher rate of return in the deferred comp plan as you are not paying taxes along the way – I used a 5% rate of return versus 4% to account for capital gains taxes along the way in the “No Deferred Comp” bucket. As you can see, you have to wait at least 8 years for deferred compensation to make sense if your income tax rate does jump to 39.6%, all else being equal.



Also worth mentioning, is a provision in the recently enacted health care legislation that imposes a 3.8% Medicare tax on unearned income (taxable interest, dividends, capital gains, rents, royalties and other non-wage income) when adjusted gross income exceeds \$250,000 for married couples, in effect pushing the top rate in 2013 and beyond to 43.4%. If this is the case, the break-even is about 14.5 years. Who knows what will happen between now and the time you elect to have your deferred compensation pay out, but most experts in the field do believe tax rates will be higher as a result of the current rates

expiring in 2013 or if potential legislation is enacted that will phase out certain deductions for high income earners - such as phasing out the mortgage interest deduction - resulting in a so called "hidden tax". To defer or not to defer depends on a number of variables and this analysis is only meant to help you kick start the conversation. Though deferring income longer may help insulate you from rising tax rates, it also increases your credit risk - as a participant in the deferred comp plan you are an unsecured creditor of the firm, and the money you deferred is subject to the claims of creditors if your company becomes insolvent. As you know full well, it's all about risk management!



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