# NON-QUALIFIED DEFERRED COMPENSATION PLANS

**Many companies offer non-qualified deferred compensation (NQDC) plans as a tool for attracting and retaining executives. An NQDC plan allows executives to earn compensation in one year but defer the compensation and related taxes to a later year. NQDC plans are designed to avoid the testing requirements and low contribution limits of 401(k) and other qualified plans in order to allow highly compensated employees to defer a greater portion of their income.**

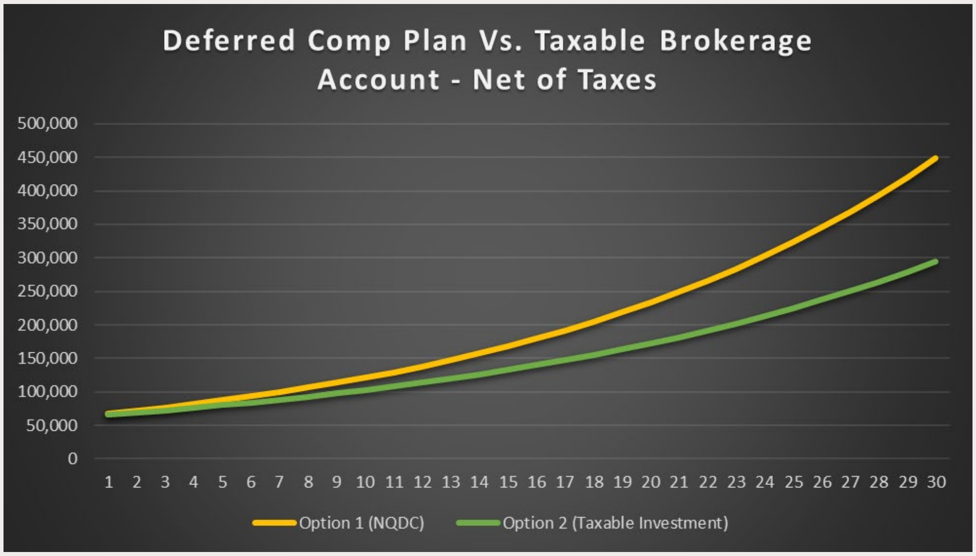
Deferring a greater portion of your income and keeping those funds invested can accelerate the growth of your portfolio over time, making NQDC plans a valuable benefit. But deferred compensation elections are generally irrevocable, and there are risks to understand before making decisions. Below we illustrate the benefits of deferred compensation.

In this example, suppose you are trying to decide what to do with your next $100,000 of income and have the following two options available:

**OPTION 1:** Defer the income by placing it in your company's NQDC.

**OPTION 2:** Receive the income, pay taxes, and invest the net proceeds in a taxable brokerage account.

For this example, we will assume that the investment options in both cases are identical, that both accounts will generate a 6.8% annualized return, and that you are in a marginal tax bracket of 37% for ordinary income and 23.8% for capital gains (20% LTCG + 3.8% NIIT)[1]. For the sake of simplicity, we'll set aside payroll taxes in this analysis.




This chart compares options 1 & 2 if you remain in the same tax bracket post-retirement, illustrating the remaining balance net of taxes in each scenario.

*Source: Coldstream Wealth Management using Coldstream capital market and eMoney assumptions.*

*Chart values represented to the nearest thousand dollars. For hypothetical illustration only. Past performance is no guarantee of future results. For methodology and assumptions, see endnote 1.*

**OPTION 1:** Your full $100,000 is invested immediately, and your account grows completely tax-deferred until withdrawn in retirement. After 30 years of growth, the account would grow to a balance of $712,000 – at the assumed tax rate, the net balance would be **$448,000**.

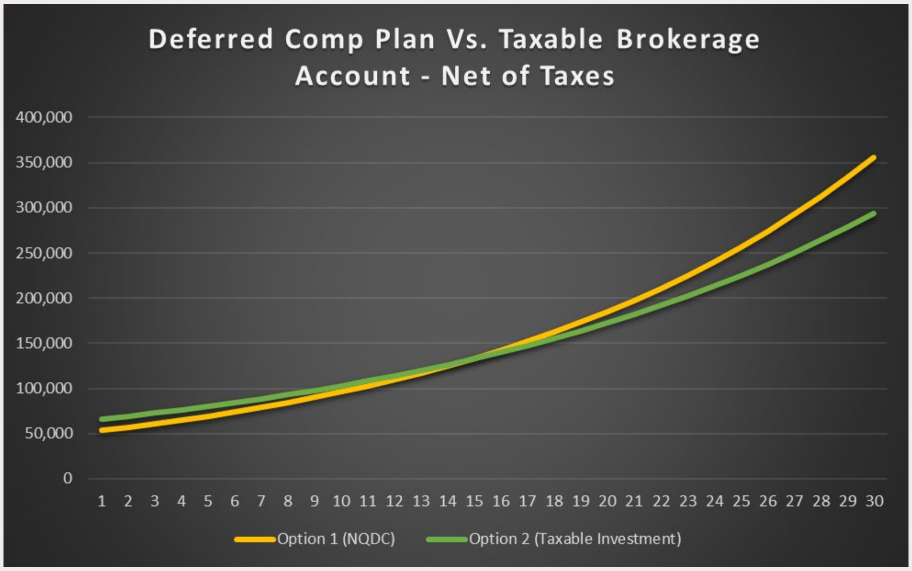
**OPTION 2:** You pay income taxes on the $100,000 up front, leaving you with $63,000 to invest. You must also pay taxes on the dividends and interest each year as the account grows. Over 30 years, the net balance ends up at **$294,000**, ***$154,000 less*** than the NQDC scenario.

# Understanding NQDC Risks

Two of the primary considerations are changes to future tax rates and the risk of default by your employer.

## CHANGES IN FUTURE TAX RATES

While most people assume that their marginal tax bracket will decrease upon retirement, this is not always the case. This may be especially true — and especially consequential — for individuals who have contributed significant dollars to an NQDC that will begin paying out after retirement.




Coming back to our example, we look at what the impact would be if tax rates were to increase post-retirement. If the top marginal tax bracket were to rise to 50% in retirement, keeping all other variables the same, **it would take almost 15 years before the NQDC plan reached a break-even point with a taxable account.**

*Based on a deferral of $100,000 with a hypothetical top marginal tax rate raised to 50%. Chart values represented to the nearest thousand dollars. For hypothetical illustration only. Past performance is no guarantee of future results. For methodology and assumptions, see endnote 1.*

## RISK OF DEFAULT

NQDC plans can avoid the rules of qualified plans because, unlike a qualified plan, when an employee enrolls in an NQDC, they are electing to forego constructive receipt of a portion of their salary or bonus — meaning that the deferred income remains an asset of the company rather than the employee. Participants are essentially issuing an unsecured loan to their employer in exchange for tax deferral. Though rare, companies sometimes do become insolvent, in which case NQDC assets would be subject to their creditors and may fail to pay out balances to participants.

## DISTRIBUTION OPTIONS

Many companies allow employees to take NQDC distributions over a number of years during retirement. While this may be beneficial, it's important to consider how comfortable you are having a substantial portion of your retirement savings tied up in an unsecured loan with a company you no longer work for.

Returning to the analogy of the NQDC plan as a loan to your employer, consider this: the excess growth generated by the tax efficiency of this strategy can be viewed as equivalent to interest on your loan. Viewed this way, the excess ending value of $154,000 after 30 years, on a starting balance of $100,000, would equate to roughly a 3.2% interest rate. Considering that 30-year treasury bonds are currently yielding around 4.8%, it would appear that many NQDC participants are not receiving a sufficient return on a risk-adjusted basis.

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# NQDC Checklist

Determining the right course of action when It comes to NQDC plans can be complex, depending in large part on the nuances of your tax situation, both pre- and post-retirement. It's important to consider potential legislative changes that could impact marginal tax rates, to examine the creditworthiness of your employer, and to consider how comfortable you are with being exposed to these risks.

To help you determine whether participation in your company's NQDC is appropriate for you, we've developed the following checklist to use as a guide:

- **How heavily concentrated are you in your employer's stock? Are you comfortable with greater exposure to the risks of the company?**

- **Are you comfortable with the financial position of the company?**

- **Are you already contributing the maximum amount to your 401(k) plan?**
  *(401(k)s allow for the same tax-deferred growth of an NQDC, but without the risk of default by your employer. One should only consider participating in an NQDC if they are already maxing out their 401(k).)*

- **How far off is your retirement time horizon?**
  *The longer your deferral period, the more you will be able to benefit from the tax treatment of the NQDC.*

- **How much funding have you already done in NQDC plans?**
  *If you have already deferred a significant amount of income, it will be less likely that you will see a meaningful decrease in your post-retirement tax bracket.*

- **Are you eligible for an HSA (Health Savings Account)? If so, are you contributing the maximum dollar amount and investing the funds?**
  *(HSAs provide for the best of both worlds: A pre-tax contribution and tax-free withdrawal if used for qualified medical expenses. If you are eligible for an HSA, contributions to this account should generally take precedence over contributions to an NQDC.)*

- **Does your 401(k) allow for non-deductible contributions and in-plan Roth conversions?**
  *(Some plans will allow you to contribute on an after-tax basis and convert these contributions to Roth — sometimes referred to as a Mega-Backdoor Roth Conversion. We recommend consulting with your advisor to determine whether this strategy is appropriate; for those who anticipate a high tax bracket in retirement, it is generally prudent to prioritize this strategy over NQDC contributions.)*

- **Are you satisfied with your portfolio's exposure to alternative asset classes?**
  *(Your NQDC will have a limited list of investment options, so for those who have not achieved their diversification objectives in asset classes like private equity/debt or real estate, it may be of interest to prioritize taxable assets you can deploy into a wider range of investments.)*

- **Do you have significant charitable goals that you are seeking to achieve with your wealth?**
  *(For those who fall into this category, you may be able to accomplish the goal of tax deferral using a Flip Charitable Remainder Unitrust (CRUT) as an alternative.)*

# Making NQDC Elections

Most employers only allow NQDC elections once a year during an open enrollment period. After that, deferral elections are irrevocable for the election period. Many employers also often require that employees set their distribution options at the time they make the deferral election, so it is important to strategize and plan ahead.

## Coldstream can help.

A Non-Qualified Deferred Compensation Plan can be an excellent benefit for reducing your current tax burden and saving for the future; however, it requires careful planning to make appropriate elections. Our planners are in your corner; we have decades of experience and can help you explore options and find the best ways to make your stock options work for you.

Contact us to learn more about how we may be able to help. Reach out at 452.283.1600 or info@coldstream.com. We look forward to learning more about the legacy you want to create.

*1. The taxable status of an investment account refers to whether any income earned in the account is taxable in the year it is earned. For our analysis, the taxable brokerage account is assumed to be invested with a Balanced objective; approximately 0.9% return from qualified dividends, 2.2% return from non-qualified dividends/interest, and 3.7% return from capital appreciation. For all scenarios, the tax rate applied to non-qualified dividends/interest is 37%. The rate applied to qualified dividends and capital gains is 23.8% (20% LTCG + 3.8% NIIT). Capital gains are assumed to be deferred until the final year of the scenarios.*

*Assumed rate of return 6.8%.*

*We assume the individual is subject to the 3.8% net investment income tax (NIIT), on all investment income for the entire deferral period. This 3.8% is included as capital gains for this example.*

*For illustration we have assumed a marginal income tax rate of 37% .*

*All investments are assumed to be liquidated at the end of the specified hypothetical investment period. For taxable accounts, any unrealized long-term gains become realized and are taxed at the applicable long-term capital gains tax rate in each scenario. We assume there are no short-term gains, realized or unrealized. We assume the NQDC account is paid out at the at the end of the specified hypothetical investment period and the full amount taxed at the applicable ordinary income tax rate in each scenario.*

*These examples are for illustrative purposes only and do not represent the performance of any security. Consider your current and anticipated investment horizon when making an investment decision, as the illustration may not reflect this.*