

consequences. The *Greensboro* court focused on the fact that the plan was available to all employees, not just a ruse to avoid taxable compensation. This introduces the concepts of employee classification and the difference between genuine benefits, tax avoidance and deferred compensation.

Since the bulk of the courses focus on *qualified* retirement plans, there are several key concepts that must be understood to appreciate the tax advantages afforded to these plans.

### **Time value of money**

A dollar today is worth more than a dollar paid later and the longer the period of deferral, the greater the difference between the present value of the dollar and the future value of the amount. Since the tax rules involve economic costs and benefits, this concept applies in the context of an employer's decision to adopt a qualified plan.

For example, \$10,000 available today is worth \$10,500 a year from now given a 5% interest rate. Another way of explaining this is to say that the future value a year from now of \$10,000 is worth \$10,500 (at a 5% rate). If interest was paid simply on the principle value invested, simple interest would result in less investment than compounding of interest. Compounding of interest says that the \$10,500 (after the first year) will accumulate in the second year to \$11,025 as opposed to \$11,000 (simple compounding). Thus, the *present value* of \$11,025 payable in two years at a 5% interest rate is \$10,000; another way of expressing this is say that the *future value* of \$10,000 payable in two years at a 5% interest rate is \$11,025. Such compounding of interest rate has a greater impact if the compounding is monthly, quarterly, or semiannually during the year as opposed to just at the end of the year.

Normally, any interest generated on principle during a tax year is taxable to the individual, and thus, only the after-tax interest is available for future compounding. In the qualified plan context, the interest or capital gains generated on the principle during a tax year is not taxable and thus the entire pre-tax amount is available for future compounding. For taxpayers at higher marginal tax rates, this pre-tax compounding of interest affords a greater tax preference.

The following chart illustrates the compounding of money and the value of making annual contributions<sup>1</sup> on a pre-tax basis. The first part of the chart illustrates how a *single* contribution of \$20,000 grows on a pre-tax versus post-tax basis. As evident from the numbers, the pre-tax deferral results in a tax savings of 266% for the 35-year-old and a 20% tax savings for the 65-year-old. The second part of the chart illustrates how an *annual* contribution of \$20,000 grows on a pre-tax versus post-tax basis.

Age 35                      Age 45                      Age 55                      Age 65

<sup>1</sup> The above table illustrates the benefits of pretax and tax-deferred growth for four sample executives (ages 35, 35, 55 and 65) assuming (1) a 1-year deferral of \$20,000 until retirement (Age 70), a 10% earnings rate and a 40% marginal income tax rate. The chart was reprinted from the May 2003 issue of *Executive Compensation Forum*, from Steven J. Cochlan and Christopher J. Zinski, Esq.

Deferred Compensation Plan

1-year deferral

Total Deferral	\$20,000	\$20,000	\$20,000	\$20,000
Years to Defer	1	1	1	1
Earnings Rate	10%	10%	10%	10%
<b>Lump Sum @ Age 70</b>	<b>\$562,049</b>	<b>\$216,694</b>	<b>\$83,545</b>	<b>\$32,210</b>

After-Tax Lump Sum @ Age 70

Deferral Plan	\$337,229	\$130,016	\$50,127	\$19,326
After-tax Investing	\$92,233	\$51,502	\$28,759	\$16,059
Incremental Gain with Deferral Plan	\$244,996	\$78,514	\$21,368	\$3,267
<b>% Gain</b>	<b>266%</b>	<b>152%</b>	<b>74%</b>	<b>20%</b>

Deferred Compensation Plan

Until retirement (Age 70)

Annual Deferral	\$20,000	\$20,000	\$20,000	\$20,000
Years to Defer	35	25	15	5
Earnings Rate	10%	10%	10%	10%
<b>Lump Sum @ Age 70</b>	<b>\$5,962,536</b>	<b>\$2,168,635</b>	<b>\$698,995</b>	<b>\$134,342</b>

After-Tax Lump Sum @ Age 70

Deferral Plan	\$3,577,522	\$1,298,181	\$419,397	\$80,587
After-tax Investing	\$1,417,450	\$697,877	\$296,070	\$71,704
Incremental Gain with Deferral Plan	\$2,160,071	\$600,305	\$123,326	\$8,883
<b>% Gain</b>	<b>152%</b>	<b>86%</b>	<b>42%</b>	<b>12%</b>

Pretax Rate for After-tax Investing to equal Deferral Plan

16.67%	16.67%	16.67%	16.67%
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10 After-tax Annual Payments @

Retirement (Age 70)

Assumes Annual Deferrals until Retirement	Age 35	Age 45	Age 55	Age 65
Deferral Plan	\$29,296	\$192,066	\$62,050	\$11,923
After-tax Investing	\$181,685	\$89,452	\$37,950	\$9,191
Incremental Gain with Deferral Plan	\$347,611	\$102,614	\$24,100	\$2,732
<b>% Gain</b>	<b>191%</b>	<b>115%</b>	<b>64%</b>	<b>30%</b>

Qualified plans afford tax advantages for both the employer and the employee. Under the normal tax rules, there is a general "matching" rule for deferred compensation payable to an employee – the employer receives a deduction when the employee takes the deferral into income.<sup>2</sup> The Code provides an exception to this rule for compensation deferred under a *qualified* plan. From the employee's perspective, there are two advantages – deductions for contributions made to a qualified plan can be currently deducted under IRC §404 (hence this is an *acceleration* of a deduction compared to a contribution made to a nonqualified plan) and such contributions accumulate tax-free under an IRC §501(a) trust. From the employee's perspective, he/she receives a vested and funded right to receive deferred compensation but is not taxed on such benefit until the time of distribution.

In the context of welfare benefits, the tax benefit to the employee may be even greater as the benefit is not even taxable when received. However, the Code does not regard these as deferred

<sup>2</sup> IRC §404(a)(5). See also *Albertson's Inc.*, 42 F.3d at 541 (stating that interest and earnings on deferred compensation were also subject to this matching rule).

compensation – they are benefits payable for the welfare of the participant and/or beneficiary but generally contingent on the occurrence of an event that is outside the control of the participant (e.g., medical emergencies, severance of employment). Also benefits that enjoy this tax preferential treatment must satisfy specific Code requirements (that will be discussed in Chapter 16), but such plans are *not called* qualified welfare benefit plans.

### **Actuarial equivalence**

This principle states that given an interest rate and mortality table, a stream of income as of a certain age and form of payment can be made economically equivalent to another stream of income at a different age and/or form of payment. If the employee is charged the actuarial equivalent cost for early commencement of benefits and/or an alternate form of benefit, there is no economic advantage associated with that early commencement or alternate form. However, if the employer does not charge the full actuarial equivalent cost of such benefit, it is subsidizing such benefit in order to encourage its use.

A lump sum payment takes the present value of the guaranteed annuity stream, using life expectancy or interest rates. There is a general rule of “8” which means that a lump sum is roughly equal to 8 times the annual life annuity (beginning at age 65). Hence, an annual annuity of \$10,000 (equivalent to \$833/month) at age 65 is equivalent to a lump sum payout of \$80,000.

After this discussion, a review of the online resources (e.g., calculators) would be helpful.<sup>3</sup>

### **Progressive Nature of the Internal Revenue Code**

Students should understand that the federal income tax code provides for different tax brackets because the marginal tax rates increase as a taxpayer’s income increases. Thus higher-income employees not only pay more tax because their income is higher, the tax rate that is imposed on their income is higher. Provide the following example to the class: using the 2005 tax brackets and tax rates for married individuals filing joint returns:

<i>If taxable income is:</i>	<i>The tax is:</i>
Not over \$36,900	15% of income
Over \$36,900 but not over \$89,150	\$5,535, plus 28% of the excess over \$36,900
Over \$89,150 but not over \$140,000	\$20,165, plus 31% of the excess over \$89,150
Over \$140,000 but not over \$250,000	\$75,528.50, plus 39.6% of the excess over \$250,000

<sup>3</sup> See savings calculator, available at [http://apps.nasd.com/investor/Information/Tools/Calculators/savings\\_calc.asp](http://apps.nasd.com/investor/Information/Tools/Calculators/savings_calc.asp) (last visited October 22, 2005). Other similar sites include <http://www.moneymag.com>; <http://www.usnews.com>; <http://www.choosetosave.org>; and <http://www.wiser.heinz.or>.

If a taxpayer made \$36,900, the tax would be  $15\% \times \$36,900 = \$5,535$ . Thus, taxpayers in the first tax bracket have a tax rate of 15%. If a taxpayer made \$50,000, he/she is now in the second tax bracket and his/her tax would be  $\$5,535 + 28\% (\$50,000 - \$36,900) = \$5,535 + \$3,668 = \$9,203$ . His/her overall tax rate is 18% (*i.e.*,  $\$9,203 \div \$50,000 = 18\%$ ). Thus, being in the second tax bracket increases the tax rate from 15% to 18% (*i.e.*, progressive). This example illustrates why \$1,000 in benefits is more valuable to a higher-paid wage earner than a lower-paid wage earner. If the employer saves \$1,000 in the form of qualified benefits for the \$36,900 wage earner, he/she would save 15% of \$1,000 or \$150 in taxes, whereas the \$50,000 wage earner would save 18% of \$1,000 or \$180 in taxes.

### **Income Tax Constructive Receipt Rules**

Normally the constructive receipt tax principles prevent a taxpayer from taking a single tax year's worth of income and allocating it into different tax years. The qualification rules provide an exception to the constructive receipt tax rules. Using the following example illustrates to the class why the qualification rules are more valuable to the high wage earners than the lower-paid wage earners: an employee is supposed to be paid \$500,000 in the 2006 calendar year. This employee is in the fifth tax bracket and his/her income tax would be  $\$75,528.50 + 39.6\% (\$500,000 - \$250,000) = \$75,528.50 + \$99,000 = \$174,528.50$ . This results in an overall tax rate of 34.9% (*i.e.*,  $\$174,528.50 \div \$500,000 = 34.9\%$ ).

If the constructive receipt rules were not in existence, the employee requests the employer pay him/her only \$250,000 of his compensation in 2006 and the other \$250,000 in 2007. The employee is now in the fourth tax bracket for both years. In 2006, the tax would be  $\$35,928.50 + 36\% (\$250,000 - \$140,000) = \$35,928.50 + \$39,600 = \$75,528.50$ . Similarly, in 2007, the tax would be the same -- \$75,528.50. While the employee pays taxes of \$75,528.50 in 2006 + \$75,528.50 in 2007 for a total of \$151,057, he/she has a tax rate of 30.2% (*i.e.*,  $\$151,057 \div \$500,000$ ), instead of a tax rate of 34.9%. Hence it would be to the wage earner's benefit to spread the income over two years instead of one year. However, the constructive receipt rule says a taxpayer who has earned compensation for services in a give year can't turn his/her back on that income in order to have it paid in future years. If a qualified plan provides a deferral of some or all of a taxpayer's compensation to a future year, it reduces the current tax rate and subsequent tax rates for the higher-paid wage earner at a *greater rate* than the current tax rate and subsequent tax rates for the lower-paid wage earner. This is why qualified plans provide greater tax savings for the higher-paid wage earner than the lower-paid wage earner.

## **§2.02 FUNDAMENTAL REQUIREMENTS OF QUALIFICATION**

It's important to have a discussion distinguishing a pension plan from a profit sharing plan, from ERISA's perspectives and the Code's perspectives. From a defined contribution plan context, pension plans were afforded a greater deductibility ceiling than profit sharing plans; this distinction was eliminated with EGTRRA '01, and thus there is little motivation for adopting a defined contribution money purchase plan. However, depending on the demographics of the employer's employees, defined benefit plans may afford greater deductible ceilings than profit sharing plans.