Pre-Tax vs. After-Tax

Why Nonqualified Deferred Compensation Plans Remain Powerful – Even in a Low-Turnover Portfolio Environment

By: Todd Mezrah

A common refrain among senior executives is that *"a well-managed, low-turnover taxable portfolio can outperform deferring income."* The logic sounds reasonable: minimize realized gains, manage capital gains taxes efficiently, and maintain liquidity and flexibility. However, when the math is fully explored across varying turnover assumptions, tax regimes, and retirement outcomes, deferring your compensation pre-tax yields higher returns.

The following modeling materials and graphics demonstrate a clear conclusion: **tax rates at distribution would need to reach extraordinarily high levels to eliminate the economic advantage of deferring income into a nonqualified deferred compensation ("NQDC") plan.**

Our findings explain why deferral remains a dominant wealth accumulation strategy, even for executives with disciplined after-tax investing behavior and favorable retirement tax geography.

To understand why this advantage persists, it is necessary to examine the structural engine behind deferral.

The Core Advantage: Pre-Tax Compounding

The primary driver of NQDC value is not investment selection or market timing, it is **the ability to compound pretax dollars over long-time horizons.**

When income is deferred:

- 100% of the gross compensation is invested
- Taxes can be postponed for decades
- Earnings compound without annual tax drag

By contrast, taxable investments, even with low turnover, starts with a reduced capital base and experiences ongoing leakage from dividends, interest, and unavoidable realizations.

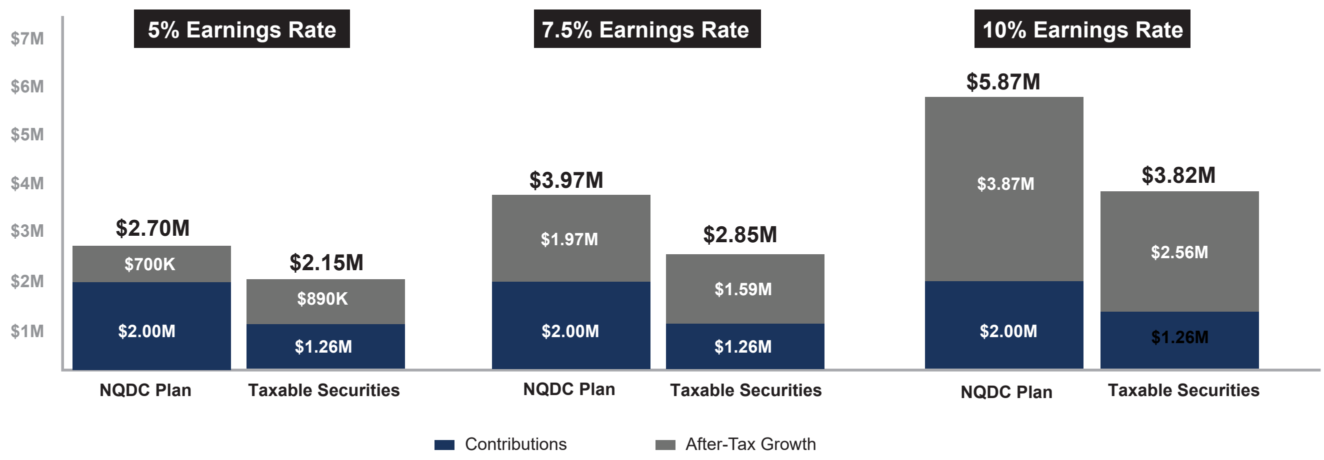
The NQDC plan modeling below assumes a conservative but realistic structure:

- Deferrals of $100,000 beginning at age 45 through age 64
- Retirement at age 65
- 10 distributions beginning at retirement
- Longterm earnings rates between 5%–10%
- Assumed Portfolio Turnover: 50%
- 37% Individual Tax Rate, 20% Long-Term Capital Gains Tax Rate, 3.8% Net Investment Income Tax ("NIIT") associated with taxable securities

Across **every modeled return environment**, pretax deferral creates a compounding advantage that is extremely difficult for taxable portfolios to overcome.

Exhibit A

Cumulative After-Tax Benefit – No State Income Tax



Despite this compounding advantage, many executives believe it disappears once portfolio turnover is minimized.

The Misconception Around Low Turnover

Executives often argue that *"my portfolio turnover is very low, so my tax drag is minimal."* While lower turnover certainly improves tax efficiency, the data shows it is **not sufficient to neutralize the benefit of deferral**.

The graphic in Exhibit B (Page 3) compares NQDC plan outcomes to taxable portfolios under varying turnover assumptions reveal:

- Even at **very low turnover**, NQDC plans maintain a meaningful after-tax advantage
- As turnover increases, the NQDC plan advantage accelerates dramatically

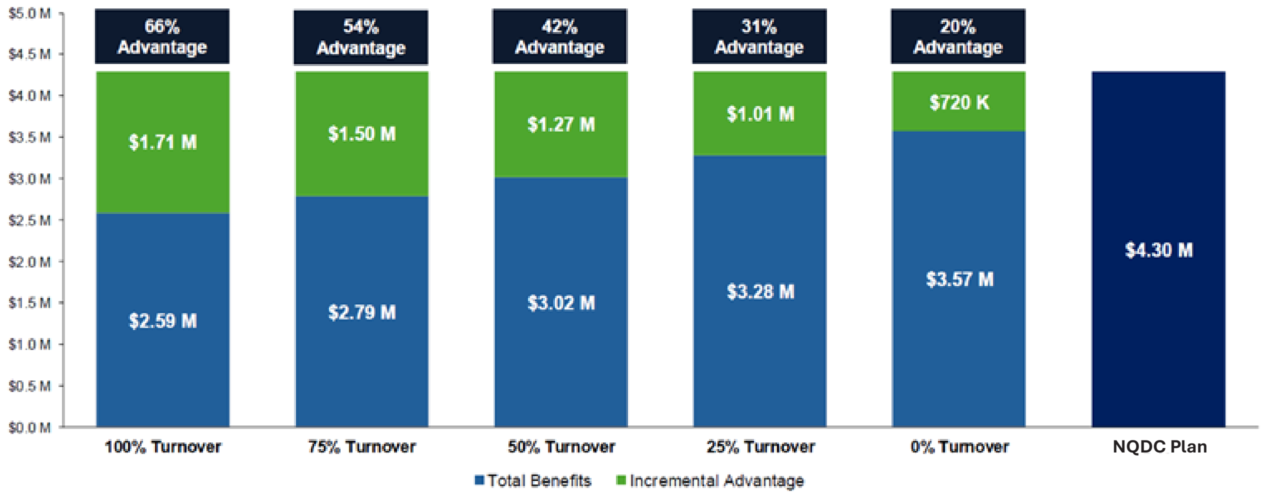
In a no state income tax retirement scenario, cumulative after-tax advantages of deferral range from:

- Approximately 20% at zero turnover
- To more than 65% at higher, but still realistic, turnover levels

When state taxes are present during accumulation, or only during working years, the advantage becomes even more pronounced.

Exhibit B

Cumulative After-Tax Benefit – No State Income Tax



Note: Assumes participant age 45, retirement age 65, $100,000 annual deferral for 20 years, 10 payouts, 8% earnings rate, 37% tax rate, 20% long-term capital gains tax rate and 3.8% Net Investment Income Tax (NIIT).

Turnover efficiency alone does not determine outcomes—tax geography often proves decisive.

State Taxes: Often the Tipping Point

One of the most overlooked dynamics in this analysis is **state income tax arbitrage**.

Many executives:

- Earn compensation in high-tax states (e.g., NY, CA)
- Retire in no-tax states (e.g., FL, TX, TN)

The modeling (Exhibit C, Page 4) explicitly incorporates this reality.

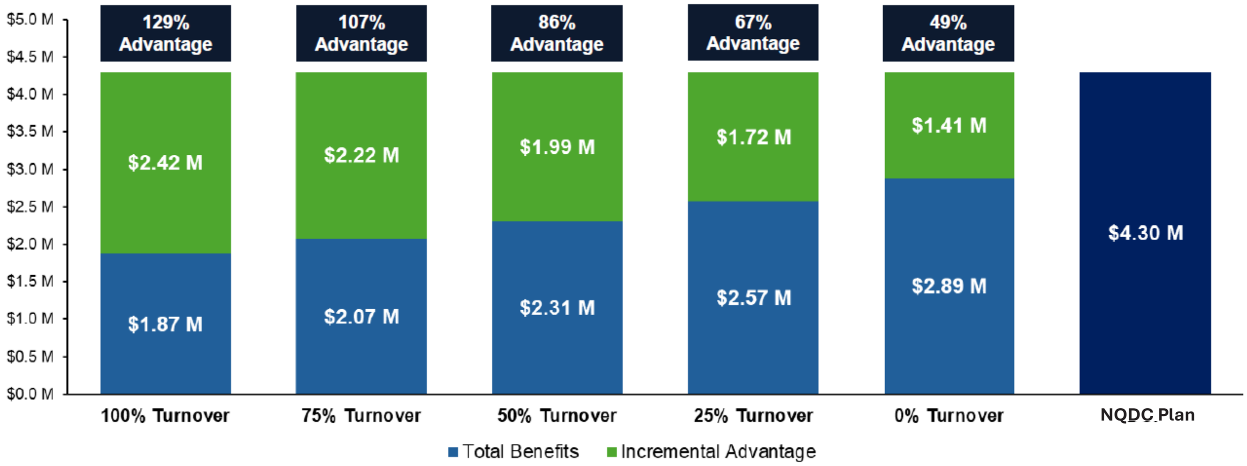
When state taxes apply **only during working years**,[1] and distributions occur in a no-tax jurisdiction:

- The cumulative after-tax advantage of deferral can exceed **100%** compared to taxable investing
- In certain scenarios, deferral produces **more than double** the after-tax wealth accumulation

[1] New Jersey is the only state where state taxes apply on distributions even if you are in a different state.

Exhibit C

Cumulative After-Tax Benefit – 12.1% State Income Tax Until Retirement



Note: Assumes participant age 45, retirement age 65, $100,000 annual deferral for 20 years, 10 payouts, 8% earnings rate, 37% tax rate, 20% long-term capital gains tax and 3.8% Net Investment Income Tax (NIIT). Modeling assumes an additional 12.1% state tax (average of New York and California state tax) through age 64.

This analysis raises a more fundamental question: how extreme must tax policy become to reverse the advantage of deferral? To answer that question, the analysis turns into a direct tax-rate stress test.

How High Would Tax Rates Have to Go?

The table on the following page (Exhibit D) illustrates the **retirement tax rate required to eliminate the benefit of deferral**, assuming:

- Retirement at age 65
- 15 distributions
- Earnings rates between 5%–10%

The results are eye-opening:

- For executives deferring at age 45 with an 8% return assumption, **tax rates would need to approach approximately 70%**
- At higher returns or longer deferral horizons, required tax rates can exceed 70%.

These are not marginal differences. They are **historically unprecedented, economically destabilizing tax levels**.

In other words:

Tax rates would have to become extraordinarily punitive before deferring income ceases to make sense.

Exhibit D

Value of Deferring Income

Age	Earnings Rate					
	5%	6%	7%	8%	9%	10%
55	53%	56%	58%	61%	64%	66%
50	56%	59%	62%	65%	68%	71%
45	59%	63%	66%	69%	72%	75%
40	62%	66%	70%	73%	76%	79%
35	64%	69%	73%	77%	80%	82%

Note: Pre-retirement tax rate assumes a 37% Federal income tax rate and a 3.8% tax on investment income associated with healthcare reform legislation. Assumes deferrals / contributions made through age 64.

Even if tax rates never rise, taxable portfolios still have a built-in disadvantage.

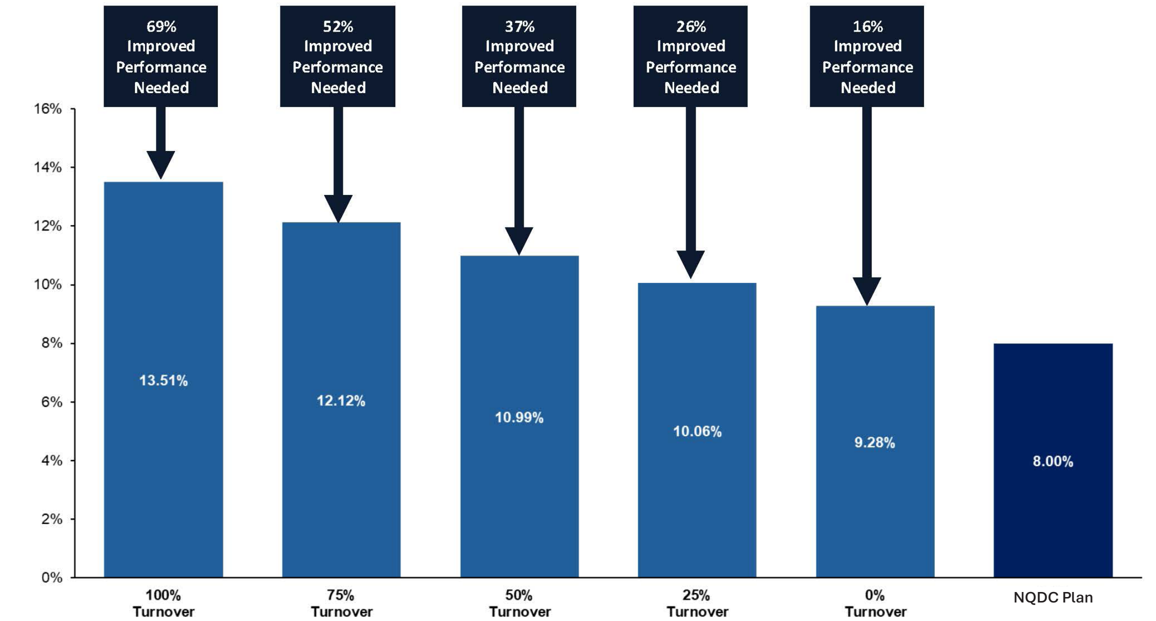
Return Equivalency: What Taxable Portfolios Must Overcome

Another way to frame the analysis is return equivalency.

Exhibit E (Page 6) modeling illustrates the **additional return a taxable portfolio must generate** to match an 8% NQDC plan return. Depending on portfolio turnover, taxable portfolios must outperform by **16%-69%**, Consistently achieving this level of outperformance is exceptionally unlikely, particularly over multi-decade horizons.

Exhibit E

Return Equivalency of Taxable Securities vs. Deferring Income



Note: Assumes participant age 45, retirement age 65, $100,00 annual deferral for 20 years, 10 payouts, 8% earnings rate. 37% tax rate, 20% long-term capital gains tax rate and 3.8% Net Investment Income Tax (NIIT).

When turnover, geography, and return requirements are considered together, the conclusion is consistent.

Turnover + Geography: Why the Advantage Persists

Once distributions begin, taxes apply to a much larger accumulated base, but that base exists *only because deferral allowed it to grow faster in the first place*.

NQDC plans outperform taxable securities even in scenarios most favorable to taxable investing:

- Low turnover
- Longterm capital gains treatment
- Retirement in a no tax state

The compounding **benefit of pretax deferral remains substantial**.

This is why focusing solely on payout tax rates misses the broader picture.

Deferral Is a Math Problem, Not a Market Bet

The belief that a low turnover after-tax portfolio can routinely outperform a pre-tax wealth accumulation strategy is more narrative than math.

The data indicates:

- Deferral wins across a wide range of market returns
- Deferral wins across turnover scenarios
- Deferral wins even when retirees relocate to tax friendly states
- Tax rates would need to be **extremely high** to negate the advantage of deferring.

NQDC is not about predicting markets or tax policy—it is about **maximizing the capital base that compounds for decades**.

For executives evaluating how to allocate excess compensation, the conclusion is evident:

Deferring income remains one of the most powerful, resilient, and underappreciated wealth-building tools available—especially when viewed through a long-term, after-tax lens. When evaluated on the basis of long-term after-tax outcomes, deferral remains the dominant wealth accumulation strategy for excess compensation.

For illustrative purposes only. Modeling assumptions derived from Mezrah Consulting analyses.

Please note the above discussion is not intended to be inclusive of all tax code sections that may apply. Mezrah Consulting and its affiliates are not tax professionals, and this document should not be considered tax advice or guidance.

More Information

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