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INVESTMENT MANAGEMENT

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INSIGHTS FROM GOELZER INVESTMENT MANAGEMENT

Strategic Wealth Decisions for High Income Earners

As a high-income earner, you have reached the position where your income exceeds your immediate needs. And most likely you have already taken the important steps of establishing an emergency savings fund, contributing to your employer-sponsored retirement plans, and securing your financial foundation. Now the key question is: How do you maximize your financial future with the cash flow you are generating?

Should the focus be on paying down debt, investing for growth, or leveraging deferred income or stock-based compensation? During this stage of your financial life, these decisions can have a profound impact on your long-term wealth accumulation. In this latest Insights piece we explore many of the various options.

Paying Off Debt Versus Investing

Not All Debt Is Created Equal

It is essential to recognize that not all debt carries the same financial impact. Because of your high income, you likely do not carry credit card debt. However, if you do, you should prioritize paying it off due to the typically high interest rates charged. The average credit card interest rate is currently 20.13%.[1] On the other end of the debt spectrum, you may have a mortgage with an interest rate of 4% or below. If that is the case, investing your excess cash flow in a diversified portfolio could allow you to obtain a higher return than the interest rate charged on the mortgage.

Tax Considerations

When deciding between paying off debt and investing, tax implications must be considered. For example, the interest on mortgage debt may be tax deductible, reducing your overall tax burden. Similarly, investing in tax-advantaged accounts like a 401(k), 403(b), IRA, or Roth IRA provides long-term tax benefits, including tax-deferred growth or tax-free withdrawals in retirement.

Balancing these factors could influence whether paying off debt or investing is the best overall choice.

Weighing Opportunity Cost

Opportunity cost plays a key role in this decision-making process. When considering whether to pay down debt or invest, ask yourself: Would investing these funds generate a return greater than the interest rate on my debt? If the expected investment return is higher than the interest rate on the debt, it may be better to invest your excess cash.

Retirement Plan Versus High-Interest Debt

In some cases, funding your retirement account can be superior to paying off even high-interest credit card debt. For example, many employers make “safe harbor” matching contributions to 401(k) plans. The matching contribution is 100% on the first 3% of earnings that you contribute and 50% on the next 2%. In essence, by contributing 5% of your earnings into a 401(k) plan you will receive the equivalent of a 100% return on the first 3% and a 50% return on the next 2%—returns that are well above high credit card interest rates.

Should You Maximize Retirement Account Contributions?

Retirement plans such as 401(k), 403(b) and IRAs come in two varieties—tax-deferred and tax free. Tax-deferred plans are funded with pre-tax contributions or, in the case of traditional IRAs, tax-deductible contributions. At retirement, withdrawals are typically treated as ordinary income to the owner. A 10% penalty for early withdrawal before age 59 ½ is assessed unless an exception applies. Tax free versions of these retirement plans are referred to as Roth retirement plans (e.g., Roth 401(k), Roth IRA). These plans are funded with after-tax contributions and withdrawals are tax free, subject to age and holding period restrictions.

The maximum contribution limits in 2025 are:

- **Traditional IRAs:** $7,000 annual limit. Individuals aged 50 or over can contribute an additional catch-up contribution of $1,000.
- **Roth IRAs:** $7,000 annual limit. Individuals aged 50 or over can contribute an additional catch-up contribution of $1,000. Please note that contributions to a Roth IRA are subject to income limits.
- **401(k)/403(b)/457 Plans:** $23,500 annual limit. Individuals aged 50 and over can contribute an additional catch-up contribution of $7,500. Also starting in 2025, SECURE 2.0 also allows a higher catch-up limit of $11,250 instead of $7,500 for employees aged 60,61,62, and 63.[2]

If you already maximize these contributions, consider contributing to other types of investment accounts to build tax diversification and future cash flow flexibility. By owning accounts with different tax characteristics, you'll have the flexibility to choose which account to draw on, thereby enhancing control of your overall taxable income.

Strategies to Consider

Build Basis with a Taxable Investment Account: If you have reached the contribution limits for your retirement plan, opening a taxable investment account with your after-tax dollars should be a high priority.

While you will pay taxes on the dividends and interest income annually, taxes on capital gains don't occur until you sell an appreciated asset. Gains realized on assets that have been held for 12 months or longer are typically taxed at the more favorable federal capital gains tax rates.

Backdoor Roth Strategy: If you are a high earner covered by an employer retirement plan, you may not be eligible to contribute directly to a Roth IRA. Currently, the income limits are $165,000 for individuals and $246,000 for couples.[3] However, you may still be able to fund a Roth IRA through what is known as the backdoor Roth IRA strategy.

This strategy involves making a non-deductible contribution to a traditional IRA and converting it to a Roth IRA, allowing for both tax-free growth throughout and tax-free withdrawals after meeting both the Roth IRA 5-year holding requirement and the age 59 ½ requirement.

Please note that if you already own a Traditional IRA funded with pre-tax dollars, you will be subject to the pro-rata rules and taxes on the conversion, even if you have both pre-tax and after-tax funds in your Traditional IRA. Please consult your tax advisor if this situation applies to you.

To Defer or Not Defer: Non-Qualified Deferred Compensation Plans

Deferred compensation plans allow employees to defer a portion of their income to be paid out later or during retirement. While 401(k) and 403(b) accounts are examples of qualified deferred compensation plans offered to many employees, Non-Qualified Deferred Compensation

(NQDC) plans are typically offered only to highly compensated executives or key management employees. These plans offer unique benefits but also come with certain risks and considerations.

Benefits of Deferring Compensation via a NQDC:

- Unlimited contributions.
- Ability to reduce current taxable income while deferring taxes on growth.
- Flexibility to schedule distributions to fund retirement, college expenses, or other goals before or after age 59 ½.

Risks and Drawbacks of NQDC Plans:

- Funds are inaccessible without penalty until a specified time.
- NQDC funds may be at risk if an employer faces financial stress.
- No loans or IRA rollovers.
- Tax bracket at time of distribution could be higher.
- If you leave before full vesting, all or part of the funds may be forfeited. The non-forfeited portion could be paid out in a lump sum distribution creating a large tax liability.

Decision Points

How Much to Defer: Defer only those amounts you don't need for your current living expenses. And be aware that some employers will automatically roll your election over each year unless you submit a change. Therefore, it is important that you review your deferral amount each year.

How Long to Defer: The form and timing of distributions must be elected at the time of deferral. Depending upon the terms of the plan, distributions could take place at a specific age, at retirement, or on specific dates tied to anticipated financial needs. While planned distributions can sometimes be delayed, they often cannot be accelerated.

Non-qualified deferred compensation plans can be an attractive option, but it is essential to weigh the benefits against the risks as part of your cash flow plan.

Leveraging Equity Compensation Plans

High earning individuals frequently have access to equity compensation plans, which align your interests with the company's success. The most common types are restricted stock plans and stock options plans.

Restricted Stock Plans: These plans grant shares of company stock, typically at no cost or a discount. The plans come with restrictions, such as time-based or performance-based criteria, until vesting conditions are met. Employees may receive dividends and voting rights immediately, even for unvested shares, but they risk forfeiture of the shares if they leave the company before vesting.

Restricted stock is taxed as ordinary income upon vesting, based on the stock's fair market value at that time. However, employees can opt for a Section 83(b) election, paying taxes on the stock's value at grant instead of vesting. This strategy allows future appreciation to be taxed at lower capital gains rates, but carries risks if the stock value decreases, or the shares are forfeited.

Stock Option Plans: These plans grant you the right to purchase company stock at a fixed price (exercise price) within a set timeframe. The two main types are:

- **Incentive Stock Options (ISOs)**, which are available only to employees and offer favorable tax treatment if specific holding requirements are met. ISOs allow employees to defer taxes until the stock is sold, with gains potentially taxed at lower capital gains rates.

- **Non-Qualified Stock Options (NSOs)**, which can be granted to employees, contractors, or board members. Unlike ISOs, NSOs are taxed as ordinary income upon exercise based on the difference between the option strike price and the stock value.

Individuals with equity compensation plans can build significant wealth over time—especially if the company stock appreciates significantly. Unfortunately, many individuals fail to monitor their exposure to the company stock, or they delay action for fear of missing out on additional gains. The result can be a concentrated position which could lead to large losses or make diversification costly due to taxes. Furthermore, if your plan is to use your restricted stock or options to fund a specific goal, like retirement or a major purchase, achievement of that goal becomes dependent on the performance of the stock.

When evaluating employer stock or stock options keep the following principles in mind:

- **Restricted Stock:** If your vested concentration of company stock exceeds 10% of your investment portfolio, consider selling a portion of the stock to reduce risk. Profits or losses on sales of vested stock held for more than one year will be treated as long-term capital gains (usually a tax rate of 15-20%) or losses that can be used to offset other gains or taxable income.[4]
- **Stock Options:** You typically have 10 years from the grant date to exercise your stock options once they vest. If some or all your stock options are "in the money" (stock price is greater than the exercise price), then developing a plan to regularly monetize your options will help mitigate the risk of your options being "out of the money" (stock price is less than the exercise price) due to negative stock performance.

A thoughtful plan for diversifying or exercising your equity compensation can help reduce overall portfolio risk, increase tax efficiency, and increase the probability of reaching your financial goals. For further information, see our March 2024 Insights piece.

Conclusion

High-income earners can improve their financial future through balancing debt repayment, tax-advantaged investing, and diversified wealth-building strategies. The right mix of these strategies will be unique for each person. A personalized approach, aligned with your financial goals and risk tolerance, is key to sustained prosperity. If have questions on any of these topics, please contact your Goelzer wealth advisor.

[1] Ted Rossman, "Current Credit Card Interest Rates," Bankrate.com, February 5, 2025, bankrate.com/credit-cards/advice/current-interest-rates.

[2] "401(k) limit increases to $23,500 for 2025, IRA limit remains $7,000," Internal Revenue Service, November 1, 2024, irs.gov/newsroom/401k-limit-increases-to-23500-for-2025-ira-limit-remains-7000.

[3] Ibid.

[4] "Topic no.409, Capital Gains and Losses," Internal Revenue Service, irs.gov/taxtopics/tc409.