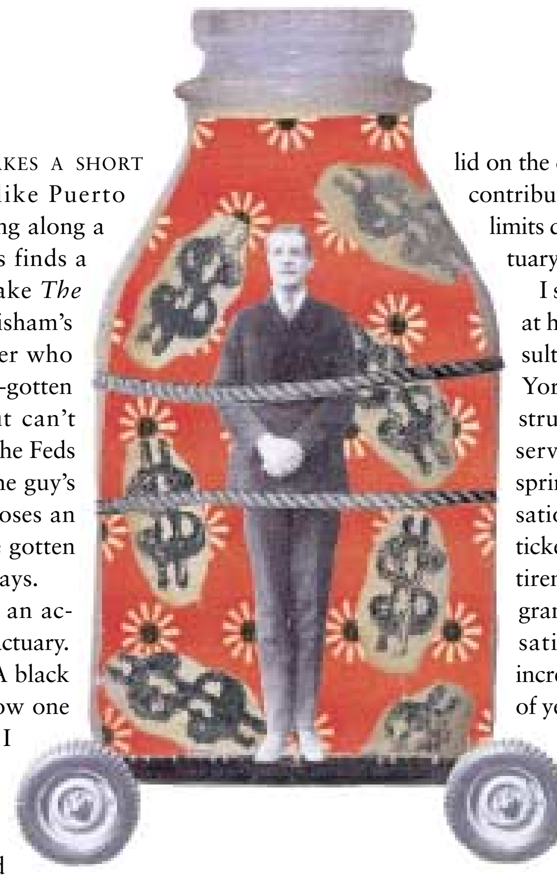
The Savored Salary–and How to Bottle It

The choice to defer compensation can bring substantial tax savings, but the benefits come with some strings attached

Mary Rowland



Illustrations by Steven Dana

When Ethan Kra takes a short break somewhere like Puerto Rico, he likes to bring along a good potboiler. But he always finds a flaw that spoils it for him. Take *The Partner,* for example, John Grisham's thriller about a crooked lawyer who takes off for Brazil with his ill-gotten gains. The Feds find him but can't make any charges stick. What the Feds overlooked, Kra says, is that the guy's home state of Mississippi imposes an income tax. "They could have gotten him for state-tax evasion," he says.

If you have Kra pegged for an accountant, you're close. He's an actuary. But not just any old actuary. "A black belt in actuarial science," is how one client describes him. When I wrote a weekly column for *The New York Times,* I kept a list of specialists—people I knew I could count on for quick and correct answers when I was on deadline. For questions on retirement, my guru was Kra.

At a meeting in Washington, D.C., not long ago, a government official told him he was responsible for the repeal of the 415(e) limits, those nasty rules written into ERISA to put a lid on the combined benefit accrual of defined-contribution and defined-benefit plans. The limits disappeared early this year. For an actuary, that's about as good as it gets.

I stop in to visit Kra from time to time at his office at the human-resources consulting firm William M. Mercer in New York, where the former Yale math instructor is chief actuary for retirement services. On this gorgeous day in late spring, we talk about deferred compensation, which Kra claims is the hottest ticket in executive compensation and retirement planning. Deferred-comp programs—electing to defer some compensation to avoid current taxes—have increased dramatically in the past couple of years for several reasons. Tax brackets crept up substantially during the early 1990s as defined-benefit plans were cut back. Most executives love the 401(k) plan, but the limits are too low to provide enough retirement savings. Finally, execs get more money in lump-sum arrangements like bonuses, which make deferment easier. Deferred-compensation programs have changed dramatically, too. Not so long ago, they were offered only as fixed-income investments. But executives familiar with 401(k) plans—with their varied mutual fund options—have demanded similar investment alternatives for deferred comp. And they've gotten them.

Kra advises executives to defer as much income as they possibly can, even if they must draw down after-tax personal savings accounts to do it. When tax brackets for most executives approach 50 percent, including state and local taxes, financial advisers don't need a math worksheet to see the power of saving money pretax. But Kra has another reason for advising deferral: Employers may be forced to cut back on these programs down the road as the balance-sheet liabilities grow too large. "I would advise an executive to get as much money in as you can right now," he says, "while the gettin's good."

Of course, along with the good you have to take the bad. When an employee chooses to defer taxes by deferring compensation, that money is not set aside for him in an account

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with his name on it. It simply represents the company's promise to pay at some future date. If the money were secured by the company in some way, then it would be taxable to the employee. He would be in "constructive receipt" of the money. With a deferred-comp arrangement, the money still belongs to the company.

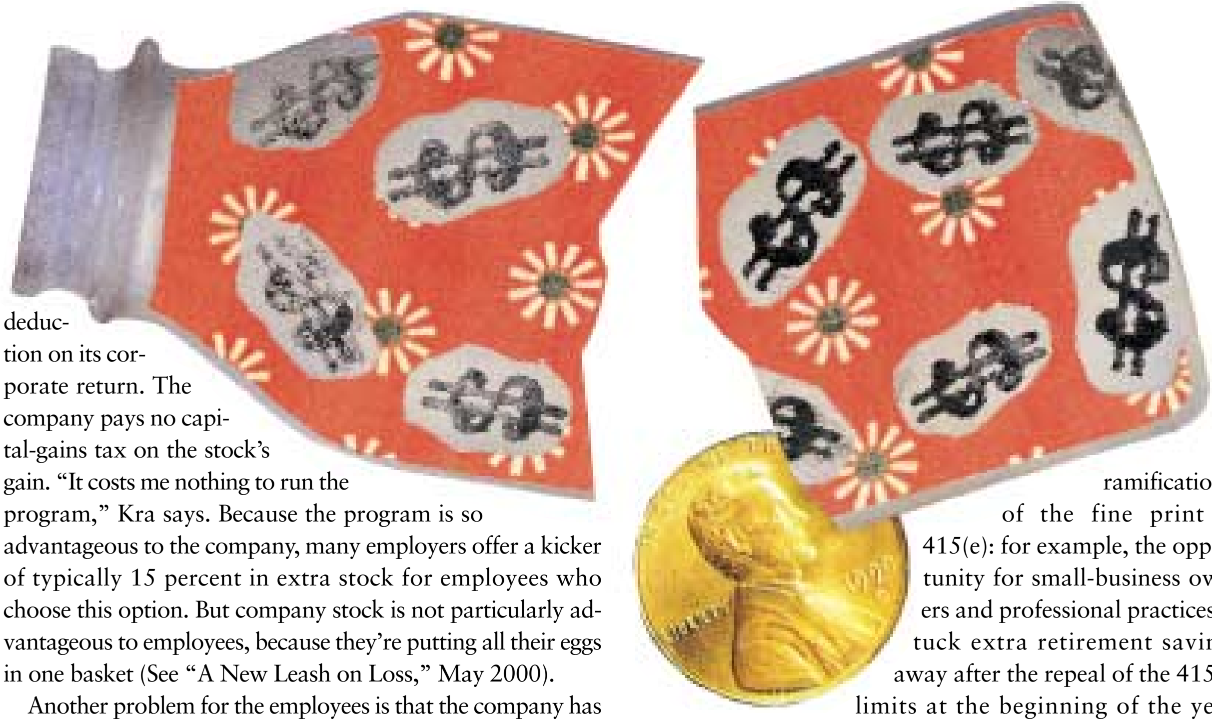
If the company were to go into bankruptcy, the exec would have to get in line with the rest of the creditors. Kra's big concern is that some executives don't understand this. He recently met with a company's managers, including the head of human resources and the chief financial officer, and "neither of them understood that issue," he says. "They nearly freaked out." The employee "must understand that he is a creditor on par with the stationery supplier, the telephone company, and the landlord."

Kra walked me through the mechanics of how deferred compensation works. Say an executive defers a $100,000 bonus. He pays the FICA tax up front. No Social Security or Medicare tax will be due when he receives the money. But he defers all state, federal, and local income tax. Because the money still belongs to the company, it must pay taxes on the sum at its own tax rate of 40 percent. So after paying taxes, the company has $60,000 left.

The company has a couple of options. It can "go naked," figuring it will come up with the deferred comp later, when it's time to pay. This is risky. Suppose the employee chooses to defer his $100,000 into an aggressive equity fund. Now the company is effectively shorting the fund. So most companies choose to hedge against the liability, typically by putting $100,000 in the mutual fund the employee chooses. Because the company has only $60,000 after tax, it must borrow the other $40,000. The company also must pay tax on the investment earnings of the mutual fund each year. When the company pays the employee, it gets a tax deduction and pays off the loan. The company's out-of-pocket cost for borrowing money for taxes shows up as "interest expense" on the profit-and-loss statement.

The second option is to use an investment–life insurance product. Instead of putting $100,000 into a mutual fund, the company puts just $60,000 into an investment–life insurance policy, because if the policy is still in force at death, no tax is due on the investment buildup in the policy. Yet the company still gets a tax deduction for paying off the executive. So if our executive defers $100,000, the company puts $60,000 into a policy and the amount doubles to $120,000. The company pays $200,000 and gets its $80,000 tax deduction, saving the interest costs. The problem with the life insurance policy option is that the company can't get the cash out quickly. Instead, it must take cash that another employee defers to pay off the first employee until, says Kra, "someone dies and it can clear the table; otherwise the firm has to take the money out of corporate cash flow." An efficient insurance program is cheaper for the company than the mutual fund option, he explains. A good program should cost just 50 basis points to maintain. But many of the programs are poorly designed and cost a great deal more than that, he says, particularly "when you have a fox guarding the chicken coop," or a life insurance agent designing the package.

The best thing for the company is to offer company stock as the option, because companies are not taxed on transactions involving company stock. If the employer takes the same $100,000, buys $60,000 in company stock and the stock doubles, it pays the employee $200,000 and gets an $80,000



deduction on its corporate return. The company pays no capital-gains tax on the stock's gain. "It costs me nothing to run the program," Kra says. Because the program is so advantageous to the company, many employers offer a kicker of typically 15 percent in extra stock for employees who choose this option. But company stock is not particularly advantageous to employees, because they're putting all their eggs in one basket (See "A New Leash on Loss," May 2000).

Another problem for the employees is that the company has no obligation to tell them what, if anything, it does to hedge the deferred-comp liability. "When you're making the choice to defer, you have no idea what the company is doing," he says. Your company might be one that chooses to "go naked."

One of Kra's biggest concerns, though, is that some employers may be accumulating too much balance-sheet liability in deferred compensation. Although the deferrals have true economic value to the executive and there is a cost to the company to provide that value, the Securities and Exchange Commission does not require that the cost show up in the proxy. "They ignore the tax cost to the company and the transfer of value," Kra says.

Kra has one client that's projecting a half billion to one billion dollars in annual deferrals. What that amounts to over the course of 20 years is a deferred-comp liability of $15 billion to $20 billion on the balance sheet. "This is one of the big hidden secrets of corporate America," he says. "My guess is that even financial executives do not fully comprehend the true cost of deferred comp." Kra believes that companies will be forced to cut back on deferred-comp arrangements once ballooning liabilities cause their balance sheets to lose their balance.

Two more points to keep in mind on deferred comp—one good, the other not so good: If the deferred comp is paid out over 10 years, the executive avoids "source tax," or tax to the state where he earned the money should he retire in a different state. So a New York employee retiring to Florida could avoid state tax if the money were paid out over 10 years. But deferred comp can be a negative in estate planning, because it cannot be used to fund a family trust, for example.

Advisers should also pay attention to some of the newer ramifications of the fine print in 415(e): for example, the opportunity for small-business owners and professional practices to tuck extra retirement savings away after the repeal of the 415(e) limits at the beginning of the year. These limits kept an employee from participating fully in both a defined-benefit and a defined-contribution plan. The rules were an administrative nightmare for big corporations, which had to track benefits in both plans for every employee of the company from the first day of employment to the date of retirement. Yet the limits rarely came into play, because the maximum salary that could be recognized by the plan, set at $150,000 in 1994 and now $170,000, put even more stringent limits on executives. In other words, they bumped up against the cap before they got close to the 415(e) limit. "The 415(e) limits were just an administrative headache," Kra says. "They cost corporations much much more than anything the government gained by them."

Going forward, all defined-benefit and defined-contribution plans are uncoordinated, making it useful to put both in place for entrepreneurs. "[The combination] allows you to maximize retirement savings," Kra says, "remembering that discrimination rules require that a nondiscriminatory benefit be paid to the rank and file." In other words, small businesses must set up the two plans for most of their employees if they want to provide them for owners.

The last thing Kra told me about on that sunny spring day was something called a SERP swap, or swapping supplemental executive retirement plans for split-dollar life insurance to pass wealth down to the next generation. But we're out of room. Details will follow soon on-line, at wealth.bloomberg.com.

Mary Rowland is the author of Best Practices for Financial Advisors *(Bloomberg Press). She speaks regularly to financial advisers on issues of practice management.*