

## You Can Pay Me Now or Pay Me Later” - Considerations with Deferred Compensation

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### A Slogan Worth Remembering

In the early 80's, there was a television commercial for Fram oil filters, which featured an auto mechanic telling a customer the firm's trademark slogan – “You can pay me now, or pay me later.” The recommendation was that the customer could pay a small amount now to replace their oil filter or a much larger amount in the future when they need costly engine repairs. This concept applies to executives that are given the opportunity to be paid now or paid later through a deferred compensation plan. Executives are sometimes given the opportunity to be paid now or later, but in a different context. This article addresses the risks and rewards of non-qualified deferred compensation plans.

### What is a Non-Qualified Deferred Compensation Plan?

Non-qualified deferred compensation (“deferred comp”) plan is an agreement between an employer and a select group of employees eligible to participate. The employee, typically at the management or executive level, can elect to forgo current compensation and be paid at a later date. Deferred comp, in essence, is an I.O.U. This can appeal to executives who are making more money than their current lifestyle requires, who have maximized qualified plan contributions and who want more income during their retirement years.

### What are the Benefits of Deferred Comp?

We find that the primary benefit of deferred comp is the

executive's ability to avoid current taxation on a portion of their income. This may be very advantageous to executives particularly if they are in their peak earning years, and have either been phased out of or have maximized their income tax deductions. Similar to a qualified plan, deferred comp allows for the deferral of taxation on both the income not realized, as well as the growth of underlying investments. Ideally, an executive would be able to coordinate the future payout of their compensation during a time in retirement when their marginal tax rate would be lower than their current rate.

Let's look at an example. Executive A and Executive B both earn \$500,000 per year. Executive A decides to maximize his 401(k) contributions, but utilizes the rest of his income for current lifestyle expenses and saves after-tax. Executive B also maximizes his 401(k) contributions, and also elects to defer \$50,000 into company's deferred comp plan to be paid out at a future date. If the executives both pay a rate of 40% (combined federal and state - taxes), Executive A would pay \$20,000 more in income tax as illustrated below:

	Executive A	Executive B
Gross Income	\$500,000	\$500,000
401(k) Contribution	\$17,000	\$17,000
Deferred Comp	-	\$50,000
Tax Rate	40%	40%
Tax	\$139,200	\$173,200

If we assume that the marginal tax rate for the executive will be equal to or lower than rates when the deferral was elected, then there is likely an economic benefit to this strategy since growth earned on the tax savings from the deferral can be significant. However, tax rates are nearly impossible to predict as illustrated in the chart below. Our executive may find that their marginal rate in retirement is quite different than their rate when they made the decision to defer income. For example, the top federal tax rate in 1975 was 70%, while

today's top rate is 35%. If an executive defers compensation at 35% tax rate, and ends up paying 70%, then the deferral was a poor decision.

one lump sum, significantly negating the benefits of tax deferral and forcing realization of income in one year. Finally, deferred compensation plans typically do not provide much in terms of investment options. Typically, the executive is

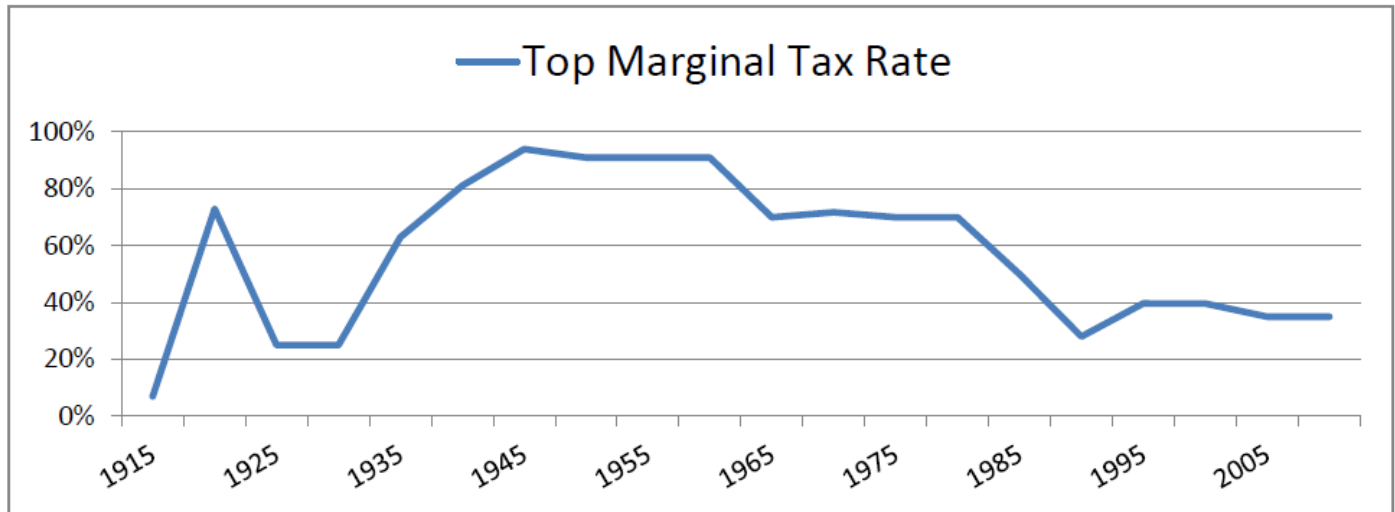


Chart Source: Taxpolicycenter.org

## Risks of Deferred Comp

If the reverse is true then it was a good decision. Unfortunately, no one can predict future tax rates, and the decision to pay the taxes once the rates have changed is irreversible, so careful consideration must be given.

One of the biggest risks of non-qualified deferred comp is credit risk. Participant deferrals are "unsecured" and not protected in the event of a corporate bankruptcy. The employee is a general creditor of the company and subject to the company's ability to pay claims in the event of a bankruptcy. While risk of the employer defaulting may be low, this low probability event represents a risk that should be considered before participating in a nonqualified deferred compensation plan. Regardless of how large a company might be and how slim the chances of a bankruptcy appear, statistics don't comfort employees who deferred their income into the plans of employers such as Enron.

Aside from the risk of the employer going bankrupt and defaulting on its deferred compensation obligations, executives also expose themselves to liquidity risk, termination or separation from service, and limited investment options. Unlike qualified plans such as 401(k)s, non-qualified deferred compensation plans rarely have loan provisions or the ability to make hardship withdrawals. This could pose a liquidity problem for an executive that needs to access capital for an emergency or a large, one-time expense. If the executive is terminated or voluntarily leaves the employer, the deferred comp proceeds may be paid out in

limited to a menu of investments similar to their qualified plan options.

## What to Consider?

Listed below are a few guidelines to consider that we believe should be considered when electing to participate in your employer's deferred compensation plan:

1. Maximize your qualified plan contributions first. Qualified plans offer tax benefits and creditor protection.
2. Determine your liquidity needs. Will you need this compensation for living needs or near term expenses? If so, you should put this excess compensation into readily available savings.
3. How much can you afford to lose? If your financial security in retirement would be threatened if your employer went bankrupt, you should not risk participating in a deferred comp program. You should have an upper threshold amount, such as 10% of your investable assets, to ensure that you do not put more at risk than you are comfortable with or than you can afford.
4. You could benefit from a tax break now, and anticipate a lower marginal bracket later. Tax rates in the long term are about as predictable as market returns in the short term. You need to quantify if the tax benefits today are worth associated risks of deferred compensation.

5. Expect to retire early? In this case, ideal scenario for spreading out deferred comp plan payouts over a number of low income years might be present. Retired executives will

I often find themselves in a low tax bracket in the years post-retirement and pre-age 70 ½ when required minimum distributions from their qualified plans and IRAs begin.

## Conclusion

Plans differ from employer to employer and everyone's individual planning needs are unique. To make the best decision on deferred compensation, review your options with your wealth manager, benefits administrator and tax advisor.

### Important Disclosure Information

Please remember to contact RegentAtlantic if there are any changes in your personal or financial situation or investment objectives for the purpose of reviewing our previous recommendations and services, or if you wish to impose, add, or modify any reasonable restrictions to our investment management services. A copy of our current written disclosure statement discussing our advisory services and fees is available for your review upon request. This article is not a substitute for personalized advice from RegentAtlantic. This information is current only as of the date on which it was sent. The statements and opinions expressed are, however, subject to change without notice based on market and other conditions and may differ from opinions expressed in other businesses and activities of RegentAtlantic. Descriptions of RegentAtlantic's process and strategies are based on general practice and we may make exceptions in specific cases.

RegentAtlantic does not provide tax advice. Please consult with a tax professional of your choosing prior to making any decisions on deferred compensation.

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