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WEALTH MANAGEMENT | December 5, 2012, 2:34 p.m. ET

Executives Deferring Pay as Higher Taxes Loom

By ARDEN DALE

With taxes set to rise next year, executives are looking to shelter more of their bonuses and salaries in employer plans that let them wait years to take their pay.

For some, the goal is to retire in a lower tax bracket, and then cash out the money. Younger workers can benefit, too, because investment earnings inside employer-sponsored deferred compensation plans compound tax-free.

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Higher tax rates in 2013 have touched off a rush to contribute to these plans before year's end. Employers are partly behind this as they ramp up their outreach to let employees know about the plans they offer.

"The level of activity has more than doubled," said J.J. Burns, an adviser in Melville, N.Y., who has reviewed plans for three clients in the past few days.

Enlarge Image
Bari Goodman

Bonuses and salaries that go into deferral plans are taxed as ordinary income when the money comes out. Currently, the top tax rate is 35%, which could rise above 43% for some in 2013, depending on how congressional lawmakers resolve budget negotiations to avert the so-called fiscal cliff. The top rate on ordinary income may rise to 39.6%, and the wealthy would owe a 3.8% Medicare surtax on top of that.

With that steep hike in mind, a 50-year-old executive in a Fortune 100 company turned to Massachusetts adviser Corey Peterson to help him defer more pay than

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he has in the past. The man, who wants to retire in about eight years, will defer about 30% of his 2013 bonus, or $30,000. He will also defer some of his $350,000 salary to shelter it from the 3.8% surtax. The Medicare tax applies to adjusted gross income over $200,000 ($250,000 for married, filing jointly).

Mr. Peterson, a senior wealth strategist at Cardinal Financial Planning in Dedham, Mass., said a number of his clients have brought in emails from employers reminding employees that they offer deferred compensation plans, and directing them to consult with their financial advisers about participating. That's unusual, he added.

Kaye Thomas, publisher of the tax information website Fairmark.com, said putting money into a deferred compensation plan is a lot like contributing to a 401(k), for tax purposes. Investment earnings add up over time but there's no tax paid until money comes out.

Tax-free compounding of investment earnings is a big benefit, even when an executive doesn't plan to wait until he's in a lower bracket to take the pay, Mr. Thomas said.

It's critical, nonetheless, that advisers remind clients of a key difference between 401(k) accounts and deferred comp plans: Employees own the money in their 401(k) all along, but employers own the deferred comp until it's paid out. An executive who has deferred pay at a company that goes bankrupt may never collect the money.

For that reason, an employer's financial health needs a close look any time someone defers pay.

Advisers also consider the age of a client to help decide how much pay to defer. The Investment Company Institute said in a study earlier this year that age plays a key role in the tax benefits from deferral. A 45-year-old with a 15% marginal rate stands to save more tax by deferring, according to the group, than a 60-year-old in the 35% bracket. A 60-year-old in the 15% bracket gets only 10 cents of benefit for a $1 contribution. At ages 50 and 40, the benefit is 17 cents and 23 cents, respectively.

Investments also play a role. The tax-benefits vary for different investments, so advisers need to look at whether a client's portfolio inside a deferral plan will produce interest income, dividends or short- or long-term capital gains.

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