

Focus

Changes in Executive Compensation Packages Spell Opportunity for Advisors

by Ed McCarthy, CFP®

Executive compensation and benefits continue to draw scrutiny. Salaries for top executives are increasing to larger multiples of average employees' pay and incidents of backdating stock options are in the headlines. Planners who advise executives acknowledge the negative publicity but report that their focus continues to be on the financial impact of changes in tax regulations and compensation packages' structure. These changes, several of which are creating new business opportunities for advisors, range from reduced flexibility in deferred-compensation arrangements to the growing popularity of defined-benefit plans among small-business owners.

Reduced Flexibility

The American Jobs Creation Act, which was signed into law in October 2004, imposed new restrictions on deferred compensation arrangements by adding Section 409A to the Internal Revenue Code. According to Pam Branshaw—partner in charge of employee benefits practice with CPA and consulting firm Wipfli LLP in Madison, Wisconsin—before Section 409A, a major concern with nonqualified plans was the concept of constructive receipt, the timing of which determined taxability to the executive. Court cases and rulings by the Internal Revenue Service focused on perceived abuse when executives were given control over timing of receipt. The act eliminated that control; consequently, many businesses are revising their nonqualified deferral plans.

"We are reviewing the agreements our clients have with their key employees," Branshaw says. "For small businesses, it comes down to the elections an employee makes at the beginning of the agreement as to how much compensation will be deferred and when they will receive the income. Those agreements must now spell out all those details and take the control away from the employee after the agreement is made."

The act's requirements can make cash-flow planning more challenging, says Nate Wenner, CFP®, CPA, a financial planner with Wipfli Hewins Investment Advisors in St. Paul, Minnesota, because executives previously had more opportunities to make changes after the agreement was in place. As an example, he cites an executive who originally planned to time the receipt of deferred compensation for her children's education. If she did not need the funds to pay for college expenses at that time, she could continue the deferral until her retirement two years later. She will no longer have as much control, which may force her to develop another education funding strategy.

"The act makes planning more difficult," says Wenner. "There will be more clarity up front as to when things will be paid out, whereas in the past there was more opportunity to make changes after the agreement was in place. Although an employee may be able to change an original agreement, any change has to be made prior to the year of scheduled payment, and the receipt of payment must be put off for at least five years. It will make a clear understanding of the tax implications of certain strategies more important. For instance, it will require planning to recognize the tax impact of receiving deferred compensation in a particular year, and you'll want to avoid other income in a high tax year."

Decline and Rise of Defined-Benefit Plans

The image of a three-legged stool has often been used to illustrate retirement funding, with Social Security, employer-sponsored pensions, and personal savings comprising the three legs. For many employees in the United States today, however, the stool has lost a leg. Boston College's Center for Retirement Research estimates that 40 percent of American workers had defined-benefit pensions in 1980; by 2004, that figure was down to 19 percent.

Stewart Koesten, CFP®, president of Koesten Hirschmann & Crabtree Inc., a wealth management firm in Overland Park, Kansas, advises executives at Fortune 1000 companies. He concurs that defined-benefit pension plans are on the way out for public companies, but he points out that the demise of a defined-benefit plan has less of an impact on a highly compensated executive than on the rank-and-file employees because executives typically have substantial income and benefits that can include stock options, restricted stock, and deferred compensation. "We look at all the retirement resources," Koesten says. "When you lose the future value of a pension benefit, then you're dealing with a different retirement analysis of what you must save through other benefits."

Some large companies, including IBM and Verizon, are freezing their plans, and Koesten says that this step might be followed by eventual benefit buyouts. He speculates that as interest rates increase, at some point corporations will begin offering to buy out, or insist on buying out, the employees' accrued, frozen benefits. "I don't think it will happen until interest rates reach some peak level, but when it occurs I bet we'll start to see some buyout offers to get the liabilities off the companies' books," he says. "That scenario raises a question: If a person has an opportunity to get out of a plan with a lump-sum option, is it possible that they might have a higher benefit by getting out today versus waiting for a buyout offer at a lower discounted value? I don't know the answer, but it's a possibility."

In contrast to large companies, smaller firms, particularly sole and small-group professional practices, are embracing defined-benefit plans. Several factors are driving the plans' newfound popularity, says Jeff Berends, FSA, executive vice president with CCA Small Business Group LLC in Denver, Colorado. The first factor is the need among many baby boomers for a rapid build-up of retirement savings. Because defined-benefit plans are age-sensitive, contributions can be skewed toward older participants. "That feature benefits self-employed boomers who need to save significant amounts that they couldn't previously when they were building their businesses," Berends says. "Now they're in their peak earning years and need to accumulate substantial retirement assets over a short period of time. The defined-benefit plan is the only option that lets them do that."

Berends points to recent tax law revisions as the second factor spurring the plans' adoption. The Small Business Job Protection Act of 1996 contained provisions, referred to as the repeal of IRC Section 415(e) combined plans limit, which took effect in 2000. The provisions affected an employer's ability to establish a defined-benefit plan after already having funded a defined-contribution plan for a number of years. The second major change to the IRC Section 415 affecting maximum benefit limitations applicable to defined-benefit plans was contained in the Economic Growth and Tax Relief Reconciliation Act of 2001, and was first effective in 2002. These two changes gave small-business owners much greater latitude in establishing qualified retirement plans, Berends says.

Pam Branshaw's experience supports Berend's claims. She has seen growing interest in defined-benefit plans from small professional firms such as medical and dental practices with three or four employees. These firms have 401(k) and profit-sharing plans in place, but the owners' contributions have reached the \$44,000 annual limit. Adding a nonqualified deferred compensation arrangement increases the owner's annual savings, but many desire to save even more. "There is no dollar limit as to how much the owner defers—it depends on the owner's age and the age of their employee group," Branshaw says. "You need to test the plan group, but as long as you're meeting the monthly retirement benefit rules, you can have significant disparity in the contributions in favor of the owner."

Technology has also facilitated financial advisors' role in recommending defined-benefit plans to their clients. For example, CCA's Web-based services, MaxPlans™, allow advisors to create plans online for single- and small-group clients. Berends says that the automated, interactive program includes plan design, contribution modeling, implementation, and ongoing administration. After the plan is set up, the advisor manages the plan's assets, while CCA serves as the administrator. Although Berends will not disclose the number of clients, he reports very strong interest from financial advisors.

Increased Savings with Defined-Benefit Plans

Jeff Berends, FSA, provided the following cases to illustrate how defined-benefit plans can increase retirement savings for owners of small firms.

Case 1: Solo Professional

The client is a 45-year-old, self-employed consultant with an annual earned income of \$250,000. His goal is to maximize his retirement plan contributions for the next ten years, which he can achieve by integrating a defined-benefit plan with 401(k) elective deferrals (option number 4). His savings options include:

Option No.	Plan	Contribution	Note
1	Profit sharing/SEP	\$44,000	Up to 20% of earned income subject to a \$44,000 maximum in 2006
2	Individual 401(k)	\$44,000	\$15,000 401(k) elective deferral, plus up to 20% of earned income subject to a \$44,000 combined maximum in 2006
3	Individual defined benefit	\$120,000	
4	Individual defined benefit + elective 401(k)	\$135,000	\$120,000 defined benefit + \$15,000 401(k) elective deferral

Case 2: Multiple Professionals

The clients work in a small professional services firm with 4 owners and 20 employees. The owners earn over \$350,000 each. Two of the owners—the senior owners—are in their fifties and wish to defer an additional \$100,000 or more into their qualified plans, which currently include a 401(k) and profit-sharing plan. The two junior owners are also interested in smaller additional deferrals. The firm wants to minimize any increase in funding for its employees.

The owners' current deferrals consist of:

Plan	Contribution	Note
401(k) deferral	\$15,000	\$20,000 if age 50 or older
401(k) match	\$6,600	50% of first 6% of pay
Integrated profit sharing	\$7,170.60	5.7% of pay exceeding Social Security wage base
Nonintegrated profit sharing	\$15,229.40	6.92% of all pay
Total deferrals per owner	\$44,000	\$49,000 if age 50 or older

By revising the plans, the senior owners can increase their contributions significantly:

Plan	Contribution	Note
401(k) deferral	\$20,000	Includes \$5,000 catch-up since they are age 50 or older
401(k) match	\$0	Eliminated
New profit-sharing plan allocation formula	\$29,000	13.2% of compensation for owners; 6.75% for nonowners (includes 3% safe harbor contribution)
Hybrid defined-benefit (DB) plan	\$110,000	Other owners: \$20,000 each; nonowners: 3% of pay
Total deferrals for senior owners	\$169,000	
Total increase in owner deferrals	\$260,000	Hybrid DB contributions
Total increase in employee costs	\$6,000	Re-purpose a portion of prior profit sharing to DB plan

A Shift to Restricted Stock Units

The practice of backdating stock options has made headlines lately, but the bad publicity is unlikely to eliminate the use of options as a compensation tool. As Koesten notes, many public companies require high-level managers to own company stock. The target value of those positions is frequently stated as a multiple of annual salary, and options help the participating executives accumulate the required amount. Koesten is seeing more use of restricted stock and restricted stock units versus traditional options, however. "It's not an exclusion of options, but there is a greater focus on restricted stock and less on options," he says. "It comes down to a combination of the two that's tilted a little more toward restricted stock."

Kevin Bachler, senior vice president with benefits consulting firm MullinTBG in Deerfield, Illinois, has also experienced a shift toward restricted stock units. A typical restricted stock plan could have three-year vesting: the executive receives the grant and it vests one-third per year over the next three years. He or she will pay taxes as the shares vest but also will have clear ownership of the vested shares. A restricted stock units program could provide the same grant and vesting schedule, but with units that are equivalent to stock instead of restricted stock shares. The grant could be part of a tax-deferred account or a separate program.

The tax treatment for units differs from that for restricted stock and that is a key factor in the plans' growth. "When the grant is fully vested, the executive has a notional account with stock units that can be paid in the form of stock at some future time," Bachler says. ("Notional" refers to values and accounts that track the underlying investments but exist only in bookkeeping form.) "The advantage to that arrangement is that the participant continues to defer the taxes until he or she takes receipt of the shares or the cash equivalent. If the stock pays dividends, they're typically paid as notional dividends either in cash or into their plan. The disadvantage with units is that they don't provide real ownership. For instance, what happens if the company becomes insolvent and the executive can't sell the stock? Also, the executive can't vote the shares."

The advantage of restricted stock units is shown in the comparison of Table 1 (Restricted Stock) and Table 2 (Restricted Stock Units). The tables show the projected value of grants received under both plans and demonstrate how the timing of income tax liabilities affects projected values, given the assumptions shown. In these scenarios, the restricted stock units account will have a greater future value than the restricted stock account: \$33,736 versus \$26,970, as graphically illustrated in Figure 1.

Table 1: Restricted Stock (All values denoted in dollars unless otherwise indicated)														
Year	Age	Beginning Balance	Annual Earnings	EOY After-Tax Dividend	Restricted Stock Redemption	EOY Vested Amount	Total Vested Amount	Income Tax Due	Capital Gains Tax Due	EOY Share Price	Shares Sold to Pay Taxes	EOY Total Shares	Ending Balance	Incremental Impact to Executive
2006	50	10,000	1,000	155	0	3,667	3,667	(1,393)	0	11.00	(126.67)	887	9,762	0
2007	51	9,762	976	138	0	4,033	7,700	(1,533)	0	12.10	(126.67)	772	9,343	0
2008	52	9,343	934	120	0	4,437	12,137	(1,686)	0	13.31	(126.67)	654	8,711	0
2009	53	8,711	871	101	0	0	12,137	0	0	14.64	0.00	661	9,683	0
2010	54	9,683	968	103	0	0	12,137	0	0	16.11	0.00	668	10,754	0
2011	55	10,754	1,075	104	0	0	12,137	0	0	17.72	0.00	674	11,933	0
2012	56	11,933	1,193	104	0	0	12,137	0	0	19.49	0.00	679	13,231	0
2013	57	13,231	1,323	105	0	0	12,137	0	0	21.44	0.00	684	14,659	0
2014	58	14,659	1,466	106	0	0	12,137	0	0	23.58	0.00	688	16,231	0
2015	59	16,231	1,623	107	0	0	12,137	0	0	25.94	0.00	692	17,961	0
2016	60	17,961	1,796	107	0	0	12,137	0	0	28.53	0.00	696	19,864	0
2017	61	19,864	1,986	108	0	0	12,137	0	0	31.38	0.00	700	21,958	0
2018	62	21,958	2,196	108	0	0	12,137	0	0	34.52	0.00	703	24,263	0
2019	63	24,263	2,426	109	0	0	12,137	0	0	37.97	0.00	706	26,798	0
2020	64	26,798	2,680	109	0	0	12,137	0	0	41.77	0.00	708	29,587	0
2021	65	29,587	0	0	(29,587)	0	12,137	0	(2,618)		(62.66)		0	26,970
Totals			22,515	1,684	(29,587)	12,137		(4,612)	(2,618)					26,970
XYZ Corporate Stock Shares			1,000						\$0.25					
Beginning Stock Price			\$10.00						38%					
Annual Stock Growth Rate			10%						15%					
Vesting Schedule			1/3 per year						Dividends Reinvested, Taxes paid from shares					
												NPV @ 10%	6,456	

Source: Kevin Bachler, MullinTBG

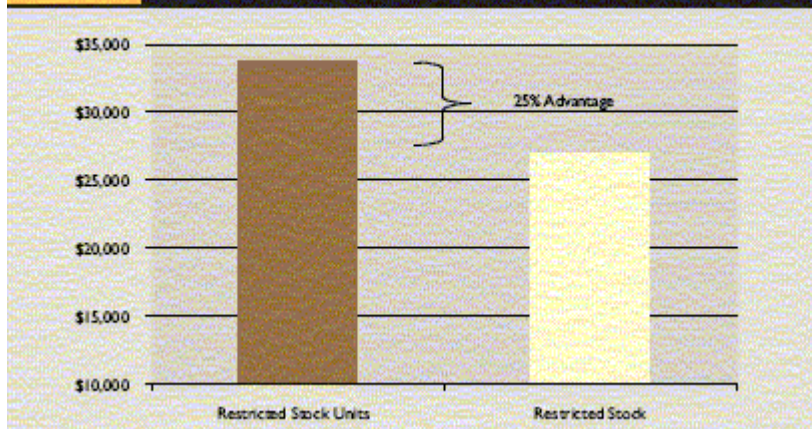
Table 2: Restricted Stock Units (All values denoted in dollars unless otherwise indicated)

Year	Age	Beginning Balance	Annual Earnings	EOY After-Tax Dividend	Restricted Stock Redemption	EOY Vested Amount	Total Vested Amount	Income Tax Due	Capital Gains Tax Due	EOY Share Price	Shares Sold to Pay Taxes	EOY Total Shares	Ending Balance	Incremental Impact to Executive
2006	50	10,000	1,000	155	0	3,667	3,667	0	0	11.00	0.00	1,014	11,155	0
2007	51	11,155	1,116	157	0	4,033	7,700	0	0	12.10	0.00	1,027	12,428	0
2008	52	12,428	1,243	159	0	4,437	12,137	0	0	13.31	0.00	1,039	13,830	0
2009	53	13,830	1,383	161	0	0	12,137	0	0	14.64	0.00	1,050	15,374	0
2010	54	15,374	1,537	163	0	0	12,137	0	0	16.11	0.00	1,060	17,074	0
2011	55	17,074	1,707	164	0	0	12,137	0	0	17.72	0.00	1,069	18,945	0
2012	56	18,945	1,895	166	0	0	12,137	0	0	19.49	0.00	1,078	21,006	0
2013	57	21,006	2,101	167	0	0	12,137	0	0	21.44	0.00	1,086	23,273	0
2014	58	23,273	2,327	168	0	0	12,137	0	0	23.58	0.00	1,093	25,769	0
2015	59	25,769	2,577	169	0	0	12,137	0	0	25.94	0.00	1,099	28,515	0
2016	60	28,515	2,852	170	0	0	12,137	0	0	28.53	0.00	1,105	31,537	0
2017	61	31,537	3,154	171	0	0	12,137	0	0	31.38	0.00	1,111	34,862	0
2018	62	34,862	3,486	172	0	0	12,137	0	0	34.52	0.00	1,116	38,521	0
2019	63	38,521	3,852	173	0	0	12,137	0	0	37.97	0.00	1,120	42,546	0
2020	64	42,546	4,255	174	0	0	12,137	0	0	41.77	0.00	1,125	46,974	0
2021	65	46,974	0	0	(46,974)	0	12,137	(13,238)	0		(316.91)		0	33,736
Totals			34,484	2,491	(46,974)	12,137		(13,238)	0					33,736

XYZ Corporate Stock Shares	1,000	Annual Dividend Per Share	\$0.25	NPV @ 10%	8,076
Beginning Stock Price	\$10.00	Shareholder Tax Rate	38%		
Annual Stock Growth Rate	10%	Capital Gains Rate	15%		
Vesting Schedule	1/3 per year	Dividends Reinvested, Taxes paid from shares			

These hypothetical taxable security values are not guaranteed nor are they a representation of past or future results. Investments in securities involve risks, including the possible loss of principal.

Figure 1: Total After-Tax Value to Executive



Advising Executives

The advisors cited in this article agreed that most of the changes currently taking place in executive compensation are incremental. Many firms and executives already have their benefits arrangements in place, but opportunities for advisors to provide new services continue to develop. The executive agents service of Koesten Hirschmann & Crabtree, for example, has helped its executive-clients negotiate employment agreements for the past several years. The service started out as a coaching arrangement with a client who was hired by an overseas corporation. Koesten's analysis of the current and projected compensation plans revealed that the client would lose much of his pension-benefit accruals in the later portion of his life if he took the new job. The loss would have affected much of his projected benefit accumulation because he would not have a pension plan at the new position. Koesten helped him value that accrual and suggested that the client negotiate that amount as part of his compensation at the new company.

"The client valued our work and suggested that we offer it as a separate service," Koesten says. "We agreed and subsequently have coached other clients on their employment agreements. We've also negotiated agreements for clients and have found that corporations are quite willing to work with a third-party negotiator. Of course, we keep the client engaged in the process. It's more like negotiating with the client as a partner, although I'm the one in the discussions with the employer."

Bachler sees several business opportunities on the horizon. Corporate human resource departments are

asking MullinTBG for additional help in deciding which notional funds to offer in their deferral plan and how to fund those arrangements. He also anticipates working more closely with executives on the allocation within their deferral plans. "We see that financial planners frequently don't get involved in helping executives allocate the assets in their deferral plans, so we'll probably provide a service like that," he says. "That will allow planners to spend more time helping executives determine cash-flow strategies: how fast they should put funds into and take funds from their deferral plans, for instance."

External forces like IRS actions also influence the makeup of compensation and benefit plans. As an example of a new benefit arising to replace one that was influenced by tax law changes, Bachler anticipates that executives will ask for a death benefit to replace split-dollar plans. The 2001–2002 tax changes, Sarbanes-Oxley, and accounting changes that affected split dollar make it much less attractive than it was in the past, he says. Nevertheless, executives still need death benefits (often more so than rank-and-file employees, due to additional estate transfer needs), and one of the various forms of split dollar can still be the best alternative for some companies. Within that context, Bachler believes that executives soon will start requesting a cost-effective, post-retirement death benefit to replace split-dollar coverage.

The broad range of compensation and benefit packages has produced another effect, Bachler says, and it's one that could benefit advisors. He believes that executives are looking for less information but more meaning. In other words, they don't want to be inundated with information—they want to know what the information means. "They want lots of choices but not lots of decisions," he says. "For example, we may tell the executive that we have 20 different plan designs available, but we picked this one and here's why. We think that's where the service level is going next. How can we offer them just as much choice but with fewer decisions? And how can we help them manage those choices and decisions for their lifetime?"

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