

This PDF is a selection from an out-of-print volume from the National Bureau of Economic Research

Volume Title: Executive Compensation in Large Industrial Corporations

Volume Author/Editor: Wilbur G. Lewellen

Volume Publisher: NBER

metadata, citation and similar papers at [core.ac.uk](http://core.ac.uk)

Volume URL: <http://www.nber.org/books/lewe68-1>

Publication Date: 1968

Chapter Title: Deferred Compensation

Chapter Author: Wilbur G. Lewellen

Chapter URL: <http://www.nber.org/chapters/c9344>

Chapter pages in book: (p. 34 - 43)

## DEFERRED COMPENSATION

Deferred compensation is defined here to include all arrangements—other than the corporation's comprehensive employee pension plan—under which an executive is promised a series of cash payments after retirement in return for services performed currently. In almost every case these instruments take the form of contractual agreements between the corporation and individual executives and, as such, may contain a variety of provisions specifying the rights and duties of both parties. While their pronounced individuality makes it necessary to evaluate each contract according to its own peculiarities, the deferral and contingency aspects of most devices resemble those of pensions and a similar analysis can be applied.

### *Focus*

The graduated personal income tax provides the most generally accepted—if not most frequently avowed—rationale for the use of a deferred payment contract. The executive's annual income and, hence, his marginal tax bracket are typically lower in retirement than during his active working life. By receiving a portion of his rewards in the later period, he incurs a smaller tax liability. Such objectives as the retention of a particular individual's services, the liberalization of executive retirement benefits in the absence of an increase in the pension rights of all employees, and the assurance that a key officer's knowledge and experience will continue to be available—as well as confidential—after he retires are more commonly claimed. Even so, the various arrangements devised are economically justified chiefly on the basis of their tax-ameliorating properties, and the question of whether and under what circumstances the other arguments advanced are valid will not be considered here.

### *Typical Arrangements*

A deferred compensation contract may conform to any one of a number of patterns. While in each case a given amount becomes payable to the executive upon retirement, the period over which such payments are to continue varies considerably. A few of the arrangements are much like pensions in that payments are promised for the duration of the executive's life and then, perhaps, to a designated heir until he or she dies as well. The majority of contracts, however, guarantee the executive a fixed aggregate sum, the difference between that figure and any payments received prior to his death being payable to his estate, either in a lump sum or in installments to a particular heir.

In return for such promises, certain restrictions are usually imposed on the executive's activities. He may, for example, be required to:

1. Remain in the corporation's employ—at its discretion—until his normal retirement age.
2. Make himself available, in retirement, for consulting or advisory services.
3. Refrain from competing against the corporation or providing information to its competitors after he retires.

If the executive fails to keep his part of the bargain, except for reasons of health, he automatically forfeits his rights to the payments due him. The particular combination of rewards and obligations contained in each agreement is reported in the proxy statement of the corporation in the year in which it is made.

### *Tax Treatment*

Because of their heterogeneity, deferred compensation arrangements have been taxed rather unsystematically over the years. The major difficulty lay in identifying the time at which the "true" receipt of income by the executive occurred, i.e., the date when the contract was entered into or the years when the payments thereunder eventually were made. In many instances the wording of an agreement was such that both its intent and practical effect were open to interpretation. Since no specific legislation similar to that defining the taxability of employee pensions

has ever been enacted in this area, a degree of confusion was the inevitable result, and the courts have been confronted with a disproportionate number of individual cases for settlement. A 1960 ruling by the Internal Revenue Service, however, more or less standardized the favorable tax treatment of these devices along the lines of the developing pattern of court decisions.<sup>1</sup> Its import was that, as long as restrictive covenants of the sort described above were part of the contract, thus introducing the possibility of forfeiture by the executive, the postretirement payments specified were to be regarded as income taxable only *when received*. The deferred compensation arrangements adopted by the companies included in the present study qualify either for this ruling or, in prior years, for the generally equivalent position taken by the courts.<sup>2</sup>

The tax treatment of any death benefits or survivorship income rights provided under the agreement depends on their form. A single lump-sum cash settlement is taxed simply as a part of the man's estate.<sup>3</sup> Where a prescribed heir becomes eligible for a continuation of the executive's annual payments, a twofold tax assessment formula applies.<sup>4</sup> The aggregate dollar amount of the payments still due is taxed as part of the estate in the same manner as a lump-sum settlement. In addition, when those payments are eventually received by the designated beneficiary, they are taxed again as ordinary income. The beneficiary may, however, deduct from taxable income the proportionate share of the estate tax attributable to each such payment. To illustrate: If an executive who was to be paid \$10,000 a year for ten years following his retirement under a deferred compensation contract which specified his wife as beneficiary died after receiving only two payments, there would be an estate tax assessed on the remaining \$80,000. Were that tax to amount to, say, \$20,000, then 20/80, or one-fourth of each \$10,000 payment received by the man's wife in subsequent years, would be tax-free to her.

<sup>1</sup> Revenue Ruling 60-31, *Standard Federal Tax Reporter*, Commerce Clearing House, Inc., 1960, Vol. 6, pp. 6296-6298.

<sup>2</sup> A more extensive discussion of the tax history of deferred compensation is contained in an unpublished Master's thesis at the Massachusetts Institute of Technology by Kenneth R. Hootnick entitled "Deferred Compensation Agreements: A Study of Their Use and Effectiveness," June 1963, pp. 10-23.

<sup>3</sup> *Internal Revenue Code*, Section 2039.

<sup>4</sup> *Ibid.*, Section 691.

*The Services Rewarded*

There are two possible interpretations of the nature of a deferred compensation arrangement. One holds that the payments received by the retired executive should properly be regarded as remuneration for services he is performing at that time. The other contends that the timing of such payments is simply a matter of compensation administration and tax planning and that the rewards really apply to the man's active working life. The latter view is accepted here.

Evidence to support the first position is allegedly found both in the method by which the executive's taxes are assessed (the law assumes that the receipt of income does not occur until retirement) and in the structure of the deferred pay contract itself—the executive is obliged after retiring to be available for consultation and to refrain from assisting any of the firm's competitors. However, the tax doctrine is based not on a judgment about the corporation's motives or logic in designing its compensation package, but solely on an appraisal of the time at which the individual executive actually acquires and is able to freely dispose of a particular kind of income. As to the second point, the man's consulting chores are, in practice, almost invariably quite nominal and hardly represent a realistic quid pro quo for the payments he is receiving. Finally, the restriction that he not compete against his old firm is also more appropriately viewed as a precondition for the receipt of pay for certain earlier services rather than as an action being rewarded in and of itself. Indeed, one could well argue that both of these requirements are made a part of the contract in most instances chiefly to bring the arrangement under the cover of a favorable tax formula and are not considered the basis of an affirmative postretirement relationship.

A similar conclusion is reached if the intentions expressed by the corporation in setting up its deferred compensation plan are examined. Whether the reason given is the retention of an executive, the supplementing of his pension benefits, or some related purpose, the implication clearly is that his services *prior* to retirement are the focus of the arrangement. In the situation where, as sometimes happens, the man's salary is reduced—or not increased along with those of other executives—at the time a deferred compensation contract is entered into with him, the

nature of the transaction is most obvious. By way of analogy, there is never any claim advanced that a pension, with its vesting provisions, is a reward for services performed *after* retirement. Accordingly, a deferred compensation agreement will be considered here as a device that represents, as does a pension promise, remuneration to the executive for the period from the time it is instituted up to the time he retires.

### *The Valuation Procedures*

In order to assess the worth of a deferred pay plan in a manner that will permit comparison with other forms of reward, the concept of a "current equivalent" is once again adopted. Since the characteristics of such plans differ to some extent from those of pensions, however, their current equivalents will necessarily have a slightly different cast.

Given the size and timing of the various payments anticipated, the contingencies associated with them, and the applicable tax liabilities, the after-tax present value of any arrangement can be calculated. Its current equivalent is then determined by asking the question: "If the executive involved were to receive instead—beginning in the year when the deferred compensation agreement is made and continuing until his retirement—an annual after-tax salary increase having the same present value, how large would that increase have to be?" In effect, it is hypothesized that the most appropriate practical alternative to a deferred pay contract is simply an addition to the man's salary which, in terms of its after-tax present value, is as attractive to him—and that this alternative is therefore a good measure of the after-tax current income counterpart of such a contract for the purpose of relating it to other, similarly translated rewards.

### *Rationale*

The current equivalent of a pension promise was taken to be the stream of annual premiums which—given an after-tax salary increase of the same magnitude—would enable the executive to purchase an individual retirement annuity having a present value equal to that of his pension. In the case of a deferred compensation arrangement, however, it is the

after-tax salary increase *itself* whose present value is regarded as the relevant "equivalence" criterion. This difference in approach is a product of two considerations.

First, the benefit structures of pension plans are, as indicated, more standardized than those of deferred compensation agreements. It is therefore possible to propose a single, fairly representative market alternative to the two types of pensions, the price of which can be used as a common index of their worth. Deferred pay plans are not so readily characterized, and the computational effort involved in seeking out a close substitute for each of the various arrangements encourages the adoption of a simpler, more direct procedure.

Secondly, there are some fundamental differences in the characteristics of the two devices. Pensions are, by definition, oriented around the probable length of the executive's life. The benefits promised consist of a series of assured annual payments which terminate only upon his death. An individual annuity policy has similar features. Through its purchase an executive can guarantee himself the same lifelong income that the pension provides. Since this guarantee is viewed here as essential to a truly equivalent position and since he cannot self-insure the particular "risk" involved—i.e., the chance that he may live too long and exhaust his funds—he must bargain with the only institution that is set up to provide that service for him. Hence, an individual retirement annuity is a singularly appropriate personal alternative to the pension.

Deferred compensation arrangements, on the other hand, are centered much less on mortality considerations. While a few resemble pensions, with the length of the actual postretirement payment period being determined by the date of the employee's death, the large majority provide in some way for a *fixed* total reward instead. Mortality is taken into account in those terms of the agreement which specify the relevant death benefits, but the aggregate payout of the contract is not thereby affected. Consequently, there is no reason to propose here as a substitute an instrument whose most prominent characteristic is the guarantee of a lifetime, and therefore indeterminate, income stream. While insurance companies do offer other contracts which resemble many of the common deferred compensation arrangements, the special advantages they have where a pension is concerned are absent in this case; there are a number

of investment media that can be regarded as sensible alternatives when mortality is not a key issue. Rather than attempt to specify a particular one, it seems more desirable to adopt a valuation procedure which is consistent with as many different choices as possible, i.e., simply calculating the after-tax salary increase which is as valuable in itself as the deferred compensation agreement in question.

### *Contingencies*

The uncertainties associated with the eventual receipt of benefits under a deferred pay contract can be separated into two categories: those over which the executive has control and those he cannot influence. The former are introduced by the forfeiture provisions written into most agreements. Thus, the executive may be required to remain with his company until normal retirement age, keep his knowledge of its operations confidential, and be available to it for consultation after retirement—or else give up his rights under the contract. Because of the severity of this penalty and because it seems likely that a highly placed executive would be willing to fulfill at least the last two obligations without an overt threat of economic reprisal, the assumption here will be that all prospective deferred payments may be considered certain insofar as these factors affect them. The possibility that the executive might resign to take another job is probably the only real concern, and it has been argued previously that turnover is negligibly small. The prospect of losing substantial amounts of deferred pay should reduce it even further.

The second type of contingency is, of course, that of mortality. Although the total before-tax payout of a deferred compensation arrangement is typically not dependent upon the length of the executive's life, its after-tax present value is. If the man should die before receiving all the payments he is entitled to, the settlement made with his estate will result in a different tax liability and perhaps in a different pattern of benefits than would have been the case had he continued to live. Some appraisal of the anticipated mortality experience of executives is therefore necessary. For the reasons given in connection with pension valuation, the 1951 Group Annuity Table seems an appropriate estimate.



### *Discount Rate*

Another form of uncertainty relevant to a determination of the worth of a deferred pay contract is that surrounding the ability of the employer corporation to meet its commitments. Not all arrangements are funded, as pensions are, and there may be some question about the degree of confidence it is proper to have in the ultimate payment of the stipulated rewards. The problem arises particularly in the case of small and new firms or those otherwise in a difficult financial position. However, since the present study focuses on large, well-established enterprises with favorable long-range prospects, it should be possible to regard their deferred compensation agreements as no less sound than their pension plans. Accordingly, if the executive were to seek to provide on his own for postretirement income having the same "risk" characteristics, a generally conservative investment policy similar to that suggested as an alternative to the pension would seem in order. A discount rate of  $2\frac{1}{2}$  per cent per annum after taxes will therefore be used to determine the present value of each deferred payment, and to calculate the after-tax salary increase that comprises its "current equivalent."

### *The Tax Environment*

Once more, various factors external to the compensation transaction must be taken into account in computing tax liabilities. Following the convention adopted earlier, the executive will be credited with income after retirement in addition to his deferred pay equal to that which he is estimated to be receiving at the time the contract is entered into, i.e., 15 per cent of his then-current aggregate direct remuneration. Anticipated nontaxable deductions and exemptions are assumed again to be 10 per cent of total income for agreements concluded during the period 1940 to 1950 and 15 per cent for all subsequent ones. The tax rates used will be those in force on the date of the present value computations. Thus, an executive who was paid \$60,000 in salary and bonus in 1955 and who was in that year promised, under a deferred compensation contract, \$20,000 annually for ten years upon retirement would—if he had no pension in prospect—be expected to enjoy a total annual post-retirement income of \$29,000. Of that amount 85 per cent would be

regarded as taxable at the rates prevailing in 1955, and 20/29 of the resultant after-tax figure would be attributed to the deferred pay arrangement. The effect of a concurrent pension will be considered later.<sup>5</sup>

### *Present Value Analysis*

The present value to an executive of each payment foreseen under a deferred compensation contract is equal to the product of its after-tax dollar amount and the probability of its receipt—discounted at the prescribed 2½ per cent rate of interest to the year the contract is entered into. The sum of all such quantities represents the aggregate present value of the arrangement. As in the case of pensions, benefits will be assumed payable yearly rather than monthly in order to facilitate computation.

The after-tax current equivalent of the device is then taken to be the annual after-tax salary increase which, if begun in the year the deferred pay agreement is made and promised the executive thereafter up to his retirement, would have the same present value. Since the individual in question might not live to receive all the indicated salary payments, a discount must be incorporated in the computations for mortality as well as for time deferral.<sup>6</sup> In Appendix F, formal mathematical expressions for the present value of a typical deferred compensation arrangement and for the determination of its after-tax current income equivalent are developed.

### *The Before-Tax Current Equivalent*

Having made these calculations, we can readily derive a "before-tax current equivalent." If it should turn out, for example, that a man age

<sup>5</sup> In Chapter 6.

<sup>6</sup> It could be argued that an after-tax current equivalent more in keeping with the nature of the deferred pay plan would be one which provided for an annual salary increase plus either a lump-sum award or a continuance of payments to the man's estate if he should die prior to retirement. While it is true that this scheme would resemble more closely the provisions contained in most contracts, it would not represent a truly "current" equivalent. Direct payments to the executive would constitute only a portion of such an arrangement and it would be incorrect, therefore, to describe it simply as a series of increments to salary, i.e., to current income.

55 is awarded a deferred compensation contract which has as its after-tax equivalent an increase in take-home pay of \$10,000 per year for the next ten years, its before-tax equivalent may be defined simply as the sequence of additions to actual before-tax salary and bonus paid during each of those years which would generate an extra \$10,000 annually after taxes. The magnitude of the requisite streams of both before-tax and after-tax increments may then be compared with the corresponding salary and bonus figures to measure the relative importance of deferred pay in the compensation package. Insofar as the "efficiency" of that package was also of interest, a further comparison could be made between the cost to the company of the contrived before-tax current equivalent, on the one hand, and the cost of the observed deferred pay arrangement on the other.

### *Summary*

Deferred compensation, as defined here, refers to the contractual agreements between corporations and certain of their executives under which a specified series of annual payments is to be made to an executive after his retirement. Such rewards are taxed at ordinary personal income tax rates when received. A deferred compensation scheme differs from a pension in that it pertains only to a single employee and generally has an aggregate dollar value which is not dependent upon mortality considerations. As with pensions, however, the relevant deferral and contingency factors are quantifiable. A "current income equivalent" can therefore be developed which enables the remunerative capacity of a deferred pay arrangement to be assessed and then compared with that of other forms of managerial compensation.