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To: Clients & Friends

Here is an interesting and timely article on tax planning for executives using a nonqualified deferred compensation (NQDC) plan. It discusses how to reduce current income taxes and potentially eliminate state income tax. Considering that this is enrollment season, these topics are very applicable.

The survey results also highlight the importance of a well designed NQDC for recruitment and retention. A whopping 67% of respondents say NQDC plans are important when selecting a new job and 55% say it influences their decision to stay with a current employer.

You may want to forward this to your plan's eligible group. Feel free to contact us if we can be of assistance.

- MBS Financial

Illustration: Gary Taxali

November 1, 2015   By: Liz Boyer

How Executives Can Minimize the Retirement Tax Hit

Employees who will cash in stock awards and deferred compensation can reduce tax burden by planning ahead

For many highly paid executives, retirement isn't just about capping off a career, or figuring out what they are going to do for the next phase of their lives. It's also about juggling large payouts from the stock awards and deferred compensation they may have accumulated over the years.

Executives can minimize the tax hit and smooth out income from such corporate perks in the early years of retirement, financial planners say, but it is important that they start the process one to two years before they plan to leave. Among other things, advisers recommend that executives take an inventory of what their short-term cash-flow needs will be in retirement and review company policies on how and when they can draw down deferred pay.

"For many executives, the year they retire is their biggest salary ever because of all the lump-sum payments" their plans mandate, says Lisa Brown, a financial adviser at Brightworth LLC in Atlanta who works with retiring executives. "Map out your plan."

Take a hypothetical executive with a $400,000 salary. In 2015, she exercises $40,000 of stock options and defers $50,000 of compensation to her company's nonqualified deferred-compensation plan. Her adjusted gross income for the year is $416,000, which also takes into account investment gains in her personal brokerage account.

She sets her retirement date for December 2016. At that time, according to her company plan, she'll trigger $600,000 of additional income for the year in the form of lump-sum payments from the deferred-compensation plan and accumulated company stock awards, boosting her adjusted gross income for the year she retires to more than $1 million.

By delaying the lump-sum payments until a few years into her retirement, when she is no longer drawing a salary, she could prevent her income from jumping so much in that first retirement year, says Ms. Brown.

Thinking Ahead

How employers and employees view nonqualified deferred compensation, or NQDC, plans

26%
Participants who anticipate a NQDC plan will provide 25% or more of their retirement income

86%
NQDC participants who are confident in their retirement readiness

Participants consider NQDC plans most important in...

Reaching retirement goals	82%
Deciding to take a new job	67
Deciding to stay with current employer	55

Important factors participants used to determine deferral amount

Estimated salary and/or bonus changes	77%
Overall investment portfolio	80
Performance of investment options	83
Progress toward savings goals	86

Why plan sponsors offer NQDC plans

To allow plan participants to save for retirement in excess of qualified plan limits	91%
To help retain key employees	83
To provide a competitive benefits package when recruiting key employees	78

Primary reasons for employer contributions

Retain key employees	40%
Restore lost 401(k) match limits	30
Motivate key employees to achieve organizational/personal performance goals	19

Source: Principal Financial Group 2014 Nonqualified Deferred Compensation Survey

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TO DEFER OR NOT?

Executives should consider all of the short-term cash-flow needs that will come up in the early years of retirement, including any money they may need to pay the taxes on stock-option exercises and to fund health and insurance needs, says Cathy Schnaubelt, a senior wealth strategist in Houston for Atlanta-based Atlantic Trust.

Those who have taken advantage of a nonqualified deferred-compensation plan in addition to their company's 401(k) may have a big decision to make. The nonqualified plans allow executives to defer part of their annual bonuses or other compensation to a point in the future, at which time it becomes taxable. Executives typically can elect to take this accumulated pay as a lump sum at retirement or opt instead to take payments starting five to 10 years after retirement and extending over time, essentially setting up an annuity-like income stream well into their retirement.

Most plans require this election to be made at least 12 months in advance of an executive's retirement date, and it can't be changed once it's made.

Executives who plan to move to a no-income-tax state such as Florida after retirement may be able to eliminate state taxes on deferred compensation by pushing out payments from nonqualified plans, says Andrew Liazos, an executive compensation attorney in Boston for McDermott Will & Emery LLP.

Those who have to take deferred compensation as an immediate lump sum may want to consider charitable giving through a donor-advised fund, says Scott Kaplowitch, an accountant at Edelstein & Co. in Boston, who recently helped a client set up such a vehicle with a $10 million lump-sum deferred-compensation payment. A donor-advised fund allows the donor to take an immediate tax deduction on the amount invested and decide over the course of years which charities will receive the funds. It also sets up the retiree's charitable giving for the long term, rather than having to factor annual giving amounts into retirement cash-flow projections, he says.

THE FINE PRINT

Some executives may find that delaying retirement into the next calendar year is beneficial, Ms. Brown of Brightworth says. It gives them another chance to make the maximum annual allowable contribution to their 401(k) plan and push out payments of vested stock and nonqualified-plan assets another year, which could be helpful if, say, the executive expects a financial windfall unrelated to work to boost his or her income.

Many advisers suggest executives delay taking Social Security payments for as long as possible, setting them up to start at age 70 to avoid adding to income in a year when large deferred-compensation payments may have to be taken.

As far as company stock awards go, it pays to review your company's policies. Some plans say those who retire earlier than a set time frame forfeit any unvested awards. Some plans require employees to meet age and years-of-service hurdles before being allowed to get all their deferred compensation-the standard is between 50 and 60 years old and 10 years of service. Some plans mandate an immediate lump-sum payout of vested stock for those who retire before meeting those requirements.

Check your plan to find out the dates that stock options have to be exercised or forfeited, says McDermott Will & Emery's Mr. Liazos.

When people are planning to leave a job, "it's never a bad idea for an employee to ask for an accounting of his or her benefits and compensation" he says, so these deadlines won't be missed. "It isn't uncommon for errors to be found. At least you can correct the errors while you're still employed."

Ms. Moyer is a writer in New York. She can be reached at reports@wsj.com.

About MBS:

Through a powerful combination of independence and experience, **Mullin Barens Sanford Financial and Insurance Services** (MBS Financial) is a leading consulting firm that assists companies with 409A and other executive compensation and benefit needs. Whether crafting a plan that balances employee retention with stakeholder interests, improving existing plan design and operation, or providing TPA search services, our clients have come to expect independent ideas and innovative concepts. Our custom solutions aim to reduce corporate income taxes, lower the cost of providing executive benefit programs, build assets for retirement, protect income, provide for heirs, and build legacies.



Kristi Barens
Principal
Main (310) 473-0060 ext. 700
Mobile (213) 359-8809
kristi.barens@mbsfin.com

John Sanford
Principal
Main (310) 473-0060 ext. 701
Mobile (805) 300-3161
john.sanford@mbsfin.com

Peter Mullin
Principal
Main (310) 473-0060 ext.703
peter.mullin@mbsfin.com

Mullin Barens Sanford Financial | 2242 Purdue Avenue | Los Angeles | CA | 90064