



Is It Time To Defer Compensation?

by [Steve Brown](#)  management

Summary: Many bank executives use deferred compensation to maximize their total earnings. It has many advantages and with the potential change in ordinary and capital gains rates, those advantages could increase. We define deferred compensation and then explain the two important ways that it can help executives optimize their compensation payouts.

Do you know the largest island in the world? Great Britain? Borneo in Malaysia? Actually, travel north and you will find it – Greenland. It is the largest in area with 822.7 sq. miles, owned by Denmark with a population of almost 57K.

While contemplating the size of Greenland vs. that tropical island you would prefer to visit, we bring you back to reality with deferred compensation. Do you currently have deferred compensation? If income tax rates go up, many bank executives will pay a larger portion in taxes — unless they enjoy deferred compensation. Deferred compensation plans have been popular for many years, but they may become especially valuable to community financial institution (CFI) executives, if ordinary and capital gains rates increase, as many experts think they will.

Deferred compensation is a common component of executive pay

Deferred compensation involves holding back substantial amounts now, then cashing in later on sums that have often appreciated in value. By strategically timing the payout, a bank executive may be able to absorb the hit of a higher income tax rate.

“The benefits of deferral are so strong that you can withstand a very large increase in tax rates,” says Timothy Kochis, founder of Kochis Global, a San Francisco-based consulting firm for wealth managers and their affluent clients. In fact, your income tax bracket would need to be above 44.7% to offset the value of deferring compensation for 5Ys.

Deferred compensation works its magic in two different ways

1. The first is through appreciation. When you are enrolled in a deferred compensation plan, your employer promises a minimum annual return on that compensation. That minimum annual return can outpace a tax rate increase.

For example, let’s say that you’re awarded an annual bonus of \$550K. You file as a single person and pay today’s top tax rate on earned income, 37%. You owe federal tax of \$203.5K, leaving you \$346.5K to spend or save. If you invest your money at 7.5% for the next 5 years, you’ll have \$437K (after paying capital gains tax).

Now let’s see what happens if you defer that bonus for 5Ys. Your \$550K earns 7.5%, so in 5 years it’s worth nearly \$790K. Your tax rate also grows over 5 years, to 39.6%. You take the deferred compensation and pay close to \$313K in federal tax, leaving you with \$477K. That’s \$40K more than you’d net by taking the bonus the same year it was issued, paying a lower tax rate, and investing the

difference. The advantage gets even stronger when you defer the compensation for longer than 5 years or if the rate of return is higher.

2. Deferred compensation's second method for saving you money on taxes? It lets you take income at a time that works to your advantage. Most executives defer compensation now to stay in a lower tax bracket, then cash it out in retirement. Your tax savings even comes with a financial cherry on top. Deferred compensation plan payouts aren't eligible for the 3.8% Obamacare tax, which top earners owe on their investment returns.

You may already be deferring compensation. However, if you aren't, it may be something to contemplate at this point in time. Talk to your accountant before making any decisions, of course.

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ECONOMY & RATES

Rates As Of: 08/03/2021 05:20AM (GMT-0700)

Treasury	Yields	MTD Chg	YTD Chg
3M	0.05	-0.01	-0.04
6M	0.06	0.01	-0.03
1Y	0.07	0.00	-0.04
2Y	0.18	0.00	0.06
5Y	0.66	-0.03	0.30
10Y	1.19	-0.04	0.27
30Y	1.85	-0.04	0.21
FF Market	FF Disc	IOER (Interest on Excess Reserves)	
0.07	0.25	0.15	
SOFR	Prime	OBFR (Overnight Bank Funding Rate)	
0.05	3.25	0.06	

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