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Deferred Compensation for Directors

By Jerry Simon

With the increase in director's personal financial risk, and the extra time commitment required to respond to shareholder and regulatory demands, directors are reducing their board commitments. Companies have no choice but to make board service worth the added effort.

Mechanics of Deferred Director Compensation

The objective of a competitive director compensation plan should be to increase the director's overall compensation without increasing the total cost to the company. The idea behind a deferred compensation plan is simple: A dollar received today is not worth nearly as much as the same dollar invested in a tax-deferred instrument and redeemed at a future date. The considerations for implementing a deferred compensation program are the same as when undertaking any new compensation program at a public company: the program should be transparent and understandable to all who read the public documents in which it is filed; the associated expenses should be comparable to any other director compensation program; and the plan should give the company the most bang for its director compensation dollar.

Under a compensation deferral program, the company does not have to pay out the director's cash component as it is earned, and therefore the company decreases total compensation expenses during the deferral period. Such programs also decrease the director's income by the amount deferred. For many directors this is a desirable feature: if they don't need the money in the current year, they often would rather have it accumulate in a tax-deferred instrument.

Director Summary: In order to attract qualified directors, companies are seeking more creative compensation solutions. The author presents one such alternative: Purchasing life insurance policies on the directors as a funding engine for a non-qualified deferred compensation program.

Investment Vehicles of Deferred Accounts

Most companies make management of director's deferred accounts very simple. The interest income from such accounts is usually 200-300 basis points over an agreed-upon index. Some companies use the 10-year Treasury Note or Moody's AAA bond rate—any easily available, recognizable, and independent index will do.

The investment instruments that companies use must fulfill the treasurer's standards: first of safety, then liquidity, and finally yield. Some cash-rich companies don't create a fund at all; they simply track the agreed-upon account appreciation for each director and pay the proceeds out of corporate cash flow when the time comes. Others create a sinking fund, managed by the treasurer as just another part of corporate cash. The company draws on the sinking fund when the time comes to pay the amounts previously deferred.

However, the company cannot recognize the amount deferred as a compensation expense in the current period. Some plans deduct the lost earnings on the foregone business expense deduction from the director's deferred income. This makes the company whole on the opportunity cost of not being able to deduct the director's compensation in the year it was earned. Of course, this comes back to the company when it pays out the deferral account.

Insurance Based Investment Vehicles

As an alternative to the above-mentioned investment instruments, many public and private companies purchase life insurance policies on their directors as the funding engine for their non-qualified deferred compensation program. The company uses the deferred fees, which it would have otherwise paid the director, to purchase a life insurance policy on the director, with the company being the policy owner and beneficiary. The life insurance cash value compounds on a tax-deferred basis during the deferral period.

The premium payments are not tax

deductible as a business expense, but the cash value continues appreciating over the life of the deferred compensation program. At some point in time, the accrued liability the company incurs for the money it owes its director becomes less than the cash value of the policy. As time goes on, this favorable gap continues to increase in the company's favor. The deferred compensation liability falls while the cash value of the policy rises.

When the director redeems his or her deferred compensation account, the company can surrender just the part of the policy equal to the principal and interest owed the director, and it can keep the remainder of the policy in force. Once the director dies, the company receives the death benefits as policy owner and beneficiary. Alternatively, the company can surrender the policy in full and pay the director in full—if the arrangement was structured correctly, both sides come out whole.

Since this plan is a non-qualified plan (unlike a 401(k) plan and other retirement plans which are qualified), in the event of company insolvency, the participant directors become unsecured general creditors of the company. If financial stability is an issue, many plans install triggers that require the company to achieve pre-defined financial benchmarks. For example, if the company incurs a predetermined number of consecutive quarterly losses, the director can have the right to accelerate payment and take the money owed.

Working Example

Let's assume that the annual cash component of a director's compensation is $60,000. Both the director and the company are in the 40 percent tax bracket. The company agrees with the director that his deferred account will gather interest at a rate equal to 200 basis points over the 11th District cost of funds—for this example, that computed rate is 6.3 percent. We'll also assume that the cash value appreciation rate on the life insurance policy used to fund the deferred compensation program is 7.5 percent. In practice the company only needs to fund the policy at 60 percent of the targeted payout because there are no taxes to account for.

The company keeps the face amount of the insurance policy as low as possible in order to drive up the cash value. Additionally, the policy should be construed as a regular insurance policy, rather than a Modified Endowment Contract (MEC). As an insurance policy, the contract is taxed only when money is paid out in an aggregate amount exceeding the cost basis (premiums) paid in; whereas a MEC is taxed anytime cash is released.

If the company did not have a deferred compensation program, and instead gave regular cash payments, the director's annual income after taxes would be $36,000 ($60,000 X (1 - 0.40) = $36,000). The cost to the company after taxes is the same $36,000. If the director retires from the board after 10 years, he will have received a total of $360,000—assuming he spends the money when received, rather than investing it.

However, under a non-qualified deferred compensation program, the director's income today would be zero. The annual premium cost to the company would be $60,000 for the life insurance policy on the director. The company must also pay taxes equal to the expense deduction they would have received had they actually paid the director. Therefore, the actual cash outlay for the company today is $84,000 ($60,000 + [$60,000 X 0.40] = $84,000).

If the director retires from the board after ten years, the value of his deferred account is about $853,000. Let's say he elects to take it all in a lump sum at the end of his tenth year of service: after taxes, that is about $512,000. Contrast this amount to the $360,000 he would have received as regular cash payments over ten years: the deferred plan pays about 42 percent more after tax.

The company, under the non-qualified deferred program, receives a tax deduction equal to 40 percent of the gross amount paid out during the year of disbursement—in this case, about $341,000, compared to the $240,000 ($24,000 tax payment X 10 years = $240,000) in tax deductions over ten years under the non-deferred plan.

The company can either cash out and retain any investment profit before tax, or it can surrender only the part of the policy required to fund its obligation and keep the rest as insurance on its now-former director. Due to the tax-free nature of life insurance proceeds, on the director's death the company will be that much further ahead—and it may choose to share the proceeds with the director's estate. The death benefit of the policy will enable the company to recover all its costs and to pay any contractual obligations to the director's estate.

Future Trends

Director recruitment and compensation will continue to be at the forefront of issues boards must address. The competition for qualified directors will continue increasing, raising demand. The supply of these qualified directors will likely fall as the number of boards on which directors are willing to serve declines, and companies will continue to seek more creative ways to attract qualified directors. ■

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