By David J. Silverman

Sooner or Later

Is deferred income a sure way to dodge the IRS? Don't count on it.

In a series of front-page articles that ran not long ago, the *New York Times* "exposed" how senior executives at major U.S. corporations were using deferred compensation plans to get away with murder. It certainly did appear that a lot of top honchos were paying very little tax on their oversize incomes. Yet I've got some news for them: If the *Times*'s crusade were somehow successful in getting the government to shut down these plans, the newspaper would be doing the chief executives of America and their trusted associates a favor they could never repay.

If I were in charge of things, deferred compensation plans would be required to have the following warning label: "This plan may be hazardous to your wealth." How could that be, you ask, when the captains of American industry are tripping over themselves to defer into the future as much pay as possible? Because deferring a tax doesn't mean you're escaping it. And when you ultimately get your hands on the dough, you may be in an even higher bracket than you are now.

But here's the real reason I go against conventional wisdom and advocate taking the cash now: Your current tax bill isn't the only tax you have to cope with. The other bill that will take a substantial bite out of your nest egg, after the $600,000 exemption, is the federal estate tax—at rates up to 55 percent. When I tell clients that their heirs may end up with only 20 cents on the dollar (after you factor in state and federal income and estate taxes), their responses range from disbelief to "Why don't they just take the whole thing?" The trick is not to let them. But to accomplish this you need to be in *control* of your money—not separated from it by having it on deposit with your employer.

Don't get me wrong. Putting money into a tax-sheltered account is the best way I know to save for your retirement. What you accumulate escapes tax until retirement, and most of us will probably be in a lower tax bracket by then. If you don't

contemplate any substantial estate tax problems, both you and your heirs will end up with more. But once you cross over the $600,000 amount that's exempt from estate tax, things take on a whole new dimension—and rather quickly.

Say you can defer $100,000 in compensation now, and you're figuring it'll be worth $200,000 in 10 years. If you are in the 40 percent tax bracket when you receive the $200,000, you will end up with $120,000, whereas if you took the $100,000 now, you would have only $60,000 after taxes. But if the $100,000 can double in 10 years, so can the $60,000. So the fact is, you've got $120,000—and you are no worse off. (Granted, you would owe capital gains tax on $60,000 in profits, leaving you with $103,200 at current capital gains rates. If you held on to the investment until death, though, there would be no capital gains tax.)

So which is the better choice? For many (wealthier) people, I say take the money now, even with the prospect of a capital gains tax. Why? Because it becomes yours now, not 10 years down the road (and that's provided nothing happens to the company you work for). Since you've had control of the money for all the intervening years, you could escape paying any estate or gift tax with only a minimum of planning.

On the other hand, if you choose deferral and die the day after receiving it, your heirs might end up with only $48,000 after state and federal income and estate taxes. That's right: All they would get would be $48,000. (To arrive at that number, I'm figuring a state inheritance tax of 5 percent.) So much for thinking someone was going to enjoy the whole $200,000. Unfortunately, it's usually the employee's heirs who discover how confiscatory our tax system really is.

QUALIFIED VS. NONQUALIFIED PLANS

DEFERRED COMPENSATION plans come in two varieties, qualified and nonqualified. It's been my experience that a lot of people aren't sure how they differ. So here's the drill: A qualified plan is protected by a strict set of pension laws. In addition to requiring that everyone in the plan be treated in a like manner and receive like benefits, the law specifies that what you and your employer set aside is protected from the claims of creditors. Some of the other aspects of qualified plans: The spouse of an employee must be provided with a survivor's benefit, the employee quite often has a say about how the money is invested and some plans are even protected by the government's pension insurance fund.

A nonqualified plan has none of these features. You're pretty much on your own. In fact, some nonqualified plans have a "bad boy clause," according to Harry Levitt, managing director of Mullin Consulting, a Los Angeles firm that specializes in executive benefits and compensation. This means that if you are fired for cause or go to work for a competitor, you could forfeit some or all of what you deferred. How's that for keeping employees in line?

So what's to like about a nonqualified plan? The thing that makes them so attractive to many top executives—besides the deferral feature—is that there are no limits to the amount that can be set aside, as there are with a qualified plan. Go ahead, ask the board of directors for as much deferred compensation as you want. You might as well.

Although there are a number of horror stories about companies going bankrupt and employees ending up with nothing, you should be aware that this happens only to the rank and file. The top dogs always make sure that whatever they set aside is protected—and earns a handsome rate of return to boot. But with the stock market up over sevenfold in the past 15 years, clearly you needn't be the CEO of General Electric or Coca-Cola to make out well. If you take what is due you, pay the tax and invest the money, while keeping a sharp eye on how to escape estate taxes, you will probably end up keeping a larger percentage than these top guys.

What Will Your Heirs End Up With?

How the estates of 13 famous people were picked over after they died.

	Total Estate	Taxes & Expenses	To Heirs & Charity	Shrinkage
Marilyn Monroe	$819,176	$448,750	$370,426	55%
Franklin D. Roosevelt	1,940,999	574,867	1,366,132	30
Robert Lehman	2,717,643	1,157,421	1,560,222	43
David Susskind	3,103,498	2,328,419	775,079	75
Sammy Kaye	3,271,206	1,491,565	1,779,641	46
Jascha Heifetz	7,397,271	2,555,879	4,841,392	35
Elvis Presley	10,165,434	7,374,635	2,790,799	73
Walt Disney	23,004,851	6,811,943	16,192,908	30
Danny Kaye	1,522,774	77,920	1,444,854	5
Andy Warhol	297,909,396	6,858,202	291,051,194	2
Alwin C. Ernst, CPA	12,642,431	7,124,112	5,518,319	56
Karen Carpenter	6,110,476	3,536,987	2,573,489	58
J.P. Morgan	17,121,482	11,893,691	5,227,791	69

SOURCE: ESTATE RESEARCH INSTITUTE

SOME ESTATE PLANNING BASICS

THE ACCOMPANYING table shows how a number of famous people left more to the government than to their heirs. Why did this happen? Because in order to reduce the value of your estate, you have to part with some of your wealth. And a lot of people are reluctant to do this. But there are many estate planning devices that allow people to have their cake and eat it, too.

SmartMoney covered these techniques thoroughly in the May 1996 issue ("Will Power"). But I'll tell you about a couple of my favorites. One is a grantor-retained annuity trust. You transfer assets that you believe will increase in value to a trust. You receive an annuity for a fixed number of years that you select. At the end of that period, the value of the assets in the trust passes to your beneficiaries, possibly free

from gift or inheritance taxes.

Two things have to be considered when setting up this kind of trust. If what you put in, less the value of the annuity, is more than $600,000, you are subject to a gift tax at the same rate as inheritance taxes. But if you placed $600,000 in trust 15 years ago and it kept pace with the stock market, you would have over $4 million that wouldn't be subject to a penny of estate tax. So for people who anticipate facing a large estate tax, it makes sense to use the $600,000 lifetime exemption as early as possible rather than waiting until they die. That way any appreciation escapes tax. One other thing to keep in mind: If you die while still collecting the annuity, the value of what's in the trust will be subject to estate tax.

Worried about Junior blowing all your assets once you're gone? Put them in a *discretionary* trust.

The reason a lot of people are reluctant to place money in trust for young children is this: What if the parents' worst nightmares come true? What if one of their children ends up on drugs or gets into all kinds of trouble with the law? With a *discretionary* trust, you can provide that the kid gets nothing or only a modest amount if he misbehaves, notes Michael Schlesinger, an attorney in New York who specializes in tax law.

One other popular device these days is the charitable remainder trust. It pays you an income for life; you even get a current charitable deduction for part of what you put in the trust. The charity gets the remainder when you die. And this is just scratching the surface; there are a whole lot of other ways to keep the Internal Revenue Service out of your estate. The resourcefulness of the high-paid attorneys and accountants who devise these methods is truly amazing. Their latest creation making the rounds: the JOLT, which stands for "Jackie O. Lead Trust." With it, a charity gets the income for 24 years, with the balance then going to the grandchildren. Now that's what I call deferred compensation. SM

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