McLagan Alert

The Perils of Pre-Pays

By Warren Rosenstein and Brian Dunn
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Over the years, some companies have actively managed the timing of incentive compensation in anticipation of tax rates changing. While there has been a fair amount of speculation around this recently, to date, there has been more discussion than any real action on this front.

With a high probability that the Bush tax cuts will not be extended to the wealthiest segment of the population (e.g., those earning more that $250,000) many executives are pushing for accelerated bonuses so that incentive compensation delivered for performance year 2010 actually gets delivered in the 2010 tax year (e.g., by 12/31/10). For many practical reasons, most firms currently will pay 2010 bonuses in the first quarter of 2011. While the pre-pay option may have initial appeal, please consider the following:

NEGATIVE PUBLICITY

With the financial services industry still reeling from the multiple black eyes it has absorbed over the last two years, it is likely that the public reaction to a firm attempting to reduce their employees' tax obligations would be a very negative one. In a climate where taxpayers are still stinging over their contributions to a bailout, any indication that the recipients of this bailout are attempting to not pay their share would likely set off a maelstrom of negative publicity.

UNINTENDED CONSEQUENCES

While it may seem clear which way tax rates are heading, it remains possible that speculation may be misguided. Firms loading more comp dollars into 2010 may actually push some number of less highly compensated employees into even higher marginal brackets for 2010, absent any rate change in 2011.

LOGISTICS

There are a few approaches that are typically considered - some make more sense than others.

Firms can consider doing a pre-pay based on a percentage of prior year bonus. For example, Firm XYZ, which typically delivers incentive comp in February, may decide to prepay 50% of the prior year bonus to employees in December. However, here are a few concerns with this methodology. Some employees may be working in lines of business that have had a significant decline in performance. Firms may inadvertently deliver more incentive compensation to some number of employees than intended. Another problem with this method is declining individual performance. An employee receiving a pre-pay of 50% of prior year incentive pay may have performed poorly in 2010 and not merit an incentive payment of this size.

Another technique is to deliver a flat payment to employees above a certain title threshold. Consider Firm ABC, which may deliver 250K to all MDs, as an advance on their bonuses. The same concerns listed above are still material: would some low performing employees, or employees in low performing businesses be receiving more compensation than intended?

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TIMING

One of the most challenging parts of implementing a plan like this is when you pull the trigger. In a year where business results are improving on a quarter-over-quarter basis, it is easier in November to decide to make a pre-payment as you are riding increasing results. 2010 has been a year that started strongly, but performance has diminished over time. It may be nearly impossible to accurately forecast year-end results.

Also, it is clear that no decision on 2011 tax rates will be made until after the November elections. By that time, it may be too late to create an accelerated bonus determination process.

UPSIDE

So, is there any value at all in firms considering this? Perhaps. If you are a small firm, likely to fly beneath the radar of the press, the regulators, etc., it may be possible to have a tight process where very late in the year, you can single out a group of employees where such actions are truly tax advantageous and deliver what will likely be perceived as a benefit. A program of this sort is likely to be appreciated by recipients, so there is some value in that regard.

OVERALL

It seems hard not to think that there is more risk / downside than upside in this case. My expectation is that this will heat up as a topic of discussion in the next few weeks, and then, as firms strategize about how to modify their deferral schemes, to better account for risk in their bonus pool funding, to anticipate and react to regulatory guidelines, and to make certain they are staffed appropriately for the challenges and opportunities of 2011, become a back-burner issue, and finally, not an issue at all.

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