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Mitigating the Risks of Non-Qualified Deferred Compensation Plans

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Author of *Managing Concentrated Stock Wealth*, 2nd Edition, Bloomberg, 2016

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I have long been a fan of non-qualified deferred compensation plans…but with important caveats. The recently heightened risk of corporate bankruptcy due to the deep economic contractions brought on by the COVID-19 pandemic raises one of those caveats to a level that every plan participant must take into very serious consideration. A risk management tool, recently created by StockShield, may turn out to be a way to soften that particular risk of the sponsor's insolvency for large deferred account balances. The other key caveats remain.

Why Defer Compensation?

In decades past, corporate executives were motivated to defer currently available compensation to some later time when, presumably, their tax rate exposure would be lower. This could occur either because the executive planned to move, after employment, to a state with lower or even zero taxes with the belief, often correct, that the employment state wouldn't be able (or sufficiently motivated to try) to tax benefits paid at that later point. In fact, states are prohibited by federal law from imposing income taxes on deferred compensation paid to former residents if the payments occur in installments over 10 or more years. This may be of little help for those senior executives who often favor short-term payouts after leaving the comfort zone of confidence in their employer's financial wherewithal…and good will…after they are no longer part of the leadership group.

More universally, *federal* tax rates used to be much more steeply graduated, with maximum rates much higher than today. Not many remember the 70% rates of the 1970s, much less the 90%+ marginal rates of the early 1960s. In those times, the expectation of having much lower rates after retirement than during employment was justification enough to motivate tax deferrals.

As marginal rates came down to the 50% range, and in more recent times, to 35-40% rates, more than just tax rate arbitrage from high rates before to lower rates after retirement was necessary to reward executives for agreeing to forego current compensation and to justify accepting the risks of that deferral. The payoff was some form of investment return on the amounts deferred. This "return" was, at first, typically some form of fixed income measure, like Treasury Bills or the prime rate. As equity investment returns proved their long-term superiority, most deferred comp plans also adopted equity options, such as the S&P 500 Index. Some plans even permit individual executives to construct a custom portfolio to be the measure of returns on deferred amounts. Because of the deferral of the tax liability, these "*pre-tax*" returns within a deferred comp plan become the equivalent of "*after-tax*" returns that would have to be achieved outside the plan if no deferral occurred.

Transforming Pre-tax Returns into After-tax Returns	No Deferral	Deferral
Compensation	$10,000	$10,000
Current tax (38.45%...1.45%*)	(3,845)	(145)
Net Investable	6,155	9,855
5 years at ***4% after-tax***	7,488	
5 years at ***4% pre-tax***		11,990
Tax at Receipt (37%*)	N/A	(4,436)
Net in 5 years	**$7,488**	**$7,554**

** In an ironic twist of tax fortune, the unlimited 1.45% Medicare tax is imposed at the outset, even if the compensation is deferred…but not at the time the deferred amounts are actually paid, making the pre-tax to after-tax advantage even a little better.*

This transformation of pre-tax into after-tax…at no increase in investment risk…is the essential genius of non-qualified deferred compensation plans. If the caveats can be overcome, there is probably no better investment vehicle for executives who have already exhausted their opportunities under qualified plans and IRAs. This is especially true if the deferred comp plan has return options that themselves present diversified exposures to desired components of the executive's overall portfolio. The deferred comp plan, from a diversification perspective, should not stand alone but should be an integral part of the executive's aggregate investment architecture.

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Higher Future Tax Rates?

If tax rates at the end of the deferral period are lower, then this already sweet deal becomes even better. But given how low rates are at present and the tone of the current political environment, lower rates in the future seem improbable. If anything, rates could go up. Would that spoil this opportunity? Well, it depends on how soon and how much. As illustrated below, the tolerable future tax rate to "breakeven" between deferring or not deferring is a function of the return opportunities in the plan relative to the returns available on the outside and a function of the length of the deferral.

Tolerable Future Tax Rates given 37% Rate Today*

After **Tax rates available outside the Plan**	**4%**	**4%**	**4%**
Pre-tax Rates inside the plan	5%	7.5%	10%
3 years of deferral	**39%**	**43%**	**47%**
5 years of deferral	**40%**	**46%**	**52%**
10 years of deferral	**43%**	**55%**	**64%**

** Ignoring the 1.45% Medicare tax advantage deferrals enjoy. Taken into account, actual tolerable future rates could be even little higher*

If returns in the plan are modest relative to outside opportunities, not much increase in tax rates would be tolerable. But if the inside return rates are strong and the deferral period is long, tax rates would have to rise a lot before this concern becomes a significant barrier to participation. Not many executives fear marginal rates returning to the 60% territory.

Payment Risks

Let's put one of these payment risk caveats quickly to the side. That is the risk of the employer's unwillingness to make payment. This rarely occurs but the risk

is real, especially with very long deferrals during which there has been a change in control, especially an "unfriendly" one. While there is a contractual obligation to pay, employers can make collection an expensive and time-consuming matter, hoping to settle for less than the nominal obligation. To combat this, some arrangements put the actual deferred amounts, plus their earnings during the deferral period, into an irrevocable trust to cover the eventual obligations of the plan. Sometimes referred to as Rabbi Trusts, these can mitigate this recalcitrance risk.

But such a trust can't resolve the solvency risk. In order to not be taxed at the outset of the deferral opportunity, the executive must meet certain timing and eligibility requirements and the funds deferred must not be formally set aside to eventually pay the deferred obligation. That payment must be and remain an *unsecured* obligation of the employer, subject to the claims of all the employer's other creditors…even any assets in a Rabbi Trust. This confidence in overcoming the solvency risk is the most crucial caveat and one that is now especially relevant.

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If the employer's solvency is currently suspect, an executive should limit the deferral to an amount that he or she can afford to lose completely. Maybe the payoff would be very big if things work out well; but if not, can one afford the loss? For very well-to-do executives, often the answer is yes. If the complete loss of the deferral is not affordable, then, obviously, one should pass on the new deferral opportunity.

But what about existing deferred accounts? If the solvency of the employer is already suspect, there is not much that can be done except to hope for the best. With few and narrow exceptions*, the tax law does not permit acceleration of prior deferrals. And it only permits postponing deferrals even longer (in hopes that the company's financial circumstances will eventually improve) by electing to further postpone the payment. The new election must be submitted more than 1 year prior to the originally scheduled payment date, and the new payment date must be at least 5 years beyond the originally scheduled payment date. That advance precision would require a particularly clear crystal ball.

**Limited exceptions exist to the anti-acceleration rule. These exceptions vary from plan to plan, but they generally apply to pre-2005 balances and to circumstances not under the participant's control, such as death, disability, change-in-control, plan termination and/or an unforeseeable financial emergency. That "unforeseen emergency" doesn't include the anticipated insolvency of the employer.*

Pooling the Risk

The risk of any company's bankruptcy is always present, and recent, severe economic circumstances have made that risk a sobering and surprising reality for several firms including JC Penney, Nieman Marcus, Brooks Brothers, Hertz, Chesapeake Energy, and Diamond Offshore Drilling. So even firms that appear financially strong today may become unable to make good on all or even any of their deferred compensation arrangements when the time comes for payment.

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I've recently been introduced to a novel arrangement just created by StockShield (www.stockshield.com) that may prove to be an effective remedy for executives with large deferred comp balances. Through their "Deferred Compensation Protection Trust," a sizeable number (10 or more) of deferred compensation plan participants, from a diversified group of solvent companies, each contribute an annual amount, as if an insurance premium, for a period of 5 or 10 years. The premiums are invested in Treasury instruments to eliminate any default risk. To keep the pooling equitable, each participant must protect an equivalent deferred comp balance (say, $1 million) and must pay a premium that reflects the current solvency risk of the employer.

The annual premium might be in the neighborhood of 1% of the "insured" balance, so $10,000 per year for a $1 million deferred compensation balance. At the end of that timeframe, if any bankruptcies have occurred, the participants in bankrupt plans share the proceeds of the pool up to the amount of the initial insured balance. The others share whatever is left after StockShield has covered its costs and profits. It is possible no bankruptcies occur, in which case the pooled cash is refunded back to participants, less any applicable fees and costs. This possibility…even likelihood…of getting almost all of the premium back significantly reduces the cost of insolvency risk protection.

Clearly, this won't be a solution for executives with relatively small balances or those who don't have the wherewithal to pay an additional, substantial "insurance" premium. But for those many executives with very large existing deferred accounts, this could be a very worthwhile option.

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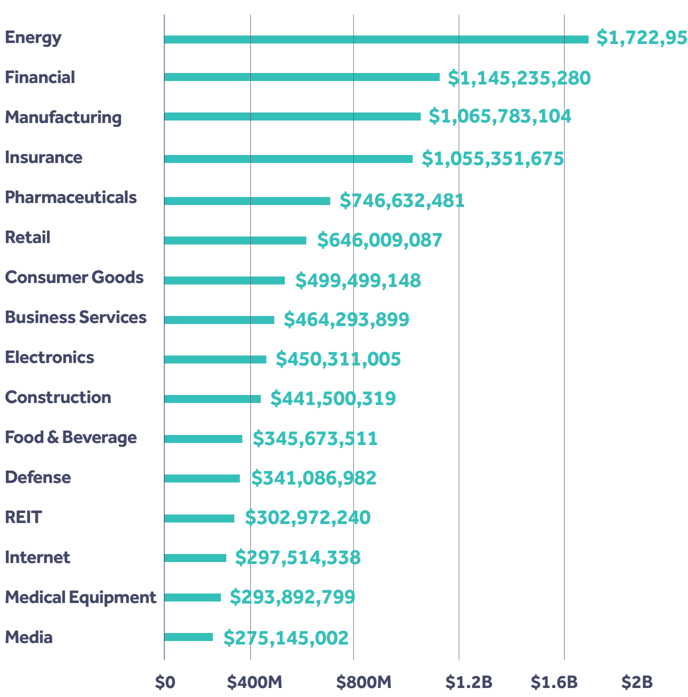
Non-Qualified Deferred Compensation of S&P 500 Companies: Account Balances of Named Executive Officers based on 2020 Proxy Disclosures



Non-Qualified Deferred Compensation of S&P 500 Companies: Cities with the Largest Account Balances based on 2020 Proxy Disclosures

** The total for Washington DC includes $406 million for the CEO of one company.*

Diversifying Concentration Risk

For more modest account holders, the appropriate protection is a careful assessment of how much risk is affordable. Concentrating too much of one's wealth in the unsecured promises of one company is even less safe than not diversifying risks among many investment options. As in every other financial decision, the threshold question is how much one can afford to lose.

Please note this article is intended to apply only to *voluntary* compensation deferrals…not the very common *supplemental* plans that many employers also provide. Most supplemental plans represent only *employer* contributions, so long as an employee is not required to forego some other benefit, these plans are very attractive despite potentially higher tax rates in the future and insolvency risk. The investment returns, whatever they are after taxes and after insolvency risks, are in effect infinite. Even if the result turns out to be zero, the employee invested no compensation amounts. Still, like voluntary deferral plans, supplemental plans can also be protected from insolvency risk with the Deferred Compensation Protection Trust from StockShield (www.stockshield.com).

Summary of Key Take-Aways

If the following caveats can be overcome, there is probably no better investment vehicle than Non-Qualified Deferred Compensation for executives who have already exhausted their opportunities under qualified plans and IRAs.

Caveat	Potential Solution
Risk of Higher Taxes in the Future	Robust Pre-Tax Compounding of Returns over Relatively Long Deferrals **and/or** Retiring in a Low-Tax State and Taking Payments Over 10+ Years
Recalcitrance Risk (Change of Heart)	Rabbi Trust
Bankruptcy/Insolvency Risk	Deferred Compensation Protection Trust

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About the Author

Tim Kochis founded Kochis Global in 2012 to foster best in class wealth management and investment planning services. For many years he has had a special interest in the developing world, particularly in China and other rapidly growing markets in Asia. Tim Kochis has over 47 years of experience in financial and investment planning. He has advised a select group of executives, professionals, and business owners throughout the United States and overseas since 1973. Before founding Kochis Global, Tim served as CEO and then as Chairman of Aspiriant and was a founder of Kochis Fitz, one of its predecessor firms. Prior to that, Tim was National Director of Personal Financial Planning for Deloitte & Touche (1985 – 1991) and for Bank of America (1981 – 1985).

Tim has long been recognized as one of the key leaders of the wealth management and investment planning profession and has had an unparalleled influence on its development, worldwide, through his long and extensive client service, his success in building and growing the leading organizations within the profession, his service in professional and educational organizations, and his extensive writing and very frequent speaking engagements to professional audiences around the world.

Tim recently completed his second term on the Board of Directors of the Financial Planning Standards Board, the international certification authority for the CFP® credential, having previously served on its Board at its founding in 2004 and as its Chair in 2005.

Past professional responsibilities have included:

- Chair of the Board of Governors of the Foundation for Financial Planning.
- Chair of the International CFP®(Certified Financial Planner) Council.
- President of the Certified Financial Planner Board of Standards, the US CFP® certification authority.
- Chair of the Board of Examiners of the CFP® Board.

As chair of the Board of Examiners, Tim was responsible for supervising the creation of the first comprehensive examination now used throughout the profession to qualify CFP® candidates. In addition, he was a co-founder of the Personal Financial Planning Program at University of California-Berkeley, one of the first accredited financial planning programs in the United States, where he taught for eighteen years. Many hundreds of currently practicing wealth management professionals were his students.

Tim serves on the Board of Trustees of the ETF and Mutual Funds business unit of the Charles Schwab Investment Management organization. Tim also works with DeVoe and Company as Special Advisor, supporting US-based RIA's with management consulting, particularly on matters relating to management and equity transition.

Tim also devotes considerable effort to philanthropy and civic involvement. Tim currently serves on the Boards of the University of San Francisco, The Asia Foundation, the 1990 Institute, and as a member of the Investment Committee of The Asian Art Museum of San Francisco where he finished a 12-year term as Trustee in June, 2017.

Tim earned a BA in Philosophy from Marquette University (1968), a JD degree from the University of Michigan (1973), and an MBA from the University of Chicago (1979). Tim served in the US Army from 1969 to 1971 including a tour of duty in Vietnam where he received a Purple Heart for wounds received in action.