

OUTSIDE-IN Compensation And Staffing

# Solving for insolvency



The heightened risk of corporate bankruptcy amid the pandemic poses a threat to savings held in nonqualified deferred compensation plans

October 5, 2020 *By Tim Kochis*

I have long been a fan of **nonqualified deferred compensation plans** — with important caveats. The recently heightened risk of corporate bankruptcy as a result of the economic contractions caused by the COVID-19 pandemic raises one of those caveats to a level that every plan participant must very seriously consider. The other caveats remain, but insolvency of the sponsor is now probably the most urgent.

## WHY DEFER COMPENSATION?

Because of the deferral of the tax liability, pretax 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. This transformation of pre-tax into after-tax — with no increase in investment risk — is the essential genius of nonqualified 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.

## HIGHER FUTURE TAX RATES?

For deferral to make sense, future tax rates don't need to be lower. Rates can even go up, depending on how soon and how much. The tolerable future tax rate to "break even" between deferring or not is a function of the return opportunities in the plan, relative to those outside, and also a function of the length of the deferral. If the return rates in the plan are strong and the period is long, federal tax rates would have to rise a lot (to 60% or even more) before this concern becomes a barrier.

## PAYMENT RISKS

There are two different payment risks: the employer's willingness to pay and its ability to pay.

An unwillingness risk is rare but real, especially with long deferrals during which there has been an unfriendly change in control. Employers can make collection an expensive and time-consuming matter, hoping to settle for less than the nominal obligation. "**Rabbi trusts**" are frequently used to mitigate this recalcitrance risk.

But such a trust can't resolve the second payment risk. The IRS requires that the promised payment must remain an unsecured obligation of the employer, subject to the claims of all the employer's other creditors.

So, if solvency is currently suspect, participants should limit any new deferral to amounts they can afford to lose completely. For existing deferred accounts, there is not much that can be done except to hope for the best. Generally, tax law does not permit acceleration of prior deferrals to avoid prospective default.

## RISK POOLING

The recent economic upheaval has made solvency risk a surprising reality for **several companies**, including **Neiman Marcus** and Hertz. Even companies that appear financially strong today may become unable to make good on their deferred compensation arrangements.

I've recently learned of an arrangement created by **StockShield** that may be a remedy for large deferred comp balances. Through its Deferred Compensation Protection Trust, 10 or more deferred compensation plan participants, from a diversified group of solvent companies, each contribute an annual "insurance" premium, for five or 10 years, that's invested in Treasury instruments. Each participant protects an equivalent balance (say, \$1 million) and pays a premium that reflects the sponsor's current solvency risk.

The annual premium might be 1% of the "insured" balance, so \$10,000 per year for a \$1 million balance. At the conclusion, participants in any bankrupt plans share the proceeds of the pool up to their insured balance. The others share whatever is left after StockShield has covered its costs and profits. If there are no bankruptcies, the pooled cash is refunded, less any applicable fees and costs.

As in every investment decision, the threshold question is how much can one afford to lose? If there is a lot at stake, some StockShield insurance might be a very smart move.

Tim Kochis is CEO of **Kochis Global** and author of **Managing Concentrated Stock Wealth**.