

Protecting the Downside Risk of Nonqualified Deferred Compensation Plans

An Informative White Paper for Corporate Executives Participating NQDC Plans

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Eighty percent of Stuart's net worth was tied up in his deferred compensation plan—more than \$10 million dollars. As a high-earning executive, he'd taken advantage of his employer-sponsored nonqualified deferred compensation (NQDC) plan and set aside bonuses and salary over several decades to grow tax-deferred for his retirement. He took advantage of the 15-year retirement payout to spread his tax liability out over several years and maximize his benefits. His \$5 million account balance now becomes worth over \$7.7 million, assuming he earns just six percent on his balance.

But he worried. Nearing retirement, Stuart couldn't shake the concern that his money may not be safe. He knew executives who had lost everything in their employer's bankruptcy. What if something happened to his company before his payout? What if new management stepped in and ran the company into the ground? What if a private equity firm took over the company and loaded it with debt?

All these unknowns concerned him. The fact that he already made his election for payout under §409A also was a concern as he couldn't accelerate payments unless he terminated his employment, which was not an option.

Stuart's worry turned to fear once he did his homework. While the balance in his qualified 401(k) plan is protected from creditors under Employee Retirement Income Security Act (ERISA) law, his NQDC money is not. In fact, he is nothing more than an unsecured general creditor, forced to stand in line behind legally protected creditors in a corporate bankruptcy.

Risks of NQDC Plans

Prior to the adoption of IRS §409A and the financial crisis of 2008, the risk of loss for deferred compensation was not viewed as very significant by most executives, especially if they worked for a large, publicly traded company. Prior to the adoption of §409A, which became effective January 1, 2005, risks could be mitigated with various protection features in the plan.

One such provision, called the “haircut provision,” allowed executives the opportunity to take a 10 percent haircut (pay 10 percent of account balance to employer) for the right to take an accelerated payout at any time for any reason. So, if you saw your employer’s financials moving south, you could pull your money out even in retirement.

In the weeks before it filed for Chapter 11 bankruptcy protection, Enron allowed a small group of executives to withdraw their money (taking the 10 percent haircut) from a deferred compensation program. This act gave them preferential treatment over some former managers who had also requested early withdrawal, according to former and current executives at the company.

IRS §409A closed that loop hole, making it far more difficult to withdraw money from NQDC plans. The IRS also implemented a process for employers who terminate plans, making it impossible to get your dollars immediately.

So, post 409A, the decision basically comes down to a trade-off between potential income tax savings versus the risk of losing your savings in the event of your employer's financial collapse.

It is difficult to estimate total tax savings because in certain individual circumstances, the tax deferral is quite attractive, especially for those executives in high- income tax states.

For those who plan where they retire, the government gives them benefits under the Source Tax Rules. If a participant elects at least 10 years of payments from the NQDC plan, he would report state income tax in the state where he or she resides at the time of payout. This provision is another major tax benefit for those in high-income tax states who relocate to lower tax states at retirement.

Next, you must compare that tax savings to the risk of total loss, if your employer goes under. This risk is tough to quantify. But it certainly isn't zero.

Over the last ten years, a number of large companies went under, or barely avoided going under thanks to government bailouts. No company can count on bailouts. Over a 20-year cycle, what is the risk of a potential bankruptcy?

Truly nobody knows, but given events of the last decade, combined with the restrictions of §409A, I ballpark bankruptcy risk at somewhere between one percent and three percent, even if you do work for a major company. And smaller companies may be more at risk, especially a private company.

Since the consequences could be devastating for you, even a one percent probability may be too high when weighed against the overall tax benefit.

The bottom line: Deferred compensation plans offer some tax savings but expose your money to a complete risk of loss. You'll have to decide if the tax savings are worth it. But the last decade has highlighted systemic risks that we didn't think existed. I would take note.

Probability of Employer Bankruptcy

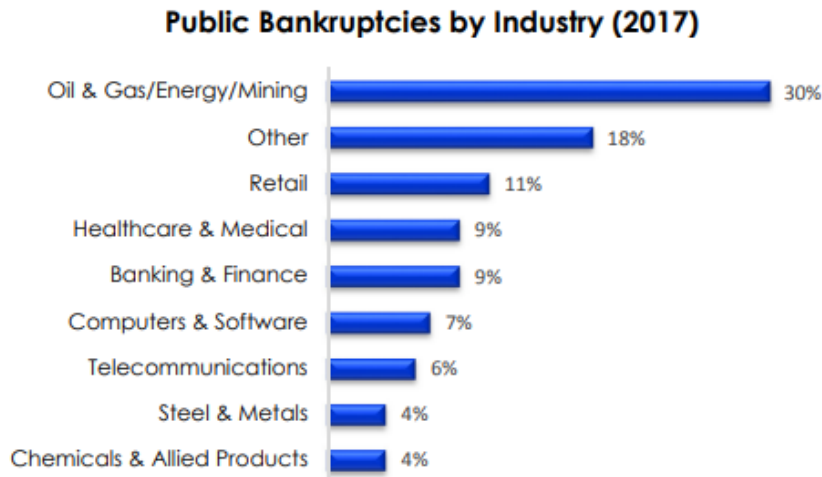
Employer bankruptcies occur all over the country and in all business sectors, particularly this last decade. On a long list of brand names appear American Airlines, General Motors, PG&E, Radio Shack and Trump Entertainment, all filing for bankruptcy to reorganize or leave the business altogether. A market leader one day whose disrupted by new technology, markets, or competitors can become an also-ran. Look at what happened to Kodak with the digital camera.

Consider this year alone. The retail sector continues to suffer the disruptive effect of online sales. As of March 2018, *Business Insider* reports that S&P Global Markets has already identified 19 major retailers most at risk of defaulting next.

- 99 Cents Only Stores LLC
- Bluestem Brands, Inc.
- Claire's Stores, Inc.
- David's Bridal, Inc.
- Everest Holdings, LLC
- Evergreen AcqCo 1 LP
- FULLBEAUTY Brands Holdings
- Guitar Center
- J. Crew Group, Inc.
- Neiman Marcus Group
- New Academy Holding Co. LLC
- Payless
- PetSmart Inc.
- Sears Holdings
- SSH Holdings
- Steak 'n Shake Inc.

Neiman Marcus and the 99 Cents store? Who could've imagined their undoing?

Let's look at the latest data on public companies by sector:



Source: BankruptcyData's 2017 Corporate Bankruptcy Review

New Generation Research's *BankruptcyData* identified that the “uptick in public¹ company bankruptcy filings since 2014 reversed this year, with **2017's bankruptcy count decreasing 28%.**”

However, an earlier analysis by BankruptcyData indicated public company bankruptcy filings increased by more than 25 percent in 2016 on top of the 48 percent rise seen in 2015.

A total of 99 publicly traded companies filed for Chapter 7/Chapter 11 protection in 2016, including 25 with assets greater than \$1 billion—compared to 19 in 2015.

The Bright Side of NQDC Plans

Before we layout your protection solution, it is only fair to review the benefits of NQDC plans. Some companies set up these plans as simply savings plans for highly compensated employees to defer compensation over and above their 401(k) plan limits which, in 2018, tops out at \$18,500. More progressive companies see NQDC plans as strategic tools to attract, retain, and reward key talent.

According to the 2017 Prudential/PLAN SPONSOR Executive Benefits Survey, 78 percent of respondents said their plans were established as retirement savings vehicles; 71 percent to restore deferral opportunity limited by qualified plan restrictions; and 72 percent said it was to attract and retain executive talent.

While NQDC plans are roughly 90 percent prevalent in the Fortune 1000, many small to mid-size businesses are only now embracing them, having come to understand their inherent benefits to:

- Recruit, retain, reward and motivate key talent
- Reward employees without a direct equity interest
- Replace equity-based comp packages (company stock/stock options) at a lower cost
- Allow private companies to compete with public firms to protect talent pools
- Create tax-leveraged financial security for key talent²
- Provide supplementary benefits to executives maxed out by limits on qualified plans
- Minimize or eliminate tax law discrimination against the highly compensated

If you've read this far, you are likely a beneficiary of a corporate-sponsored NQDC plan and believed, until now, that your money was safe. You're not altogether wrong.

However, read with caution. The “unfunded” nature of NQDCs pulls the executive beneficiaries to the back of the line in the rush of first-position creditors who seek recovery of whatever assets remain in the company. Unfunded plans are more widespread than funded plans because they provide the benefit of tax deferral yet avoid most all of ERISA's onerous requirements. Funded plans must comply with ERISA, which mean limited deferral opportunities.

Don't confuse "funded" and "unfunded" arrangements. Because your employer set up a rabbi trust¹ and put assets in the trust like mutual funds or life insurance, the IRS views that arrangement as "unfunded" since those assets are subject to general creditor claims of the sponsoring employer.

The unsecured general creditor status of unfunded NQDC plans often forces participants to take lump-sum distributions, which denies them the advantage of tax deferral and deferral compounding on a tax-deferred basis.

Tax benefits versus risk—we content executives or highly compensated employees who participate in NQDC plans may not understand the nuances of gain or loss. For example, the long bankruptcy proceedings of Lehman Bros. left employees in a position no better than subordinated bondholders. They lost everything.

Executives of the twice-bankrupt *Reader's Digest* were equally wiped out, though they did receive three cents on the dollar. Let's say they accumulated one million dollars in their NQDCs; they walked away with \$3,000, not enough for even a decent vacation.

Traditional Ways to Protect NQDCs

As these plans went into effect decades ago, triggered by the inequity between high- and low-income earners caused by ERISA, several mechanisms emerged to protect account balances.

Many plans adopted a rabbi trust arrangement to provide protection against the company's unsecured promise. Remember, in effect, your NQDC plan is an IOU from your employer to pay your retirement savings at some point in the future, depending on your distribution elections. Some 80 percent of plan sponsors use rabbi trusts as benefit security, cites a study by Mullin/TBG, a business unit of Prudential Retirement.

¹A **Rabbi Trust** is a non-qualified deferred compensation arrangement in which funds are invested in an irrevocable **trust** to be held for the benefit of employees for retirement purposes. Many companies use this arrangement to protect assets against change-in-control of the company or default by the employer. These assets are subject to the claims of general creditors and do not protect the executive against corporate bankruptcy.

Rabbi Trusts

A rabbi trust is established by the company sponsor to hold assets, separate from the other company assets, for purposes of paying future participant benefit obligations. However, for the plan and the participant accounts to maintain their tax-deferred status, the assets of the rabbi trust are available to general creditors of the company **in the event of the company's insolvency**. So, your protection is limited. Protection only extends to change in company control, change in company policy on paying benefits, or change in the company's financial condition, *short of bankruptcy*.

Credit Default Swaps

One exotic form of NQDC plan protection is the somewhat maligned credit default swap (CDS), designed to protect against credit risk. For example, an executive could buy a CDS against his company's bonds, assuming he doesn't own company stock outright and company creditworthiness is not in question. If the company goes bankrupt or defaults on its bonds, payment from the CDS could cover the NQDC balance.

But this approach carries its share of thorns. First, a CDS must be bought by an institution, not an individual, adding to the complexity of acquiring one. Second, they're quite expensive in the high-five figures. Third, and most important, you cannot buy a swap to stretch beyond a ten-year period without an impossibly expensive renewal. Then, this becomes an exercise in balancing risk. Because to gain a worthwhile tax benefit from the NQDC, you need a tax-deferral period beyond ten years.

Enter the Deferred Compensation Protection Trust™

StockShield recently developed the Deferred Compensation Protection Trust™ (DCPT) following the successful market entry of our Stock Protection Trust™, for which it owns the patent. The Stock Protection Trust substantially reduces your stock's downside risk while preserving its unlimited upside potential, especially beneficial for those executives holding concentrated stock positions.

As a risk management mechanism, the DCPT delivers affordability, tax-efficiency, ease-of-use, complete transparency, and it is simple to understand. Think of the DCPT as a non-traditional risk mitigation strategy that protects corporate executives from losing their entire NQDC account balances. In effect, it hedges the downside risk of holding your retirement assets on the dark side of the moon, so to speak, where your employer's IOU may be hidden, too.

The DCPT is built on the time-tested principles of both Modern Portfolio Theory and risk pooling. By using risk pooling, one can spread similar financial risk—cost-effectively— across multiple participants in a self-funded plan to protect against losses. What's more, this combined approach transforms single-account/single-company balance risk, allowing investors to mutualize, or substantially reduce downside risk, while retaining all future appreciation of their NQDC assets and income.

How the DCPT Works

Twenty investors, each with a \$5 million account balance² in an NQDC plan, sponsored by a different company in a different industry, contribute \$500,000 (net of a one-time placement fee equal to one percent of protected NQDC value) into the DCPT (20 x \$500,000 = \$10 million). StockShield also structures a five-year trust.

For ten years, the cash is invested in 10-year U.S. Treasury Bonds. At the end of the 10-year term, the assets pooled in the trust are paid based on the following number of bankruptcies:

Zero Bankruptcies

Each participant receives their money back net of 1% placement fee: \$500,000
Annual cost of 10 years of protection: \$5,000
($\$50,000$ placement fee divided by 10) = **0.10%**

One Bankruptcy

The beneficiary of the bankrupt NQDC plan receives \$5,000,000.
Each of the other 19 participants receives \$263,157.90
Annual cost of 10 years of protection ($\$550,000 - \$263,157.90 / 10$): \$28,684 = **0.57%**

²Each unit of \$5 million can be comprised of several participants in the sponsor's plan. Important to note, the yield on U.S. Treasury Bonds cover the annual administrative services of the DCPT.

Two Bankruptcies

The beneficiaries of the two bankrupt NQDC plans each receives plans each receives \$5,000,000. Each of the other 18 participants receives \$0
Annual cost of 10 years of protection ($\$550,000 / 10$): $\$55,000 = 1.10\%$

Three Bankruptcies

The beneficiaries of the three bankrupt NQDC plans each receives \$3,333,333.33
Each of the other 17 participants receives \$0
Annual cost of 10 years of protection ($\$550,000 / 10$): $\$55,000 = 1.10\%$

So, if you do not face a corporate bankruptcy during the 10-year term, you're wrapped in a no-risk solution for the small investor sum of \$5,000 to protect what could be many millions of dollars. But if you do, the protection will pay you your account balance.

When you do proper planning, the DCPT can help you reduce your tax liability while having the peace of mind that you are protected. It can allow you to take advantage of the source tax rules and reduce or eliminate state income tax. As an example, a California executive resides in Nevada at retirement, he/she saves 13.6% California income tax and deposits only 1% in the DCPT with the good chance of getting that deposit back.

How do you find the investors for a DCPT? Leave that to StockShield.

Fortunately for Stuart, he found his way back to peace of mind.

Once his DCPT was in place, his fear dissolved because he knew his \$10 million is now protected to the fullest extent possible.

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EBS is an independent executive benefits consulting firm which provides total plan management services with respect to programs specifically designed for key employees and professionals. Those services include:

- Consulting with respect to plan design,
- The structuring of related financing and benefit security arrangements,
- The design and management of the participant communication, education and enrollment processes,
- Management of any informal funding assets and,
- On-going plan administration and technical support.

More information about the firm can be found at: www.executivebenefitsolutions.com.

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