Deferred Compensation Protection Trust™

Protecting Nonqualified Deferred Compensation Assets

New Strategy May Be Game Changer for Executives with Large Deferred Compensation Balances

Consider the following list of companies. What do they all have in common?

- American Airlines
- Blockbuster
- Borders
- Brookstone
- Caesars Entertainment
- Chrysler
- CIT Group
- Circuit City
- Calpine
- Conseco
- Colonial Bank Group
- Delta Airlines
- Enron
- Friedman's
- General Motors
- General Growth Properties
- General Atlantic & Pacific
- Global Crossing
- IndyMac
- Lehman Brothers
- Lyondell Chemical
- Linens N Things
- Marvel
- New Century Financial
- PG&E
- Radio Shack
- Six Flags
- Sports Authority
- Sbarro
- Trump Entertainment
- Thornburg Mortgage
- United Airlines
- Washington Mutual
- WorldCom

All were leading companies at one time – and all filed for bankruptcy.

If you held an executive position with one of these companies and participated in their nonqualified deferred compensation plan (NQDC) or supplemental executive retirement plan (SERP), your compensation balance and liabilities were directly exposed to the bankruptcy risk. More than likely, you lost money.

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Inside NQDCs

NQDCs emerged as a common corporate benefit in part triggered by a cap placed on contributions to government-sponsored qualified retirement savings plans, like your 401(k). High-income earners were unable to contribute the same proportional amounts to tax-deferred retirement savings as low-income earners.

When the enactment of the Employee Retirement Income Security Act (ERISA) took place in 1974, an inequity between high- and low-income earners resulted. Companies began to offer savings plans considered “nonqualified.” The word nonqualified simply means that the plan is not subject to the requirements of a qualified plan regulated by ERISA.

NQDC plans can be designed for a select group, again, not subject to ERISA requirements, giving high-income earners a steadfast way to defer the actual ownership of income to avoid income taxes on earnings, and achieve tax-deferred investment growth.

NQDC plans are used to attract, retain, and reward top talent. In fact, 94 percent of companies responding to the 2014 Mullin/TBG Executive Benefits Survey indicated they had at least one nonqualified plan. These plans have also begun to penetrate the small business sector in recent years.

Consequence of ERISA

Understandably, ERISA was enacted to protect rank and file employees from potential abuses by senior management and, in that regard, ERISA is a success. However, the unintended consequence is discrimination against the precise executives tasked with leading the corporation. Arguably, companies highly compensate senior executives because they deliver relative value to the business enterprise, its ability to grow, and profit.

High-income earners also assume greater risk and exposure to corporate liability during their employment. Higher salaries, bonuses, and retirement incentives such as the NQDC plan help to offset this risk factor; however, any compensation deferred must be “subject to the claims of general unsecured creditors,” to maintain tax deferral status.

Securing with Rabbi Trust

Many plans adopted a rabbi trust to provide protection against the company's unsecured promise. These trust arrangements protect participants by preventing the company from using any assets deposited in the trust for any reason other than to pay benefits in the nonqualified plan.

In fact, 80.3 percent of companies in the Mullin/ TBG Executive Benefit Study use Rabbi Trusts to provide participants with benefit security. With a Rabbi Trust, assets are protected against corporate change of control, management's change of heart, or changes in the financial condition of the company, short of bankruptcy.

The Rabbi Trust originated when the IRS determined that an irrevocable trust established for a rabbi by his congregation was not subject to current income taxation of the assets. Those assets were regarded as subject to the claims of the congregation's general creditors.

Many tax practitioners looked at this private letter ruling and considered it the ideal device to protect an executive's nonqualified assets in the event of a change in company control, a change in the company's policy on paying benefits, or a change in the company's financial condition, short of bankruptcy. Official guidelines were issued by IRS in 1992 codifying its use as a benefit security device. As a downside, however, the rabbi trust cannot insulate plan beneficiaries from corporate bankruptcy risk.

Adoption of 409A Brings in More Restrictions

The Internal Revenue Code added Section 409A, effective January 1, 2005, under Section 885 of the American Jobs Creation Act of 2004. Section 409A carries a far-reaching effect because of the exceptionally broad definition of "deferral of compensation."

In part, the enactment of Section 409A responded to

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the practice of Enron executives who accelerated payments under their deferred compensation plans to access the money before the company went bankrupt. What's more, a history of perceived tax-timing abuse existed due to limited enforcement of the constructive receipt tax doctrine, further adding to the rise of Section 409A.

With the lack of flexibility in NQDC plans due to 409A, more and more executives have chosen not to defer as much as in years past. On the deferrals they do make, they are taking lump sum payments, which is not tax effective.

One of the major advantages of NQDC plans enables executives to spread payments over time, which leverages compounding the account balance over 10, 15, or 20 years. The following chart shows you the advantage:

	Lump-Sum Payment	Payments Over 10 years	Payments Over 15 years	Payments Over 20 years
Pre-Tax	$1,000,000	$1,000,000	$1,000,000	$1,000,000
After-Tax[1]	$600,000	$85,427 x 10 yrs.	$65,877 x 15 yrs.	$56,635 x 20 yrs.
Total After Tax	$600,000	$854,270	$988,155	$1,132,700

[1]Assumed 40% tax rate
[2]Assumes investment earnings of 7.0%

Increase Benefits through Source Tax Provision

In general, under the federal source taxation rule, deferred compensation earned by an employee or former employee while a resident of a state, but paid when the individual is no longer a resident of that state, is not subject to that state's income taxes, if the compensation is paid over the individual's life or life expectancy, or is paid in installments scheduled over 10 years or more, or if the compensation is paid under certain qualified retirement plans or "excess" plans.

So in our examples above, your tax rate could be reduced which would increase your after-tax retirement benefits. The only risk you must take is that of a general unsecured creditor. Is the return worth the risk? In some states, you pay a hefty price on payments short of the 10-year required minimum. The top rate in California is 13.3 percent; Connecticut 6.99 percent; Illinois 3.75 percent; Massachusetts 5.10 percent; Minnesota 9.85 percent; and New York 8.82 percent.

Deferred Compensation Protection Trust™

Now, executives can access a cost-effective risk management strategy to protect NQDC account balances. The concept was developed by StockShield, a Los Angeles-based firm which holds the patent on the process for protecting concentrated stock positions. StockShield's experts created the Deferred Compensation Protection Trust (DCPT) with the following key features:

1. The Deferred Compensation Protection Trust is a new, "non-traditional" approach to NQDC risk management.

2. Based on the time-tested principles of both Modern Portfolio Theory (MPT) and Risk Pooling, the DCPT developed from the company's Stock Protection Fund for protecting concentrated stock positions.

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3. Risk pooling enables the cost-effective spreading of similar financial risk across participants in a self-funded plan designed to protect against losses.

4. By combining the powerful benefits of Risk Pooling, the Deferred Compensation Protection Trust transforms single-account/single-company balance risk by enabling investors to "mutualize" and, therefore, substantially reduce downside risk, while retaining all future appreciation of their NQDC assets and income...all at an affordable cost.

Affordable Protection for NQDC Balances

Participants in NQDC plans are often forced to take lump-sum distributions to mitigate the risk of unsecured general creditor status. Also, they may overlook the advantage of tax deferral and deferral compounding on a tax-deferred basis.

Regardless of the reason, for those participants aware of the risk of becoming a general unsecured creditor, the Deferred Compensation Protection Trust offers greater assurance and security that in a catastrophic event, like the sponsoring-employers' bankruptcy, participants' net worth will not be decimated.

It is important to point out that protection is usually structured over a five-year period and is renewable. The annual cost could be as low as one to two percent of the value you wish to protect, far less than the state income taxes you would pay by not spreading your payments.

If you would like more information on the valuable protection provided by the Deferred Compensation Protection Trust, please contact us.

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