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THE TECH EMPLOYEES GUIDE TO DEFERRED COMPENSATION

In this guide, we'll cover everything you need to know about Deferred Compensation Plans (DCP), so you can make an informed decision during your enrollment period. We'll outline how they work and the four most common questions we hear about DCP plans.

A clever person once said it's "difficult to make predictions, especially about the future." This is true with most things, and it's undoubtedly true with investing. However, despite the unpredictability of the future, there comes a time when we must place our bets and choose a direction—Ideally, one that tips the odds in our favor.

409(a) Nonqualified Deferred Compensation Plans present one of these opportunities.

You willingly forgo income today with the faith that your company will survive many years into the future to make good on this liability to you—all for a tax benefit that tips the odds in your favor.

As a participant in your company's deferred compensation plan, you've become an unsecured creditor of your company. You should think about that opportunity as skeptically as a bank underwriter would when approving a loan. As Andy Grove once said, "only the paranoid survive."

This guide will address the four fundamental questions we hear from employees considering deferring income into their deferred compensation plan.

THE FOUR KEY DCP QUESTIONS:

1. **What's the risk of deferred compensation?**
2. **Second, what's the magnitude of the tax benefit from deferring income?**
3. **Third, should I participate, and how much to defer if so?**
4. **Finally, what distribution schedule should I elect?**

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Question #1:

WHAT'S THE RISK OF THE DEFERRED COMPENSATION PLANS?

As a non-qualified deferred compensation plan, your DCP account is, by rule, an unsecured liability of your employer. Meaning if your employer goes bankrupt, you could lose part, a majority, or all, of your balance in this account. By participating, you become a creditor of your employer—and lower in priority to any creditor whose loan is secured by the company's assets.

This is the primary risk and the main drawback of participating in your DC plan.

So how do you think about assessing this risk to capture the potential tax benefits?

We quantify the risk by looking at factors specific to your employer and factors specific to your personal situation.

Company-Specific Risk Factors

The key question here is how likely is it that your employers will default on its deferred compensation obligations, and what's the magnitude of the default if so. To answer these questions that we can look at a few metrics ranging from the most general to most specific.

> ***First, how likely is a publicly-traded company to file for bankruptcy?***

On average, around 80 public companies file bankruptcy each year. During a recession, this number obviously goes up (136 and 210 filed for bankruptcy protection in 2008 and 2009, respectively) but drops in times of economic expansion (58 and 64 filed in 2018 and 2019, respectively). Taking that 80 companies per year into the 3,700 listed companies here in the US tells us that roughly 2% of public companies file bankruptcy each year.

Of course, not all companies are created equal. Smaller companies should be higher risk, and Apple isn't the same risk as J.C. Penny.

And of course, even in the case of bankruptcy, some creditors end up recouping a portion of their money.

> ***So, the next question becomes, what happens to the deferred compensation liabilities of a company in the event of a bankruptcy?***

The two main types of business bankruptcies are chapter 7 (liquidation) and chapter 11 (reorganization). Chapter 11 typically involves negotiation with creditors and is usually more favorable for those with liabilities in a deferred compensation plan.

Here are a few examples from past corporate bankruptcies that are instructive:

- **CIT Group –** November 2009 Chapter 11 bankruptcy. Executive benefits, including deferred compensation plans, survived intact.
- **Eastman Kodak –** January 2021 Chapter 11 bankruptcy. Executive Deferred Compensation plan paid out only 4-5% of the balance (although executives were given shares in the newly issued stock). Those below the executive level were largely made whole along with other creditors.¬
- **GM –** June 2009 Chapter 11 bankruptcy. Participants received a two-thirds "haircut" of any benefits in excess of $100,000 in annual distributions.
- **Nortel Networks –** June 2009 Chapter 7 bankruptcy. Participants recovered 97% of the funds in their deferred compensation accounts on the day of bankruptcy.

The last question is then, how likely is your company, given its current financial positioning, to file bankruptcy?

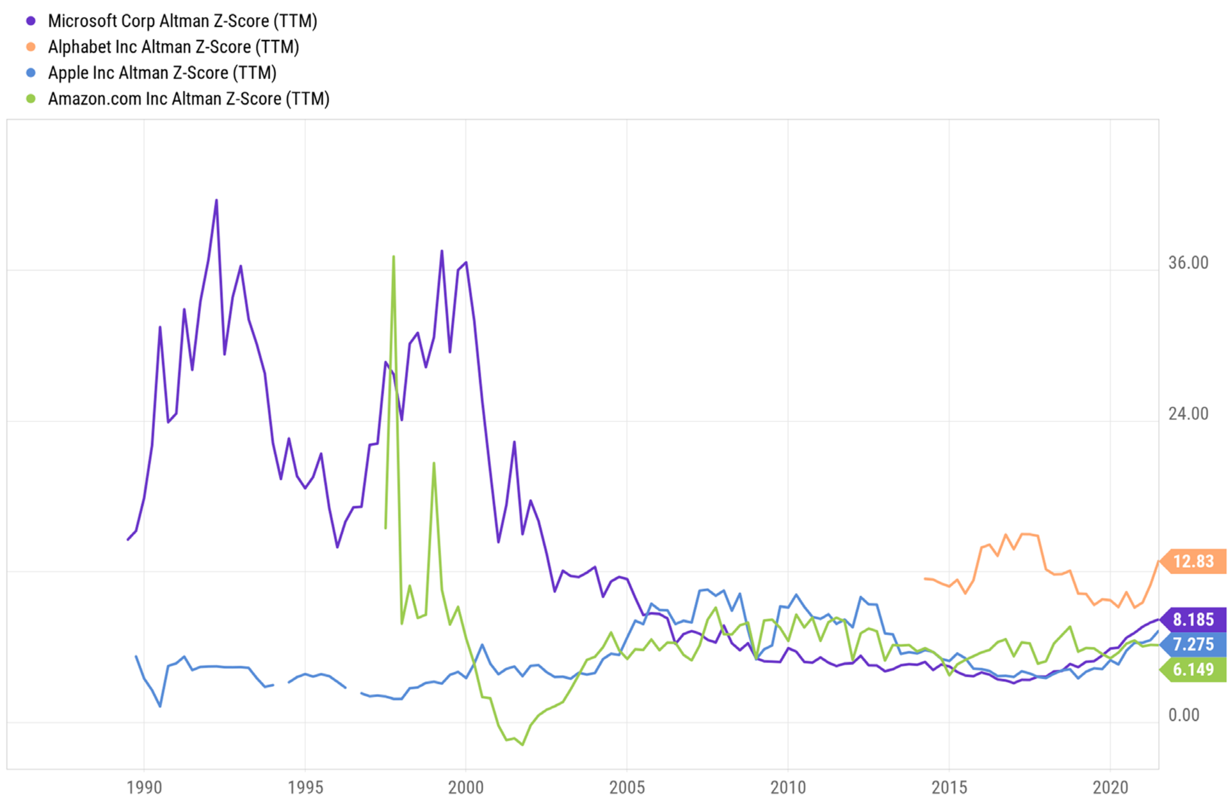
The Altman Z-score, developed by NYU Professor Edward Altman in the late 1960s, is a metric devised to assess a firm's bankruptcy risk. Altman's Z-score uses a blend of publicly available financial statement information (working capital, retained earnings, profit, market value, assets, and liabilities) to predict companies' bankruptcy risk (at least in the near term).

The higher the score, the better:

- The "Safe Zone" is a score of 3 or higher.
- The "Grey Zone" is a score between 1.81 and 2.99
- The "Distress Zone" is a score of less than 1.81

Using Microsoft as an example below, you can see its Altman z-score is 8.19, which has been trending up since reaching a low around 2017. This score puts them in the safe zone and above ("safer") than other Tech giants such and Apple and Amazon.

Altman Z-score



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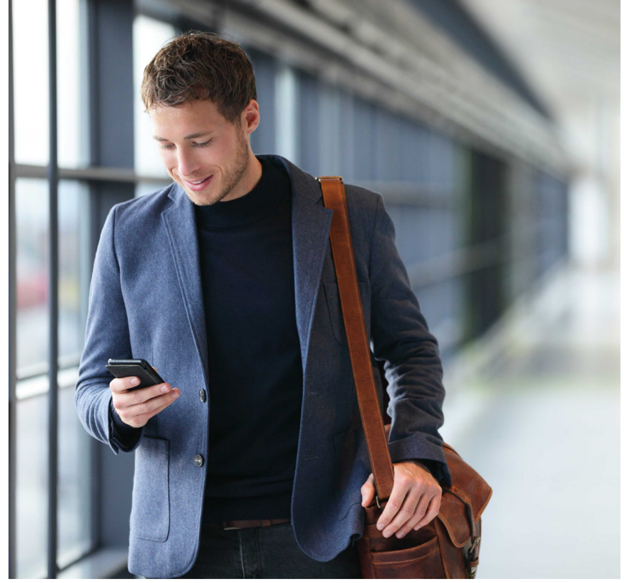
It appears Microsoft is safe in the short term, but obviously, with deferred compensation plans, we need to look out many years in the future. Here is where factors specific to you as an individual come into play.



Personal Risk Factors

In addition, to assess the risk of your employers, you should assess three personal risk factors.

1. **Your distribution timeline.** The longer you defer the money, the greater the benefit from the tax deferral, but the more risk you are taking on. We typically suggest deferring the income as long as possible, but if you are planning to stay at your current employer for many years, know that this comes with added risk.

   ✔ **Action item:** Calculate your distribution timeline for prior and future deferrals

2. **Your total current exposure to your employer.** This includes money in your deferred compensation plan in addition to company stock (RSUs, ESPP shares, other shares) and any stock options. While the deferred compensation plan is a debt of the company, not equity, like your shares, if things go wrong at the company, the shares are at more risk. If you're concerned about the risk of your employer, reducing equity holdings are a good place to start.

   ✔ **Action item:** Calculate total exposure to your employer (DCP balance + Market Value of Company Stock + Stock Options / Total Net Worth)

3. **What percentage of your total net worth is in the DCP account?** The higher the percentage, the greater the risk and the more cautious you should be about deferring additional income.

   ✔ **Action item:** Calculate DCP balance as percent of total net worth (DCP balance / Total Net Worth)

If, after doing these calculations, if you are concerned about your total exposure to your employer, see the strategies outlined at the end of this guide.

Question #2:

WHAT ARE THE TAX BENEFITS OF DCP?

Deferred compensation plans have been around for decades, promising two potential benefits.

1. **Tax Rate Benefits**
2. **Tax Deferral Benefits**

Initially, with top marginal tax rates as high as 90 percent in the 1960s and 70 percent in the 1970s, these plans' primary benefit was to shift income into lower-tax retirement years. Now, with lower tax rates (the top marginal income tax rate is 37 percent + 2.35% Medicare), tax brackets fairly compressed, and higher executive compensation (meaning potentially large payouts from deferred compensation and other assets in retirement), most tax analysis is done at the top marginal tax bracket both pre and post-retirement (except for state-specific income tax planning which we will address in a bit).

Today, these plans' main benefit is the tax deferral feature—the ability to invest your money pre-tax and have it grow untaxed until the money is paid out.

Tax Rate Benefits

These are more difficult to pin down and quantify, but this potential benefit can show up in three places.

First, you may expect to be in a lower tax bracket after leaving your employer. With the end of salary, bonus, and RSU income, this may very well be the case. But depending on the size of your deferred compensation distributions and other sources of income, this isn't always a foregone conclusion.

Second, you might expect a beneficial tax rate change if you plan to move from a higher income tax state to a low- or no-income-tax state in retirement. Moving from Oregon to Washington during the distributions of your deferred compensation account would save the 9% Oregon income tax bill.

Lastly, deferred compensation is a chance to wager on future tax rates. Although given the current tax environment, a bet on lower tax rates in the future doesn't look wise.

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Tax Deferral Benefits

The main tax benefit of a deferred compensation plan is the ability to defer taxes—Allowing you to invest your money pre-tax and have it grow without tax until the money is paid out.

The longer the tax deferral is in place, the more valuable this is. Deferring taxes one year before retirement and then over a 10-year distribution schedule has value, but deferring taxes for 20 years (allowing your money to grow pre-tax) has a lot more value.

Of course, this comes with the risk of your company not being around to make good on its deferred compensation obligations in 10 or 20 years.

Using the assumptions listed in Table 1 below, we can see that deferring income for fifteen years for an individual at the top marginal tax bracket (37% income tax + 1.45% Medicare + 0.9% Medicare on wages over $200k) and earning a pre-tax return versus an after-tax return results in 36% more of wealth even after paying income taxes on your distribution from the deferred compensation plan. This is true no matter the deferral amount.

Behold the power of compounded tax-free gains!

Inputs	
Years Deferred	15
Income Tax	39.35%
Pre-Tax Return*	7.54%
After-Tax Return**	5.97%

	SCENARIO 1		SCENARIO 2		SCENARIO 3	
	Tax-Deferred	Taxable	Tax-Deferred	Taxable	Tax-Deferred	Taxable
Total SERPLUS Deferral	$28,750		$65,625		$85,625	
Income Tax Saved Year 1	$11,313		$25,823		$33,693	
Net Investable Amount	**$28,750**	**$17,437**	**$65,625**	**$39,802**	**$85,625**	**$51,932**
Account Balance	$85,544	$41,611	$195,263	$94,983	$254,772	$123,930
Tax on liquidation (lump sum)	$33,661	$0	$76,836	$0	$100,253	$0
After-tax value	$51,882	$41,611	$118,427	$94,983	$154,519	$123,930
Total Benefit Post-Liquidation	$10,271		$23,444		$30,589	
Total Benefit as % of amount deferred	35.7%		35.7%		35.7%	

** Pre-tax return using the Vanguard 2035 Target Date Retirement Fund (VTTHX) via Morningstar. 15 year period ending Sept. 30, 2021*

** After-tax return using the Vanguard 2035 Target Date Retirement Fund (VTTHX) via Morningstar. 15 year period ending Sept. 30, 2020.*

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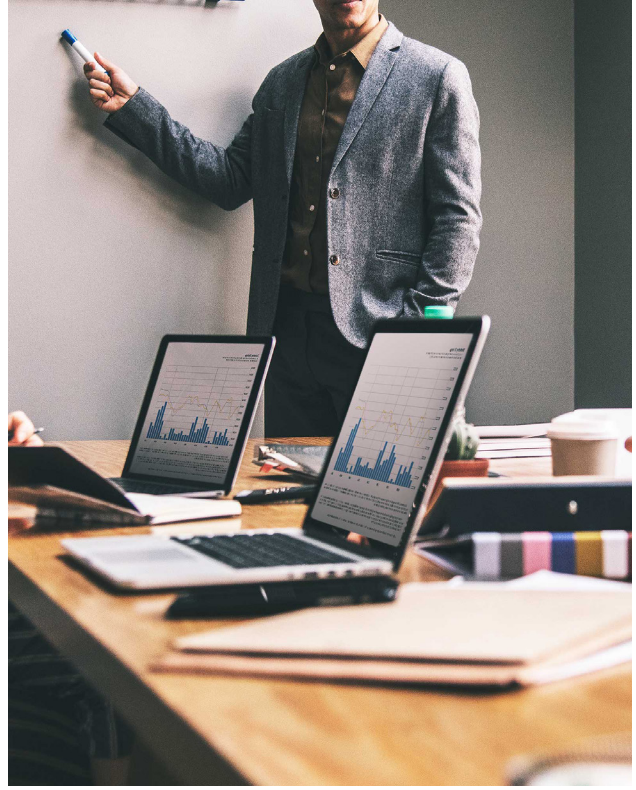


Question #3:

HOW MUCH SHOULD I DEFER?

Before contributing to a deferred compensation account, you want to make sure you are allocating funds to other tax-advantaged and safer accounts.

Fully fund your 401(k), HSA, and IRA accounts first!

Once these accounts are funded, the decision on how much to defer into your DC plan will mainly come down to factors specific to each individual.

How risky do you perceive your employer to be now and in another 10-15 years?

How much risk do you have individually tied to your employer? Include salary, bonus, and stock in addition to money already in the deferred compensation plan?

How much can you afford to defer from a cash flow perspective?

Planning Opportunity:

If cash flow is an issue to deferring additional income, consider using cash from selling RSUs as they vest to fund deferred compensation. RSUs will be taxed as income as they vest, increasing your tax bill today. Deferring income can be a way to offset that additional income and invest those proceeds tax-deferred.

Question #4:

WHAT DISTRIBUTION SCHEDULE SHOULD I SELECT?

Lastly, once you decide how much to defer, you must select a distribution schedule.

Again, this decision comes down to the tradeoff between deferring taxes for as long as possible and the account being an unfunded liability of your employer.

The sooner you elect to take a distribution, the lower tax-deferral benefit you receive. But a longer out into the future your distribution schedule is means a greater time period the liability remains with your employer.

With most plans, you can elect to have the money distributed while you are still employed or at termination/retirement.

From there, you will need to decide if you want the money distributed to you as a "lump sum" or spread over a number of years—We've seen the options range here from as few as three years to as many as fifteen. While employed

With Microsoft as an example, that's up to 15 years from when you terminate your employment—which could be many years in the future.

Another strategy for a company that's flexible with distributions, like Microsoft is, is to select a distribution that's five years out and then roll it out another five years when you get within 12 months from that date. This allows you to still get the benefit of deferring as long as possible with the flexibility of potentially taking the distributions within the next five years if needed.

The caveat there is if there are some specific individual circumstances where you know your tax rate will be lower in the future, it may make sense to defer out to a specific year.

> *Typically, we suggest deferring for as long as possible to get the maximum tax benefit.*

Bonus Section:

THREE STRATEGIES TO OFFSET THE RISKS IN DEFERRED COMPENSATION PLANS

For the majority of those employees deferring compensation at public companies, things will work out fine. But for those wishing to take some risk off the table, here are a few options.

Shift Your Risk – Sell Equities

One way to reduce your risk in your employer is to sell the company stock you hold instead of making a change to your Deferred Compensation. Obviously, if the company is in trouble, the stock price will decline in addition to the credit risk increasing. But you could imagine a scenario where the stock price declines but the company remains solvent. By selling stock and deferring compensation, you transition your risk from equity risk to credit risk and (at least theoretically anyway) higher up in the capital structure.

Here's how you might combine deferring compensation along with selling your existing shares to lower your risk in the future viability of your employer and still reduce taxes along the way.

- Assume you need $120k for living expenses
- After income tax (rounded to 40%), that requires a salary/bonus of $200,000 (200,000 * (1-.40) = $120k)
- For those holding company stock, another way to generate $120k for living expenses is from selling that company stock.
- This exploits the difference in tax rates between income and capital gains.
- To generate $120,000 in cash you could sell $157,480 of company stock ($157,480*(1-.238) = $120k). Furthermore, this assumes a $0 basis…any higher basis means less tax and, therefore, fewer shares sold.
- This technique does three things:
  - Allows you to save $42,000 in taxes in the current year, and
  - Allows you to trade equity risk in your company for, theoretically safer, credit risk
  - Shifts a concentrated equity position to a more diversified portfolio

This first technique trades one type of company-specific risk for another (and saves taxes along the way).

Now let's look at a couple of options to directly hedge the risk in your employer.

Buying Deep Out-Of-The-Money Puts

Buying a put gives you the right to sell stock at a price set today and therefore profit if the price drops below the strike price.

Using Intel as an example, using puts to hedge the Deferred Compensation plan could be structured as follows:

- Let's assume you have deferred $1 million into the Intel DCP.
- You buy 50,000 January 2023 put options at a $25 strike for $1.27 (price as of 11.11.2020)
- If Intel's share price declined to $5 between now and January 2024—which it's assumed it would do if it is in (or on the verge) of bankruptcy—your profit equals $1 million $20 per option times 50k options.
- Your cost for this protection equals $63,500 ($1.27 x 50k)
- The total cost for this insurance is 6.35% of the amount hedged or a little more than 3% per year.

It's common for listed options only to extend out a couple of years, so with this strategy, you would either need to roll it every other year, or you could potentially work with a trading desk to create a longer-dated, custom option.

This 3% cost per year is obviously not cheap, and many companies will prohibit executives from shorting their company stock (which buying a put is typically considered since you profit if the price of the company stock falls).

Due to these restrictions and the cost, let's look at one more option.

Deferred Compensation Protection Trust

A more recent entrant into this space is the Deferred Compensation Protection Trust. Developed by a company called StockShield, this Trust essentially pools your risk with others across various companies and industries. An example of how this works according to their website:

Twenty (20) participants, each with a certain minimum balance in an NQDC [Non-Qualified Deferred Compensation] plan sponsored by a different company in a different industry, deposit a small amount of cash (e.g., 1%) for each year of desired protection (minimum five years). The pooled cash is invested in US Treasury Securities. At the end of the term of the trust, the assets pooled in the Trust are paid according to the number of bankruptcies.

Assuming your company files bankruptcy in the period covered, the pooled funds would be used to offset your loss. If no companies in the pool file bankruptcy, the funds are returned minus trust expenses.

1% per year for protection isn't too bad of a deal, although you run the risk of your losses not being fully offset in the case of multiple bankruptcies.

A FREE DCP ELECTION ASSESSMENT

Obviously, there is a lot to this decision of whether to defer money into a DCP and to balance the risk and rewards of the plans.

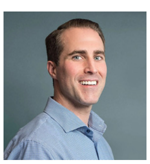
That's why we created a Free Deferred Compensation Assessment. In the assessment, we'll answer the key questions outlined in this guide specific to your situation. We'll analyze:

- √ Your risk level in your employer's plan
- √ Your tax benefit of participating
- √ Potential contribution amounts
- √ Your current and future distribution schedule

For a sample assessment and to sign up, click below

GET YOUR FREE ASSESSMENT

YOUR TEAM OF FINANCIAL SPECIALISTS



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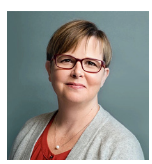

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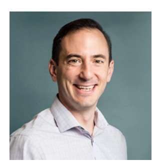

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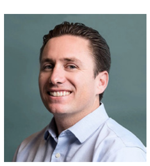

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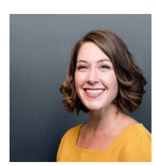

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