Mayflower Capital
Independent Financial Advice

Don Martin, CFP®
940 Stewart Dr., Ste. 319
Sunnyvale, CA 94085
phone: (650) 949-0775
www.mayflowercapital.com
don@mayflowercapital.com

Hidden Risk in Non-Qualified Deferred Compensation

Corporate executives can save considerable amount of taxes by using a Non-Qualified Deferred Compensation (NQDC) arrangement that defers employment compensation until retirement. However, few people understand just how risky this is.

NQDC requires that the deferred pay be held by the employer in a book entry form with no protection from the company's creditors. Also there is the risk that future management could exercise recalcitrance and refuse to pay without filing bankruptcy. The only protection is for the employee to buy a Credit Default Swap (CDS). These can be purchased at reasonable costs for periods of five years for roughly 25 to 40 basis points a year if the company is rated "A to AAA". The longest period of time they can be purchased for is ten years. The problem is that even very healthy companies can become weak and sickly after ten years and no one sells a CDS for more than ten years. If an employee were to buy a ten year CDS and try to renew it after ten years it might be only available at an exorbitant price. The fact that the future long term price of the needed protection is unknown means that there is too much risk in a NQDC. An analogy would be to buy a rental property with the intent of always having insurance on the property but with no right to sell the property until 30 years in the future. If it was not possible to renew the insurance contract then a prudent owner would try to sell the property. What if he could not sell the property for 30 years and had no insurance? Investment advisors spend a lot of time reviewing investments for hidden risk. They look for a return that compensates for the amount of risk that an investment has. They seek to diversify investments. They seek investments with transparency. Yet to correctly use a NQDC the advisor would need to recommend that a client only sign up for a time period of less than ten years so that it is possible to know what the cost of a CDS would be. However to get a significant tax benefit from NQDC one needs a tax deferral period in excess of ten years. If one signed up for a ten year deferral the money might get paid when the person was still working and thus he would be taxed while in a high tax bracket. The NQDC fundamentally has too much risk for an investment advisor to recommend. In order to recommend it I would need to know what the cost of a CDS for the employer is for the next 30 years, which is unknowable. The need for CDS is a real concern. Of the 30 stocks in the Dow in 1970, a few went bankrupt, and only 20% are still in the Dow. That is a startling concept that 80% of the top 30 companies were removed from the Dow in forty years. No one would sign up for an investment with an 80% chance of a downgrade or partial failure and no one should sign up for a risky investment without

calculating the cost of using a CDS if the investment required a multi-decade non-cancellable commitment.

To be prudent in using a NQDC one would need to keep buying CDS every five years on his employer only to see the cost rise to prohibitively expensive levels. These fees may not be fully tax deductible. A NQDC should be seen as a risky investment due to extreme inflexibility. The proper way to invest is to be flexible and move in and out of asset classes as a major paradigm shift occurs with an asset class. With NQDC there is no flexibility about the need to close out the position if the employer should become financially shaky. If you worked at a healthy company and had a five year CDS that has now expired, what do you do after five years when the company becomes very shaky and the cost of a new CDS is very expensive?

The risk you take with NQDC is like making an unsecured 30 year loan to your employer which can't be cancelled or recalled. By contrast, non-mortgage loans made by banks often are due in a period of a few years or have clauses requiring the borrower maintain the same financial health or else pay back the loan immediately. Even mortgages have an expected life of 12 years due to home sales and refinances. By "loaning" your employer your deferred compensation you are taking on a contingent risk that someday your employer could be like the 80% of the Dow members that were removed from the Dow. No bank would loan money under these asymmetric conditions of inflexibility, lack of transparency, lack of diversification, etc. So you should not loan your employer an unsecured non-callable loan either.

A basic principal of financial planning is to never chase after an investment because of alleged tax benefits but instead consider it based on non-tax merits. Failure to heed this has caused investors to lose money with flaky, illiquid tax shelters where the general partner has all the power and there is no practical way to sell the investment at a reasonable price.

Another problem with NQDC is that the income, when paid, is taxed as ordinary income even if it was invested in stocks when held by the employer. By contrast, after-tax income invested in assets that produce long term capital gains would be taxed at lower rates.

The tax benefit of NQDC is outweighed by the hidden and unknowable cost of buying a CDS and is outweighed by the loss of long term capital gains tax treatment.

For more information contact Don Martin, CFP®

don@mayflowercapital.com (650) 949-0775 Follow me on Twitter @DonMartinCFP

Subscribe to my blog at www.mayflowercapital.com/blog

11-28-2011