Executive Benefit Solutions

How Executive Benefits Enhance Executive Compensation Programs

Cost-Effective Benefit Programs Provide Win-Win Outcomes for Executives and Shareholders

An Informative White Paper from
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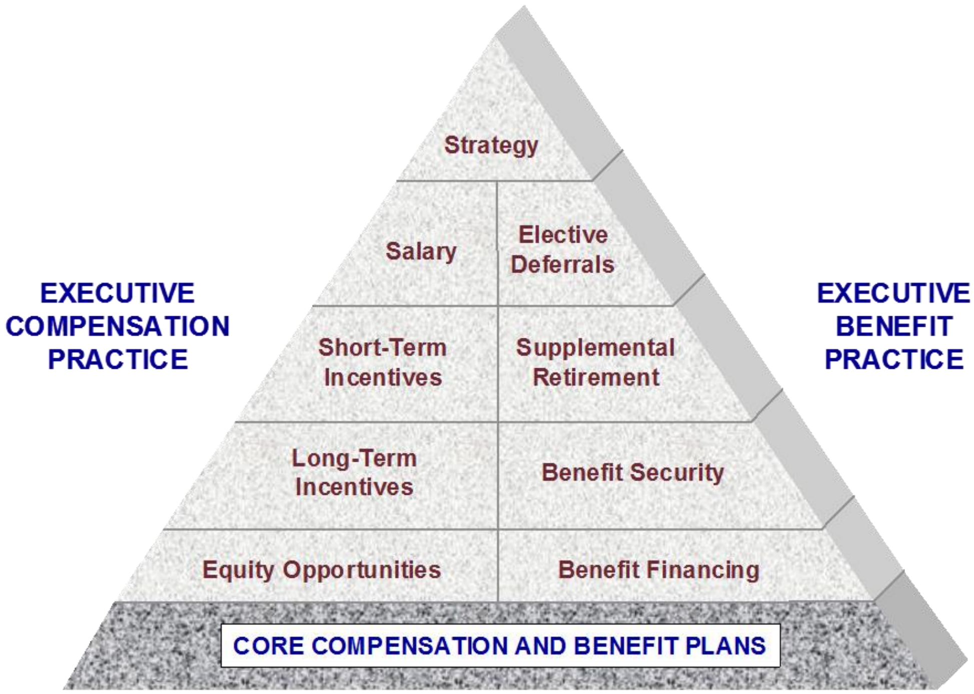
When people discuss executive compensation, they usually discuss only half the story, mistakenly focusing on the cash and equity side of the equation, and forgetting about the executive benefits side, as illustrated below.



Executive benefits should integrate into a company's total rewards program to ensure desired performance of executive participants. In reality, many executive benefit alternatives cost less from an accounting standpoint. What's more, these benefits can be designed to drive the right behavior.

Executive benefits and perquisites include deferred compensation, supplemental executive retirement plans, financial counseling, as well as supplemental life and disability insurance.

Programs like stock options and restricted stock can end up costing shareholders more than deferred compensation (DCP) and supplemental executive retirement plans (SERPs), and they do not totally reward executives for their performance.

When you issue stock options or restricted shares, for example, you either under pay or overpay the executive, based on how the market treats company stock. ***Let's do a brief overview on the nature of executive benefits.***

This white paper explores the needs of the three major constituent groups regards executive benefits—employer, executive and shareholder—and evaluates trends and best practices. We examine each of the prevalent benefit arrangements and review their general purpose, objectives, prevalence, structure, tax impact, cost and cash flow considerations, as well as offer a six-step process to help you identify the right benefits for your firm and merge them into a total rewards package.

Overview of Executive Benefits

Executive benefits are often looked at as "extra compensation"—that is, payment over and above salary, bonus and equity. Consequently, boards, shareholders and the media alike scrutinize executive benefit plans more than ever.

Therefore, it is important to use an objective basis and process to determine which of the many possible benefits make good business sense. Equally important, know how these benefits could help or hurt an organization's ability to attract, retain, reward or motivate those key employees who make a difference in your firm.

The Dilemma

For the last ten years, the stock market has been flat. Between massive layoffs and hiring freezes, many stock plans are underwater. Many companies are treating this change as an opportunity to refine and optimize their total compensation because other alternatives may be more cost-effective for shareholders.

Clearly, companies struggling to rebuild profitability and growth must begin to compensate their executives more than would be required when times are flush. In short, the harder the economic times, corporate leaders require better compensation packages.

With most stock programs underperforming, flat or underwater, companies need to look to other shareholder-friendly alternatives, programs that consistently attract, retain and reward their key executive contributors. With the major issue of whether to expense stock options is in the past, the field is wide open.

These conditions have led to an environment of restraint, or at least reconsideration of executive benefits already in place. We must ask ourselves: ***How does one determine what packages of benefits are best-suited for a given company? Which benefits are truly necessary and aligned with overall executive compensation philosophy? Which are likely to add value to shareholders?***

Executive benefits can help to counter the reverse discrimination of core benefit plans such as the 401(k), retirement, life and disability, imposed on highly compensated executives by government limitations.

Let's now investigate select benefit solutions and how they work.

Nonqualified Deferred Compensation (NQDC) Plans

Deferred compensation forms the core of executive benefits. If designed optimally, it can be one of the lowest cost benefits that align the interest of executives with those of shareholders. The use of deferred compensation causes no dilution in ownership, nor does it cost the company significant dollars to provide.

In a deferred compensation arrangement, executives are offered the option of deferring their own compensation into tax-advantaged accumulation accounts.

These accounts are comprised of the same compensation dollars that would have otherwise been paid in salary or bonus. Those dollars are invested in mutual fund investments based on the executive's own risk tolerance.

Today many plans also offer annuity solutions and guarantees to assure the income will be there. As an example as part of the fund line-up the participant can defer all or a portion of their income into a life time income with guarantees with some contracts as high as 8 percent. The plans assets could be allocated to index funds like the S&P 500, with a floor guarantee not to lose amounts deferred.

A typical NQDC plan allows executives to defer 80 to 90 percent of their base salary and 100 percent of their annual incentive awards. The deferrals accumulate and grow at a set rate of interest or at a rate of return determined by some form of investment such as a mutual fund.

For many companies, the primary objective of these programs is to offer an additional vehicle to facilitate wealth accumulation, as well as tax and portfolio management opportunities.

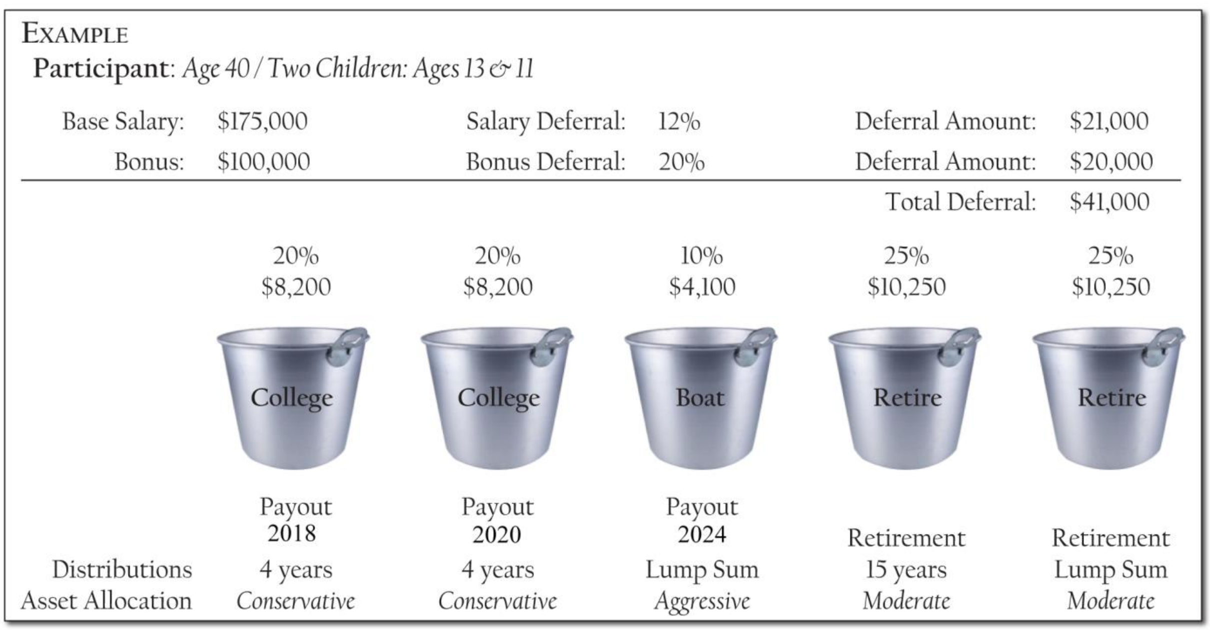
NQDC plans today are more like a "tax-deferred cash management" program, giving the executive an opportunity to plan for his or her life events, such as collage cost for their children or retirement.

The following chart illustrates a 40-year old executive who elects to defer 12 percent of his $175,000 salary and 20 percent of his $100,000 bonus.

You will notice, he set up five "buckets" with various distribution dates. The first election is 2014, set up as a college fund for his son contributing 20 percent of his election, electing a distribution of four year starting in 2018.

The second bucket was designed for his daughter who anticipates college in 2020. After the kids are out of school, he plans to buy a boat, so he elected to defer 10 percent of his contribution election until 2024. Each bucket also allows him to set up his asset allocation based on the risk he is willing to take.

And finally, he set up two retirement buckets: one designed to be paid in a lump sum, and the other to be distributed over 15 years. There are tax benefits when you tax distribution over more than a 10-year payout. The tax benefits allow you to retire in a lower tax state than the one in which you deferred the compensation, for example, deferring in California and retiring in Nevada where there are no state taxes.



Deferring Taxes

Many organizations also allow the participant to defer restricted stock units, as a way of tax planning around these units when they vest. As an example, when a company issues RSUs with a four-year vesting period, the executive pays taxes on the value at the time of vesting. In most cases, he or she sells off enough shares to pay the taxes. With a NQDC plan, the executive can elect to defer the RSUs within 30 days of issue, and own and control the shares within the NQDC plan, and not pay tax until they actually take distribution.

A NQDC plan is a valuable tool for management to align its interests with its shareholders. As cited earlier, a company may decide to use such a plan to attract key employees, or let it serve as a parking place for signing bonuses with "golden handcuff" vesting requirements.

Finally, a company may use such a plan as a retention tool offering a company match that vests years in the future. The reason these plans are so prevalent is that the cost of offering such an arrangement is negligible due to the use of various funding vehicles. Yet these plans provide executives with the advantage of tax-deferred savings and investment growth.

Excess Benefit Plans

There are two types of excess benefit plans available but both restore lost qualified retirement benefits due to legislative limits. Excess benefit plans, like a deferred compensation plan, are nonqualified. This means they are exempt from the filing, reporting, funding, and fiduciary requirements of ERISA (Employee Retirement Income Security Act).

The first type of excess benefit plan restores benefits due to Code Sec. 415 limits. This plan is referred to as a restoration plan and simply compensates for lost qualified plan benefits. For 2014, the defined benefit plan limit is $210,000 (Code Sec. 415(b)). The defined contribution plan limit is $52,000 (Code Sec. 415(c)).

These plans can be in either a defined benefit form, as a supplement to a qualified pension plan, or in a defined contribution form that may, for example, restore benefits contributions in a profit sharing or 401(k) plan. The second type of plan restores benefits that are withheld due to compensation limits (Code Sec. 401(a)(17)) imposed on qualified defined benefit and defined contribution plans. In 2014, the compensation limit under this section is $260,000. This provision could significantly lessen executives' qualified plan payments, particularly those of the top echelon of executives who often earn well in excess of these limits.

Supplemental Executive Retirement Plans (SERPs)

SERPs are nonqualified plans that do more than restore excess pension plan benefits. These plans can provide additional benefits by applying a different definition of compensation like annual incentives or other compensation. Further, they can offer more advantageous provisions than those offered by qualified plans. Some of the typical feature enhancements include an alternative benefits formula, different accrual pattern, or different early retirement features.

A SERP can be very flexible in design. It can take on the form of either a defined contribution or defined benefit plan. In addition to the objectives of retirement income security and wealth accumulations, SERPs are often designed to achieve other objectives such as providing an attractive recruitment tool for mid-careerexecutives, rewarding for performance by linking to company performance goals, and being used as a retention tool.

SERPS are often considered the most effective type of supplemental retirement program because of their inherent flexibility. The prevalence of "performance-based SERPs" has increased as they have proven more cost-effective than stock options or restricted stock with no dilution.

A company can zero in on the type of performance it requires; that is, increased margins, cash flow, net earnings, EBITDA (earnings before interest, taxes, depreciation and amortization), or earnings per share.

Securing the Benefit

With new secular trust and insurance after-tax funding designs, these arrangements can be structured as tax deductible to the company and fully secured against company creditors. A secular trust is an irrevocable trust, usually established by the employer that holds assets to be used for the exclusive purpose of providing funds for the payment of nonqualified benefits. The establishment of a secular trust provides additional security to participants over and above the rabbi trust in that the assets in a secular trust are not subject to the claims of the company's creditors.

Today, the secular trust concept can be achieved by using institutionally priced life insurance contracts owned by the executives. Life insurance current tax policies allow for the accumulation of cash values to grow tax deferred, and distributions are non-taxable, which could provide greater amounts of retirement income than traditional deferred compensation plans that are taxed at distribution. The portability of these plans is a key attraction to executives, too. The implementation of this concept is growing faster than traditional deferred compensation arrangements.

Supplemental Life Insurance

In connection with sound financial and estate planning, life insurance programs that provide income replacement are not uncommon at executive levels. Most basic group plans offer limited opportunity to provide significant levels of death benefit protection.

The disconnect between a company's life insurance policy and its total compensation and benefits strategy occurs when the bulk of an employee's compensation is derived from bonus and incentive pay, while the group life plan delivers a benefit based on a multiple of salary (*1.5* times the salary with a cap of $200,000).

As a result, companies that offer a total compensation package which emphasizes security and flexibility should consider providing supplemental life insurance protection as a multiple of total compensation for its top management. The rule of thumb is three to five times the total pay with no cap.

Executive Long-Term Disability

Similar to group life insurance, group disability plans have limitations and often exclude total compensation. The group disability plans also offer a multiple of salary with some monthly cap—66.67% of salary with a cap of $15,000. They have the incorrect definitions of disability to cover an executive's responsibilities. Today, companies are designing supplemental plans to fill the void. The benefits are based on total compensation, as well as the value of stock options.

Perquisites

Perks come in many shapes and sizes: access to corporate aircraft, country club dues, car allowances, gym memberships and more. One of the fastest growing perks which helps tie everything together is **financial counseling.**

With the ever-increasing complexities surrounding financial planning and the myriad of investments now commonly used by even average salaried employees, financial counseling and planning services are prized by executives. In fact, roughly one-third of companies currently provide some form of assistance to their executives, according to a 2009 Clark Consulting study.

One may question whether financial counseling services accomplish specific objectives or simply give recipients the perception of a valuable benefit.

In my long experience, yes, perceived value exists, but there is the measurable value of financial counseling services that motivates executives to focus their full attention on company performance, secure in the knowledge that their personal finances are kept in order.

Financial counseling and planning can also substantially enhance an executive's appreciation and understanding of the value of the total compensation package as offered through company-sponsored benefit programs.

Net Takeaway

Now that you are armed with useful information, you are ready to determine, or with the help of a professional service firm, which executive benefits fit within the total compensation package. Here are the basic steps in the process:

1. **Determine Objectives**. Design a program to correspond with the total compensation philosophy of the company.

2. **Examine Benefit Security Devices**. In general, executive benefits are nonqualified so to maintain perceived value, you must secure the benefit with a Rabbi Trust, for instance. You must also analyze the cash flow and profit and loss impact to guarantee your benefit plan is resilient and cost-effective for shareholders.

3. **Obtain the Board of Directors Approval.** Be sure to formally incorporate the program, its purpose and objective, eligibility, structure, and administration/ monitoring requirements in the total compensation and benefits strategy.

4. **Implement the Plan.** The best-made plans may be ignored or undervalued if the benefits are not communicated properly and frequently. Implementation represents the heart of your plan, and communication its blood flow. Many firms use branded web-based portals, online enrollment, financial counseling, and other dedicated content to properly communicate the plan.

5. **Select the Best Vendors and Administrators.** These service providers can ensure performance tracking, cost management, and program communications, to identify a few of their valuable services. Consider first existing vendor to your 401(k) plans. In this way, it can coordinate executive benefits with existing programs to offer a more seamless benefit statement, so welcomed by your participants.

6. **Monitor the Plan.** Given the complexities of compensation benefits, taxes, and legislative changes, it is advisable to work with a competent outside specialty firm. What you've overlooked and it can uncover will pay handsome dividends over the long run.

Take advantage of the win-win outcomes available to you, your executive team, and your shareholders.

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Executive Benefit Solutions, headquartered in Boston, is a totally independent, objective and fee-based firm specializing in the full range of executive benefits from design through administration. For a complimentary discussion on the state of your executive benefit program, call us today.

For more information on valid business reasons to speak with us, please contact:

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