Two Ways Directors Can Use Board Compensation to Save for Retirement

Even When Companies Eliminate Directors' Retirement Plans

A Brief and Informative Position Paper for Boards of Directors and Compensation Committees

April 2020

By William L. MacDonald
Managing Director, EBS

EBS Executive Benefit Solutions

"What is the appropriate compensation and benefit package for outside board of director members?"

A simple question with a complicated answer. And, many factors impact the answer:

- Desired package amount
- Organizational size
- Public or private
- For-profit or not-for-profit
- Director committee ships

Pay Board Members Directly?

Regardless of whether, or how much, they get paid, board directors are bound by their fiduciary duty to do their best in planning and overseeing the organizations they serve.

Board of directors' **responsibilities** became more challenging this past decade. Since the 2008 financial crisis, investors and regulators have more strongly scrutinized board performance. Such scrutiny has elevated the degree of difficulty in recruiting reliable board members willing to serve.

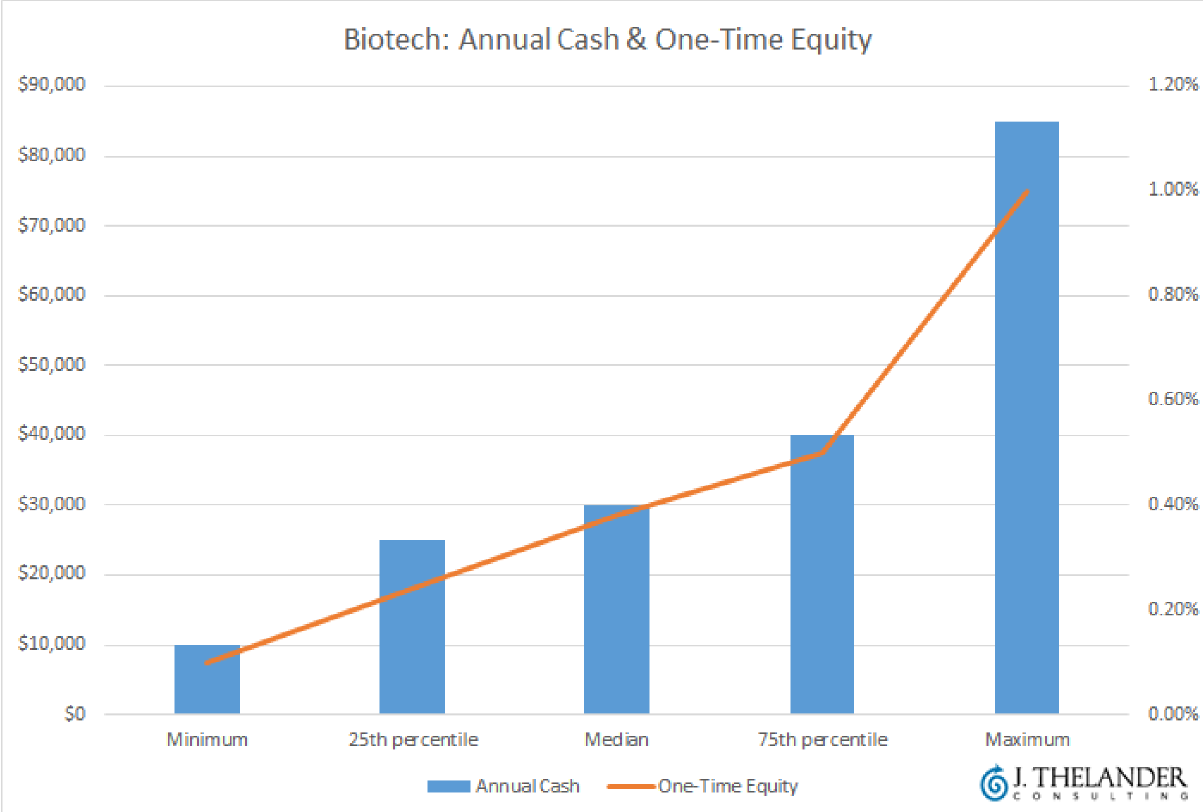
Non-Investor vs. Investor Board Members

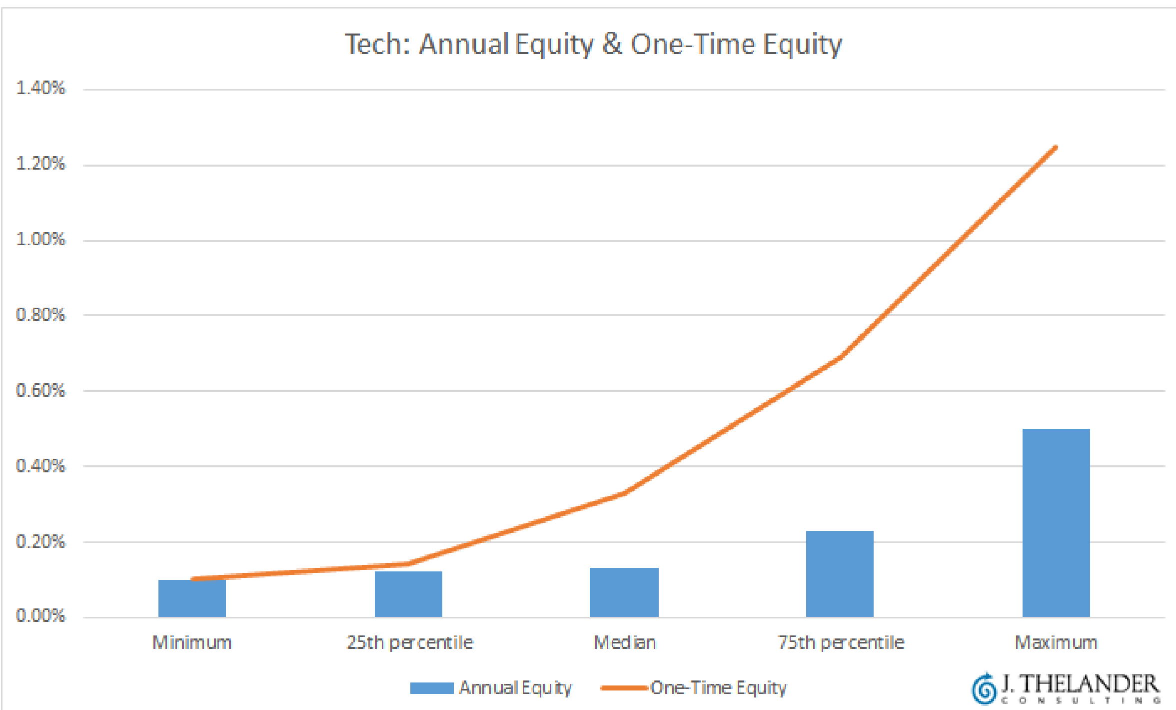
A board member can be defined in two ways: non-investor or investor. Conventional wisdom leads us to believe that investors' motives are clear. When the company does well, they do well.

In the case of non-investor board members, they earn compensation as independent directors through cash or minor equity, either on a one-time basis or annual, or both.

By way of example, note the chart below, which depicts that private biotech companies more often compensate directors with annual cash/one-time equity. In comparison, the equivalent private tech companies offer both yearly and one-time equity, with no annual cash.

This 2017 data, gathered by the J. Thelander Consulting firm, gives insight on each sector's most preferred form of compensation.





In these two examples, we show data on private companies where, in most cases, directors are also substantial investors, or part of a private equity firm where they're well compensated. Therefore, it is not as much about directors' fees as it is about protecting their investment. For the balance of this report we want to focus on professional directors.

Let's step back a moment to recall the compensation headlines pre-2008.

What Changed the View and Scope of Directors' Pay?

The first changes in director compensation arose in 1996 with the release of the **National Association of Corporate Directors' (NACD) Blue Ribbon Commission Report on Director Professionalism.** I served on this committee as a co-contributor. The report issued multiple recommendations, which sparked new trends—paying directors with cash and equity, dismantling pension and benefits programs, and adding independent directors and lead directors.

Then in the early 2000s, corporate failures erupted with Enron, WorldCom, and numerous other companies backdating stock option plans. This egregious action produced the **Sarbanes-Oxley Act**, reframed board responsibilities, and caused significant changes in the role of the audit committee.

Collectively, these actions led to a deeper investigation of directors' responsibility and involvement in those committees which drove pay increases. Eventually, companies shifted to offers of board equity grants in place of stock options.

Then came the **Dodd-Frank Act**. Compensation committee chair responsibilities increased by encouraging an annual advisory say-on-pay vote for shareholders. Many boards have since added retainers for compensation committee chairs that closely resemble those for audit committee chairs.

Past benefits, such as pensions and perquisites, are being replaced by programs that better align the interests of directors with those of shareholders, including::

- Stock Ownership Guidelines
- Value-Based Equity Award Determination
- Vesting Periods for Equity Awards

Common Pay Elements for Directors

If you read proxy statements, as I do, you will see that, currently, the most common pay element at Fortune 500 companies are:

- Cash retainers for board service
- Annual equity grants for board service
- Committee chair retainers
- Retainer for lead director of non-executive chair

This position paper focuses on how a director can use his/her board compensation to save for retirement, even though companies have eliminated directors' retirement plans. Many plans continue to offer deferred compensation plans to allow the director to defer income. Later in this paper, we'll also discuss the role of qualified pension plans to tax defer income for later retirement for directors.

Directors' Deferred Compensation Plans

Many companies, especially publicly traded, allow directors to defer cash retainers and restricted stock units (RSUs). Some of these companies also grant deferred stock units, which directors receive after they leave the board.

To ensure an attractive and competitive pay package, companies often sponsor director-deferred compensation plans to allow the director to take distributions over time to minimize taxes on the distribution. As an example, he/she could elect to receive retirement benefit payments over 5, 10, 15 or 20 years. Taking a distribution for ten years or longer could have certain state income tax benefits if a director moves after retirement to a state with a lower income tax rate than the rate for the state in which the compensation was earned.

Deferred compensation programs may also require mandatory deferral of equity awards until the director leaves the board. This type of design can be quite beneficial, and it eliminates potential concerns over director insiders selling stock to cover tax costs while on the board.

Note, however, there can be considerable differences in age and wealth across a group of directors: Large mandatory deferrals may be attractive for some and less so for others. A critical point—ensure that all directors understand the economics and ramifications of mandatory deferrals and agree on the design before implementation. It's almost impossible to change deferrals once in place.

Deferral of Restricted Stock Units (RSUs)

Typically, board members receive annual grants of full-value equity awards, such as restricted stock, restricted stock units, or deferred stock units. There has been a continued decline in granting stock options to board members, in part because the volatility in value associated with stock options is inconsistent with the non-employee directors' fiduciary role, unlike an operator/manager of the business.

For those companies that grant equity awards to non-employee directors, the decision to provide an award that accounts for at least one-half of the value of total compensation for board members can ***help align*** the long-term interests of non-employee directors with those of shareholders. Many companies, such as Intel, allow directors to receive RSUs in place of cash fees. For example:

> **Intel RSUs in place of Fees.** Under the "RSUs in Lieu of Cash Election" program, independent directors can elect to receive 100 percent of their cash compensation in the form of RSUs (but not less than 100 percent). RSUs elected in place of payments in cash have the same vesting terms as the annual RSU grant to directors.

With such a large amount of equity in a director's pay package, it is not uncommon to see deferred compensation arrangements in place.

Enhancing the RSU Deferred Compensation Plan with Diversification

Many companies permit their executives and directors the opportunity to defer RSUs rather than be taxed upon vesting. Another way to maximize the deferral value of RSUs is to allow the director to diversify the portion of his or her deferred compensation account denominated in RSUs into other notional investments offered under the plan.

For example, if the deferred compensation plan permitted diversification at retirement the director could diversify away from a concentration in company stock when he is no longer on the board. So, the director would elect to defer his/her RSUs until retirement and make an election to take distributions over a number of years (i.e. 15 years) to better manage federal, and perhaps, state income taxes.

For more information on this concept see https://executivebenefitsolutions.com/resource/how-to-use-your-deferred-compensation-plan-to-create-a-personalized-restricted-stock-wealth-management-plan-rs-wmp/.

Prevalence of Nonqualified Deferred Compensation Plans for Directors

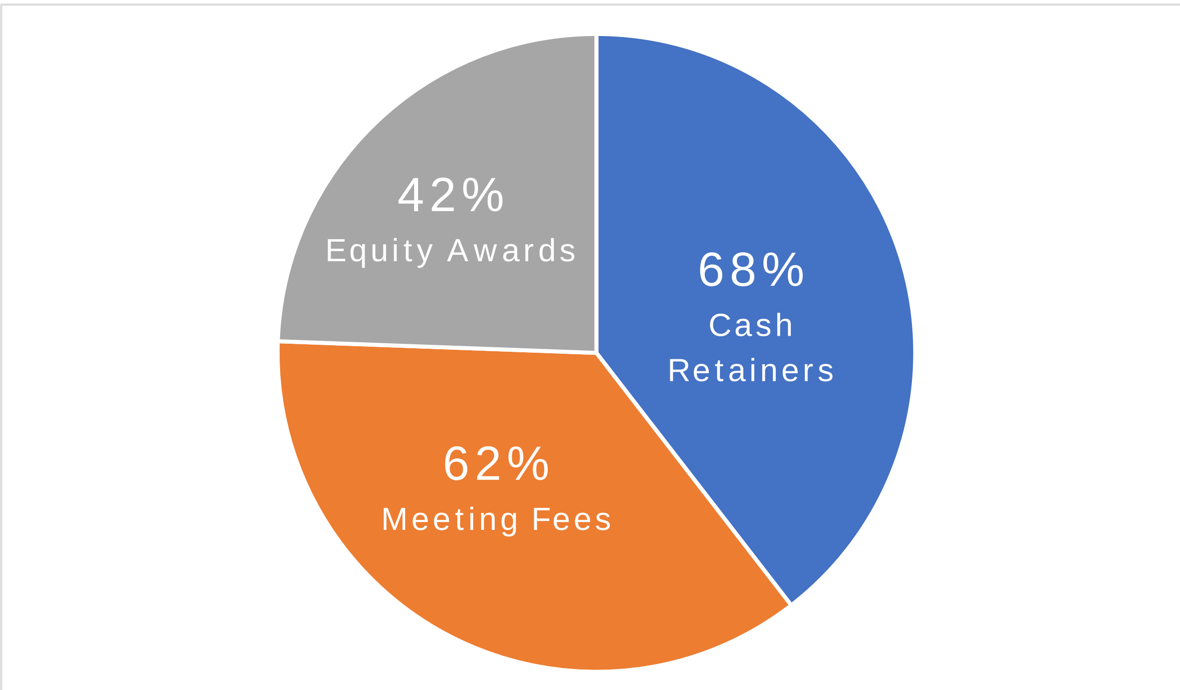
According to the **2018 Prudential Plan Sponsor Study**, 28 percent of respondents offer a separate nonqualified plan for their board of directors, up six points (22%) from the prior year. Consistent with last year, large companies (31%), public companies (36%), and tax-paying organizations (32%) are more likely to offer a separate plan for their BODs.

Once again, the top two deferrable compensation types for boards of directors are cash retainers (68%) and meeting fees (62%)—but both are down from 2017 by 8 points and 6 points, respectively. Equity awards are allowed to be deferred by 42% of employers with separate plans for boards of directors—up 15 points from last year's 27%, again ***pointing to a shift in tying executive benefits to company performance.***

Types of Deferred Compensation Allowed in the Board of Directors Plan

Fred Whittlesey, in his compensation blog, writes about 50 ways to pay your board. And the recipient of this compensation may be able to defer some or all of this compensation. While many companies have nonqualified deferred compensation arrangements, under which independent directors can defer all or a portion of the fees otherwise payable to them for their services, many do not.

In these situations, an independent director may be able to establish his or her own qualified retirement plan. "Earned income," (compensation derived from personal services) is *the* basis for a contribution to such a qualified retirement plan.



These plans can be designed as either a defined benefit or defined contribution, depending upon one's individual situation. Formulate your decision by the deferral amount needed.

Director's Qualified Plan Alternative

Qualified defined benefit and defined contribution plans provide the optimal retirement plan for members of high-paying corporate boards. Independent directors generally are paid in stock and cash—the cash fees are considered compensation to fund a retirement plan. They are categorized as self-employment income by the IRS, therefore can be used to set up a qualified plan.

Defined benefit plans allow the highest deductible contributions of any retirement plan. Current IRS regulations allow a participant to fund a lifetime pension of up to 100 percent of compensation, not to exceed $230,000, as early as normal retirement age of 62. To do so requires an accumulation of almost $2.95M by age 62 to provide the benefit, as determined by IRS actuarial tables that consider life expectancy and assumed earnings—for the year 2020, the maximum compensation is $285,000. The IRS annually indexes these compensation and benefit limits. This benefit limit assumes a single-life annuity starting between age 62 and 65.

So, let's take an example. David Smith is an outside director for two different companies. His total cash compensation for the two board is $530,000. David is 67 years old and is retired from a major company where he receives pension benefits. He would like to tax defer as much of his board fees as possible.

With two board seats and income of $530,000, and an average three-year compensation history (net Schedule C) of $530,000, David could defer $26,000 into a 401(k) and make a defined benefit contribution of $345,000. The accumulation reaches $1,868,631 at age 71 (five-years of contributions) and the equivalent monthly pension for life totals $15,097 or $181,164 per year.

He also has the option of using a profit-sharing formula, or a defined benefit formula or a combination. The following chart cells showcase contribution examples using different funding methods:

CURRENT AGE	***PROFIT Sharing Plan***	***DEFINED Benefit Level Funding***	***DEFINED Benefit MAX. Funding***	***DEFINED Benefit MIN. Funding***
45	**$57,000**	**$114,918**	**$240,282**	**$19,023**
50	**$57,000**	**$177,250**	**$301,387**	**$25,930**
55	**$57,000**	**$255,875**	**$373,847**	**$34,651**
60	**$57,000**	**$283,231**	**$462,983**	**$46,030**
65	**$57,000**	**$57,000**	**$477,612**	**$47,024**
70	**$57,000**	**$57,000**	**$565,644**	**$56,313**

In the above example, one of the major advantages over a Director's Deferred Compensation Plan is that these benefits are protected by ERISA (Employee Retirement Income Security Act). Under the deferred compensation arrangements, those assets are subject to the claims of the sponsor's creditors. Also qualified pensions assets can be rolled into an IRA (Individual Retirement Account) when nonqualified deferred compensation assets cannot be rolled in an IRA.

As you can see, various design methods can be used. EBS, working with our actuarial resources, can provide you with a custom feasibility study and more detailed information.

Make a real difference

Sitting on a board allows you to make a real difference, a priority benefit. You can play a key role in the success of another company or person, which is hugely rewarding and makes the significant investment in time and energy worth it.

With proper planning, you can also make a difference in wealth accumulation and tax planning by utilizing the vehicles we discussed in this paper. Financial planning organizations, like My Financial Coach (www.myfinancialcoach.com), who work with directors and other independent contractors have experienced a major increase in directors seeking tax planning around their directors compensation.

❖❖❖❖

EBS | Executive Benefit Solutions

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.

CONTACT INFORMATION:

EBS-Boston
20 Park Plaza, Suite 1116
Boston MA 02116
Phone: **617.904.9444**
Fax: 866.903.9927

Christopher Rich
Managing Director
crich@ebs-boston.com

Chris Wyrtzen
Managing Director
cwyrtzen@ebs-boston.com

Robert Flood
Managing Director
rflood@ebs-boston.com

National Administration
801 East Plano Parkway, Suite 216
Plano, TX 75704
972.422.8298

Bonnie Barnes
Vice President of Plan Administration
bbarnes@ebs-boston.com

EBS-West
1902 Wright Place, Suite 200
Carlsbad, CA 92008
760.788.1321

William L. MacDonald
Managing Director
858.759.8637 wmacdonald@ebs-west.com

Don Curristan
Managing Director
760.788.1321 dcurristan@ebs-west.com

Trevor K. Lattin
Managing Director
949.306.5617
tlattin@ebs-west.com

EBS-Milwaukee
601 Genesee Street
Delafield, WI 53018
262.853.7755

Robert Birdsell
Managing Director
bob.birdsell@ebs-milwaukee.com

EBS-Richmond
3801-A Westerre Parkway
Richmond, VA 23233
804.317.9670

Hugh Carter
Managing Director
hcarter@ebs-richmond.com

EBS-Southeast
101 Plaza Real S, Suite 808
Boca Raton, FL 33432
828-654-8400

Glen E. Horecky, RFC, CSA
828-777-4524
ghorecky@ebs-southeast.com