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EXECUTIVE COMPENSATION

Moderator: JAMES F. MC JOHN. Panelists: LANE B. WEST, WILLIAM E. WITT. Recorder: JANE L. LOONEY

MR. LANE WEST: During this portion of the presentation we will focus on retirement, disability and survivor benefits provided to corporate executives above and beyond those provided to rank and file employees. These benefits are provided through a variety of vehicles and enhance the total compensation package. Our primary focus will be on the techniques used to fund these programs with particular emphasis on the nonqualified plan area. However, before getting to the nonqualified area, I'd like to review several types of executive life insurance.

LIFE INSURANCE PLANS

Let us first discuss various plans that are available to provide life insurance.

EXECUTIVE LIFE INSURANCE PLANS

- o SPLIT DOLLAR PLAN
- o RETIRED LIVES RESERVE
- o SECTION 162 PERMANENT
- o COST PLUS GROUP TERM
- o NONQUALIFIED

Probably the oldest type of executive life insurance is the Split Dollar Plan. This plan is simply a means of financing the purchase of insurance. Under this plan, the corporation and the employee share the cost of the policy. The corporation normally pays a portion of the premium representing the increase in the policy's cash value. By showing the accumulated cash value on its books, the corporation does not have to book an expense relative to its investment in the policy. The employee pays the remainder of the premium. In this way, the cumulative corporate cost is always equal to the accumulated cash value and no "expense" is incurred. Upon death, the corporation recovers the cash value and the net amount at risk is paid to the named beneficiary.

Let's look at the taxation of this approach. Each year, the employee pays a tax on the difference between the P.S. 58 cost and his portion of the premium. If the policy pays dividends, the employee also pays tax on these dividends.

A very popular executive life insurance benefit is the Retired Lives Reserve plan. Under this plan the corporation pays an additional premium to the group carrier which is ultimately used to purchase a post retirement death benefit. Under current law, group life insurance can be provided in a discriminatory manner. In addition, under current law, there is no annual taxation to the retiree for this coverage. Again, in the United States, there are changes pending in Congress that make this form of executive life insurance less attractive. In fact, there is a

private letter ruling that says if benefits are fully guaranteed then the economic value of the post-retirement death benefit is taxable when the executive retires. Apparently, by careful design you can avoid this problem.

A third type of executive life insurance is Section 162 Permanent Life Insurance. Under this approach, the employer simply pays the life insurance premium on a policy covering the executive and owned by the executive. The payment which is paid as a bonus is deductible assuming it is reasonable compensation. The payment is also immediately taxable to the employee. The employee may use the dividends or cash values accumulated under the policy to pay his additional tax liabilities. One disadvantage of this plan and the Split Dollar Plan, is that there are no golden handcuffs applied to the employee as exist under the Retired Life Reserve Plan. Another disadvantage is that the corporation does not recover its investment as it does under the Split Dollar Plan.

The fourth type of life insurance plan can be called "Cost Plus Group Term/Permanent" plan. This is a hybrid plan which provides additional group life insurance to the executive through a cost plus arrangement. That is, no premium is paid to the group carrier until the time the employee dies. At that time a premium equal to the death benefit plus an expense loading is paid to the group carrier and the group carrier in turn pays the group life death benefit. Because the group insurance premium is tax deductible to the employer, the after tax cost is only one-half of the group life insurance premium (assuming a 50% corporate tax bracket). To fund the eventual group life premium, the company purchases a whole life insurance policy on the life of the executive with a death benefit equal to one-half the group life insurance proceeds. Since the corporation owns this policy, the premiums are deductible and the proceeds are not taxable. By using a minimum premium scheme, a corporation can minimize its investment in the whole life policy. The advantage of this method, as well as the three other previously described methods, is that upon the executive's death, payments to the beneficiary are generally received income tax free. One advantage of this method over the Retired Lives Reserve is that the executive has no guarantee that benefits will be paid after age 65.

NONQUALIFIED PLANS

This leads us to the use of executive life insurance plans in the nonqualified area. Today, there are several techniques used to fund nonqualified plans and I will be touching on each of these.

TYPES OF NONQUALIFIED PLANS

- o DEFERRED COMPENSATION
- o SALARY CONTINUATION

There are two types of nonqualified plans; the "deferred compensation" plan and the "salary continuation" plan. Both of these plans normally take the form of contractual arrangements between the corporation and the executive.

These agreements promise the executive certain benefits in exchange for his service and loyalty to the corporation. As I will discuss later, these agreements are normally unsecured.

The deferred compensation plan normally involves employee money. You will find life insurance agents selling this as an executive 401(k) plan. The salary continuation plan normally is employer money and provides benefits over and above other benefits being provided. One other characteristic is that a deferred compensation plan is normally a defined contribution arrangement. The salary continuation plan is normally a defined benefit arrangement, although I have seen salary continuation plans which were simple money purchase type plans.

DEFERRED COMPENSATION PLAN

The deferred compensation plan involves the deferral, prior to being earned, of an employee's salary to a specified date. The employer normally credits interest on the employee's money. The rate might be the prime rate or the rate earned by an insurance policy backing the plan. Normally the plan, if funded, is informally funded, and the money is available to the general creditors of the company and is considered part of general assets. The plan can be unfunded or funded in a variety of ways as we will discuss later.

The plan can be used in conjunction with:

- o Regular pay or a pay raise
- o Annual incentive pay
- o Long term incentive pay

Deferral can be to a specified date (for example five years) or to retirement. The election must be irrevocable to avoid taxation.

Once the benefits are determined, a deferred compensation plan can be informally funded in the same manner as a salary continuation plan.

SALARY CONTINUATION PLAN

The other type of nonqualified plan is the "salary continuation" plan. The primary purpose of a salary continuation plan is to provide an additional pension. These plans usually provide death and disability benefits in addition to the retirement benefit. However, these benefits are secondary.

Probably the best known salary continuation plan is the "excess benefit" plan. These plans are specifically allowed by ERISA to cover deficiencies under qualified plans caused by the imposition of the 415 limitations. The further reductions in these limitations by TEFRA has already caused an increase in the number of "excess benefit" plans.

What are some of the differences between qualified and nonqualified plans?

- o Qualified plans are subject to the coverage (including nondiscrimination), reporting, funding and fiduciary standards of ERISA. Because nonqualified plans are free from these requirements, the employer has great flexibility in designing a nonqualified plan. The corporation is free to select not only who is covered, but also the benefits provided to the individual participants. Note that if the group covered is too large, the plan might be considered a pension plan and therefore subject to ERISA, including funding requirements.

- o Qualified plans enjoy certain tax advantages which are not available to nonqualified plans. The principal advantages are:
 - o Employer contributions are deductible when made
 - o Investment earnings accumulate tax free
 - o Employees and beneficiaries are taxed only upon benefit receipt

Because the nonqualified plan does not enjoy these advantages, the corporation must be careful in its design and funding of the plan to avoid or minimize any tax liabilities.

In addition, the corporation must make a choice between providing vesting in the plan or funding the plan. If vesting and funding are provided, the benefits become taxable to the employee as they become vested.

If funding is provided, it usually is informal; that is, the funds are general assets of the corporation in which the employee has no direct interest, and the investment usually carries with it its own tax sheltered income.

Examples of these investments are:

- o Life insurance and annuity products (including Retired Lives Reserve)
- o Preferred stocks and certain high yielding common stocks due to the 85% inter-corporate dividend credit
- o Municipal bonds or tax-free mutual funds

I've talked about the types of nonqualified plans and some of their characteristics. Prior to discussing funding issues, let's spend a few moments talking about why a company might adopt one of these plans.

OBJECTIVES

These plans have existed for many years, but have shown phenomenal growth during recent times not only due to the ERISA and TEFRA benefit limitations, but also the desire to ensure that the executive compensation package remains competitive. These plans can be used to foster a variety of corporate objectives.

One objective would be to recruit key people. Persons who change jobs need to know they are not sacrificing their family's future. Assuming the former employer sponsored a final pay pension plan, the executive's benefit would be frozen as it relates to his service at termination. Under his new employer's qualified plan, he cannot be given credit for service with the former employer. To correct this, the new employer could offer a nonqualified plan which would allow his past service benefits to increase as his pay increases.

Nonqualified plans can also be used to retain employees by providing pay and benefits greater than the competition, or by providing vesting schedules that make it impossible for the executive to leave without a substantial forfeiture.

Another use of these plans would be to encourage early retirement.

Probably all consulting actuaries are asked from time to time to make calculations related to supplemental early retirement benefits.

Another objective would be to compensate for inadequacies in qualified plans. The more obvious inadequacies relate to the ERISA benefit limitations which are further restricted by TEFRA. Other uses might be:

- o Upgrade a career average formula to final average
- o Provide for inadequate service
- o Cover total pay
- o Improve benefits for key employees without increasing benefits for other employees
- o Provide a "floor" plan where a profit sharing plan has produced inadequate benefits. Many of the corporations' senior executives could have been promoted through the ranks and might have a totally inadequate current account balance when related to their final pay
- o Finally, another objective could be to actually defer current income to times when the employee's tax rate is lower

The most common consideration in determining if supplemental benefits are needed is the adequacy of the benefits provided by the qualified plans and Social Security. Under a typical pension plan providing 50% of average compensation less 50% of Social Security to career employees, replacement ratios would look something like this:

| | ANNUAL SALARY LEVEL | | | |
|-----------------|---------------------|-----------------|-----------------|------------------|
| | <u>\$10,000</u> | <u>\$25,000</u> | <u>\$50,000</u> | <u>\$100,000</u> |
| Social Security | 44% | 30% | 17% | 8% |
| Pension Plan | <u>22%</u> | <u>29%</u> | <u>36%</u> | <u>40%</u> |
| Total | 66% | 59% | 53% | 48% |

The illustrated replacement ratios include pension benefits and Social Security as a percent of the final pay. At a \$50,000 salary, the replacement ratio would be 53%, and at \$100,000 it would be 48%. These assume 6% salary increases. In reviewing this information, the employer may determine to provide a larger benefit to the persons earning \$50,000 or more. For example, targeted ratios in the 60%-75% range are not uncommon for nonqualified plans. Let's take a look at the replacement ratios of a profit sharing plan.

| | ANNUAL SALARY LEVEL | | | |
|-----------------|---------------------|-----------------|-----------------|------------------|
| | <u>\$10,000</u> | <u>\$25,000</u> | <u>\$50,000</u> | <u>\$100,000</u> |
| Social Security | 44% | 30% | 17% | 8% |
| Profit-sharing | <u>23%</u> | <u>23%</u> | <u>23%</u> | <u>23%</u> |
| Total | 67% | 53% | 40% | 31% |

Under this particular nonintegrated plan, the corporation has been contributing 5% per year, the fund has earned an annual rate of 8% per year

and the employee has 30 years of service under the plan. Note how quickly the replacement ratios drop. For a \$50,000 salary, it is 40%, and for a \$100,000 salary it is only 31%. It becomes obvious that the qualified plan and Social Security do not provide an adequate income to the higher paid employees.

PLAN DESIGN

Once the corporate objectives are set, the basic retirement benefit and the ancillary benefits can be determined. The most common approach is to use an "umbrella" plan. That is, the plan specifies a certain percentage, say 70%, of final average compensation be provided, including the benefits paid under the qualified plan and Social Security. Another approach would be to approximate this benefit by simply providing a fixed percentage of final average pay. I have seen plans with maximum and minimum benefits as well. Many insurance illustrations show fixed benefits payable over a fixed period and are driven by the insurance illustration and not by the objectives and needs of the employer. I feel that the "umbrella approach" is a more sound approach to benefit planning. Death benefits provided under these plans are fairly liberal, but generally are subordinate to the retirement benefit. Disability benefits are sometimes provided either as an immediate income or a continuation of coverage for the death benefit and the retirement benefit.

FUNDING

I would like to focus our attention on the actuarial aspects of these plans, that is, the funding of the plans. As I mentioned earlier, the plans are generally informally funded to avoid any current taxation to participants. There are three ways in which the cost of these plans are generally funded:

- o Pay-as-you-go
- o Book reserve
- o Insured funding

Both the "pay-as-you-go" method and the book reserve method fall under the self-funded approach. The "pay-as-you-go" method is used for insignificant benefits or for other benefits where the effect on the sponsor is deemed to be immaterial and therefore, the simplicity of this method is utilized.

The "book reserve" method is simply a reallocation of a portion of the company's surplus account to a liability account. It signifies that a portion of the general assets of the corporation are being set aside to provide for future compensation. Accounting principles require the establishment of such an account for all nonqualified plans unless the sponsor can show the effect on the financial statements of the company is immaterial.

While there are no tax advantages associated with the establishment of a "book reserve", the reserve is a legitimate measure of a contractual obligation and therefore is recognized by the IRS in measuring the level of retained earnings. That is, in a closely held corporation, these reserves are considered liabilities which justify the retention of cash in the corporation and the nonpayment of dividends.

The third funding method which we will discuss is the use of whole life insurance. As I mentioned earlier, insurance is a tax favored investment vehicle because the cash values accumulate on a tax deferred basis. By buying an insurance policy, the corporation is simply making an investment. The policy and the face amount are chosen so that upon the death of the employee, the company recovers all the benefit payments and premium payments, and in some cases, the cost of having its money tied up for the life of the executive. When compared to self-funding, these plans can generally provide a larger death benefit. Because, on a cash basis, insurance death proceeds generally will exceed the investment in the contract, the company ultimately will have a lower net charge to its earnings than under the self funded approach.

On the other hand, the insured approach requires a longer commitment, higher early cash flows and higher risk. In order to gain the tax benefits of insurance, policies must be held until the death of the insured. Only in this way can the tax on interest earned on the cash values be avoided.

Here is how insurance funding works.

The policies are owned by the corporation and not the employee. The policies are payable to the corporation. Because the policies are considered investments and because the premium payments are not taxable to the employee, the premiums are not deductible.

In order to make these plans effective, you must use tax leveraging. As with all life insurance proceeds, they are not subject to income tax. The corporation uses tax leveraging to minimize its investment in the contract. The corporation borrows all but four annual premiums and only pays these four premiums and the interest on the policy loan. The interest paid on the loan is tax deductible, thereby lowering the effective rate of interest paid. In many policies today, the insurer credits almost the full interest paid on the policy loan back to the policy and this interest accumulates tax free.

In order to maintain a reasonable death benefit, the policy chosen should be a participating or increasing whole life policy. The corporation must hold the policy until death to realize the full tax advantages. Due to the possibility of turnover among the covered group, the policy must give the owner the right to transfer insureds.

Before looking at a comparison of insured funding and self-funding, I would like to focus on the risks involved in insured funding. The first two are critical considering the tax legislation pending in Congress.

The first one is carrier performance. For example, an insurance agent might tell you dividends have increased in 18 of the last 19 years. There is the potential that illustrated dividends, which were relied upon in purchasing the policy might not be paid or might be reduced. The new tax act is requiring many billions of dollars in taxes from insurance companies that must come from somewhere. It will either increase premiums or decrease dividends. In looking at these policies, you have to be cognizant that the dividends may not increase as quickly as they have in the past.

I mentioned the four out of seven rule. Uncle Sam is paying for a lot of the financing due to the tax structure. If the interest paid on the policy loans were not deductible, this technique would be severely restricted.

Another risk is that the program might be changed or terminated. The company is stuck with insurance policies that were purchased knowing they would have to be held until the death of the executive, but might want to change the program in the meantime.

Then you have the short-term cash squeeze in the first seven years during which you are obligated to pay the premiums but you do not have the resources. Finally, the corporate tax bracket might change. I will show an example of that.

Let's look at an illustration of self-funding compared to insured funding.

SELF-FUNDING

| <u>YEAR</u> | <u>RESERVE ACCRUAL</u> | <u>CASH FLOW</u> | <u>CUMULATIVE CASH FLOW</u> |
|-------------|----------------------------|----------------------|---------------------------------|
| 1 | \$ 2,222 | \$ 0 | \$ 0 |
| 5 | 2,222 | 0 | 0 |
| 10 | 2,222 | 0 | 0 |
| 15 | 2,222 | 0 | 0 |
| 16 | 0 | 12,500 | 12,500 |
| 20 | 0 | 12,500 | 62,500 |
| 29 | 0 | 12,500 | 175,000 |

The annual benefit is \$25,000 and the corporation is in a 50% tax bracket.

The corporation's cost on an after-tax basis would be \$12,500 per year in the 16th through 29th years. If the individual lived 14 years (from the 15th to the 28th year), the corporation would have a total cost (after-tax) of \$175,000. Applying actuarial funding methods, that is, funding the plan from the time it is installed until retirement using a 12% interest rate, the annual book reserve accrual would be \$2,222, again on an after-tax basis. The reserve accrual would be credited with interest at the corporation's opportunity cost rate. At the time of the last benefit payment, the charges to earnings, which are equal on the reserve accrual and the interest credited to the reserve, will equal the after-tax cost of benefits or \$175,000. Note that interest will continue to be credited to the reserve until it is depleted. The total reserve accrual would be \$33,300 and the total interest credited would be \$141,670.

INSURED

| <u>YEAR</u> | <u>INSURANCE CASH FLOW</u> | <u>NET ANNUAL CASH FLOW</u> | <u>CUMULATIVE CASH FLOW</u> |
|-------------|--------------------------------|---------------------------------|---------------------------------|
| 1 | \$ 8,948 | \$ 8,948 | \$ 8,948 |
| 2 | 331 | 331 | 9,279 |
| 3 | 662 | 662 | 9,941 |
| 4 | 993 | 993 | 10,934 |
| 5 | 9,941 | 9,941 | 20,876 |
| 6 | 9,941 | 9,941 | 30,817 |
| 7 | 9,941 | 9,941 | 40,758 |
| 8 | (39,585) | (39,585) | 1,173 |
| 9 | (968) | (968) | 206 |
| 10 | (1,369) | (1,369) | (1,163) |
| 20 | (7,911) | 4,589 | 15,362 |
| 29 | (64,244) | (51,744) | (43,443) |

Under the insured approach the same benefits are paid.

However, cash flows start at a much earlier time. Note that in the second, third and fourth years of the illustration, the company only pays the interest on the borrowed premiums. Remember, under insurance funding, four of the first seven premiums are paid without borrowing. This allows the company to deduct the interest paid on any loans.

All of these figures are on an after-tax basis for simplicity. In practice, this would be done on a before tax basis and a deferred tax account would be set up to take a credit based on the corporation's tax bracket.

In the eighth year, the entire cash value is borrowed and the company continues to borrow the premium and cash value increase until the death of the participant. Note, in the 29th year, the individual is assumed to die and the company collects \$64,244 from the policy. Also note that on a cumulative basis, the company has income, even after the benefit payments of \$43,443.

Let's look at a summary of the two alternative funding methods.

SUMMARY COST ANALYSIS

| | <u>Self-Funded</u> | <u>Insured</u> |
|------------------|--------------------|----------------|
| Total Cash Flows | \$ 175,000 | \$ (43,443) |
| Present Value | 16,953 | 7,562 |
| Annual Cost | 2,222 | 991 |

As one can see, the insured method produces income to the corporation on a cash basis, but when the time value of money is considered there is a cost to the insured method. The discount rate used in these illustrations was 12%.

Let's look at another method of comparing competing policies.

POLICY A

| <u>YEAR</u> | <u>BENEFIT CASH FLOW</u> | <u>INSURANCE CASH FLOW</u> | <u>TOTAL CASH FLOW</u> |
|-----------------|------------------------------|--------------------------------|----------------------------|
| 1-5 | \$ 0 | \$ 225,061 | \$ 225,061 |
| 6-10 | 80,820 | (216,987) | (136,167) |
| 11-15 | 171,229 | (105,851) | 65,378 |
| --- | --- | --- | --- |
| 41-45 | <u>140,195</u> | <u>(1,657,889)</u> | <u>(1,517,694)</u> |
| Total | \$ 3,802,085 | \$ (5,682,670) | \$ (1,880,585) |
| Premium: | | \$ 99,619 | |
| Rate of Return: | | 5.78% | |

POLICY B

| YEAR | BENEFIT CASH FLOW | INSURANCE CASH FLOW | TOTAL CASH FLOW |
|-----------------|----------------------|------------------------|--------------------|
| 1-5 | \$ 0 | \$ 236,137 | \$ 236,137 |
| 6-10 | 80,820 | (253,050) | (172,230) |
| 11-15 | 171,229 | (251,547) | (80,318) |
| --- | --- | --- | --- |
| 41-45 | <u>140,195</u> | <u>(2,205,074)</u> | <u>(2,064,879)</u> |
| Total | \$ 3,802,085 | \$ (9,286,950) | \$ (5,484,865) |
| Premium: | | \$ 97,804 | |
| Rate of Return: | | 13.57% | |

The illustration shows the cash flow from the benefit payments and the insurance policies in five year brackets. Note that, for illustration purposes, I have not shown the 16th to 40th year figures. Benefit payments started in the 7th year and continue to the 42nd year and total (after-tax) \$3,802,085. This illustration assumes all executives live to age 80 and receive 6% per year salary increases.

The insurance cash flow shows an expense during the first five years, and income thereafter. The final column is the sum of the first two columns.

Policy A is a fixed loan rate policy and shows an income at the end of the program of approximately \$1.9 million and a rate of return, after benefit payments, of 5.78%. Total income to the corporation at the end of the program is \$1,880,585.

Policy B is a variable loan rate policy and shows an income at the end of the program of approximately \$5.5 million and a rate of return, after benefit payments, of 13.57%. Total income to the corporation at the end of the program is \$5,484,865. Other things being equal, Policy B would be a better buy.

Let's look at the effect of a change in the corporate tax rate on the rate of return. You have a company that has key man insurance and is in the 50% tax bracket, but they are a conservative company and do not want to touch the cash values. That policy, upon death, will yield the company about 7.2%. If the company minimized its investment by borrowing, the yield on that policy would increase to 18.5%. That shows the effect of borrowing versus not borrowing. Also, if the corporate tax bracket changes and they are still borrowing in full, the rate of return drops.

Finally, let's focus on the accounting aspects of these programs.

There are two accounting rules that can apply to nonqualified plans. The first is APB-8, which applies to the accounting for pension plans. If it can be determined that the nonqualified plan is a plan rather than a series of individual agreements, APB-8 can be applied to the financial accounting for the plan. Essentially, this allows the actuary to choose any number of funding methods and thereby extend the funding of past service costs beyond the retirement age of some participants. This can give substantially lower accounting charges.

The second accounting rule is APB-12, which governs individual arrangements. If this rule applies, the cost of the agreements must be fully accounted for by the retirement or termination of the executive. Essentially, the individual level premium method or an individual aggregate method is mandated, resulting in high initial accounting charges. If you are putting in an arrangement for a group of executives, it might be better to write it as a plan without exceptions for benefits. If there are a lot of benefit exceptions, your accountants will want you to treat them as individual arrangements.

Irrespective of which rule applies, an overriding consideration is the "materiality" of the resulting accounting charges. If the charges are deemed to be immaterial to the financial results of the company, then the company may choose to account for the agreement on a "pay-as-you-go" basis.

Any insurance policies present to fund the agreement are accounted for on a "pay-as-you-go" basis. That is, premiums are charged as expenses, and the increases in cash values are credited as income. Once the accumulated cash values exceed the accumulated premiums, the insurance policy becomes an income producer. Policy loans are shown as liabilities or may be netted from the cash value asset.

An insurance organization proposed to the AICPA a "ratable charge" accounting method for insurance policies. This method has certain merit. Their contention was that the insurance policy was an investment, like the purchase of a plant or equipment. The cost basis of that policy, which is simply the sum of the premiums paid, would be reflected on the books as the cost of the plan. Under the traditional approach the cash values, not the sum of the premiums, are shown as the asset. They were saying that by showing the sum of the premiums there was no cost. I suppose one reason they were saying this is that it would be easier to sell if the company did not have to show an expense on the books. In any event, the AICPA rejected the argument.

While many accountants agree that the insurance will eventually produce income to offset the expense of a nonqualified plan, there have been no accounting pronouncements which will allow the offsetting of the income from the policy and expense of the nonqualified plan through the use of actuarial calculations. In other words, no accounting rules allow us to combine these.

In conclusion, we have covered types of executive life insurance plans, nonqualified plans and their funding. When selecting a nonqualified plan, the client's objectives must be determined first, then a plan designed to meet the objectives and finally the technique chosen to fund the plan.

MR. WILLIAM WITT: In order to attract, retain, and motivate high caliber executives, organizations (ranging from non-profit hospitals to Fortune 500 corporations) are finding it necessary to compensate these executives differently than the normal rank-and-file employees. The significant components of a competitive executive compensation package generally include at least a mix of the following:

1. Cash compensation, including base salary, bonuses, and incentive compensation;

2. Qualified deferred compensation agreements that all employees participate in, such as defined benefit plans, profit sharing plans, 401(k) thrift/savings plans;
3. Non-qualified deferred compensation agreements, including supplemental retirement plans to compensate for ERISA and TEFRA limitations or additional tax deferrals, and golden parachutes, such as to guarantee the continuance of income for a certain number of years;
4. Stock Option Plans; and
5. Other executive perquisites.

I will be discussing two of the previously mentioned items, incentive compensation and "Golden Parachutes". As a prologue to each area, let me say that the entire area of incentive compensation and golden parachutes, as well as executive compensation in total, is difficult and complicated. Before any changes, modifications, or implementation of any policies are made, the top management of the organization must examine all aspects of the proposed policy, including the effect of such changes on current existing compensation and benefit practices.

An incentive compensation plan is generally defined as a short term (usually annual) performance related reward plan that provides additional compensation to certain employees when specific performance targets are achieved. These targets are established, agreed upon and communicated to the employee before the performance period begins. Recently, trends have indicated that the incentive compensation program, or pay-for-performance, has replaced to a large extent the annual discretionary bonus plans that historically were not objectively determined against performance.

Incentive compensation is generally paid to top management, those employees compensated at \$75,000 or above. These are the individuals who have the most impact on the organization's profitability and continued growth. However, incentive compensation is available to some middle management, especially those in creative positions or service industries, such as computer software manufacturers and representatives; these individuals are typically paid in the range of \$40,000 to \$50,000. With the current buzzword of "pay-for-performance", you will see this form of compensation increasing, both in relative size of the total available payout and in the number and level of individuals eligible.

Incentive compensation is generally paid in cash at the end of the year, when the organization's year end profitability and other incentive linked requirements are known. Incentive compensation may be based upon a formula, dependent upon either the improvement of certain measures or perhaps the attainment of specified targets. Also, sometimes the incentive awards are based upon the comparability and competitiveness of the organization against other similar companies.

There are certain requirements in order for an incentive compensation plan to work effectively, and each needs to be communicated and adhered to for effective administration of the plan.

1. First, realistic performance goals should be established and

clearly communicated to plan participants before the performance period begins, such goals being exemplified by return on sales, return on investments, revenue growth, etc. Upper management will be required to examine reliable information to render an objective judgment of the individual's performance against these goals. These individual or team performance measures should be based on a relatively short-term basis, usually annual, to avoid the pitfalls of relying too heavily on an upturn/downturn cycle.

2. Secondly, the performance measures should be substantially controlled by the participants in the incentive plan. In other words, plan participants should be rewarded or penalized based on their performance, not on measures based to a large extent on factors outside their control (i.e., inflation, governmental restrictions, etc.).
3. Third, the results of critical decisions should be traceable to the individual participants so that their performance can be evaluated. If responsibilities and decisions of individuals overlap, the results cannot generally be attributed to specific individuals.
4. Finally, and probably most importantly, upper management must be willing to objectively judge performance. Managers must accept the responsibility of individual performance evaluation, and evaluate based on the performance measures included in the plan. As we are probably all aware of, this can be difficult and uncomfortable, but essential to a viable and effective incentive plan.

A recurring problem concerning incentive compensation is whether or not to include it in other benefit areas, such as Group Life or Retirement Plans. If the incentive award is considered a major and important component of the individual's worth to the organization, the incentive award should probably be included. If the individual and family are accustomed to this annual award, upon retirement or death, the inclusion/exclusion of such in the definition of earnings may be substantial. Frequently, retirement plans define compensation as W-2 earnings, and in doing so the award will be recognized by the plan, but depending upon the time of payout perhaps in the wrong year. Other implications may arise by the inclusion of any bonus/incentive awards, as then overtime and/or commissions may need to be included in the definition of compensation in the life, pension, profit sharing and thrift/401(k) plans.

In general, incentive compensation or pay-for-performance, is becoming much more prevalent. Upon implementation, modification, or review, upper management must address the problem of the levels of the incentive awards, and whether or not to include them in the other benefit programs.

The second half of my presentation will be on the subject of "Golden Parachutes", another "in" topic in corporate boardrooms and executive suites. With the steady increase in merger activity of recent years, the trend toward golden parachutes is understandable and, some might argue inevitable. But this golden parachute phenomenon is also a risky and questionable response to complex post-merger policy issues facing American industry.

The existence of top management contracts is not new, but until recently few had takeover clauses. The general makeup of golden parachutes today varies widely. Overall, they guarantee some protection to one or more executives in the event, whether anticipated or factual, of some change of control.

Usually golden parachutes are extended to only a handful of key, upper management types. Several corporations, however, have recently increased parachute coverage substantially, ranging from 10 executives to 250 takeover contracts for individuals from assistant vice presidents on up.

The change of control that may implement these contracts can vary greatly: from a hostile takeover of an independent company which might continue as such after the merger, to a multi-ownership situation leading to quick absorption of control. The nature of the protection sought by the contract can also vary widely. Some golden parachutes guarantee specific job titles and descriptions, others promise a salary range, or a particular bonus or pension arrangement; no standardized approach has yet emerged. Terms can range from 12 months or less to 10 years or more. Frequently, in the case of seasoned CEO'S, the term is geared to the years remaining to normal retirement.

The fear surrounding takeovers in recent years has led to some widespread misconceptions about golden parachutes; let me try to clear some of these up.

First of all, following the leader, bad for any compensation practice, is particularly inappropriate in the merger area. One client may read of Company X's contracts and feel it necessary to duplicate them; however, just as some companies are better suited than others for bonuses or "key-man" insurance policies, some golden parachutes may be perfectly acceptable in one organization and completely absurd in another.

Secondly, golden parachutes are rarely just a matter of preserving the status quo of a particular compensation agreement. The ultimate golden parachute goal is often difficult to quantify, that being to protect the status or dignity of a particular position. Some areas the board should address are:

- o What length of protection should each individual have?
- o Will executives closer to normal or early retirement get special protection?
- o Should a title, position "level", reporting relationship, pension amount, or a pay level be protected?
- o If pay is to be protected, how is pay defined? Should it include a guaranteed bonus or a minimum compensation level?
- o Most importantly, is this guarantee good regardless of company performance?

For example, CEO compensation is generally equated with company performance. However, is it performance in relation to historical performance, or to some measure of relative industry performance, or perhaps to some predetermined measures of return? This is similar to the incentive compensation policies, but locking in the performance measures for possibly a much longer period.

Another misconception concerning golden parachutes is the notion that they add to the total acquisition cost. Although true, the sums involved in many unsolicited tender offers may be in the eight, nine, even ten figure range. A few million dollars is generally inconsequential in these deals.

Golden parachutes may not be the solitary reason that top managers endure a long, somewhat "messy" takeover deal. Managers do not tend to "give up the ship" during a takeover. As a matter of fact, by leaving the organization at this time, the individual would be perceived as exceeding disloyal.

Management contracts do not resolve the uncertainty found in any job; they do not create clear assurances. Golden parachutes may make them clearer, but all the responsibilities of a CEO cannot really be written down in black and white. For example, how do you legally define the CEO relationship to the board and shareholders, and how far down do you draw the line? Do you worry about the individual two years from retirement who would stay anyway?

Also, with the exception of an extremely hostile, or stupid, acquisition, generally acquirers provide for upper management at least at the level that they would provide for themselves. Buyers will go overboard particularly during the transitional, initial years to retain and compensate the acquired management. This is especially true in the case of acquirers buying companies whose businesses they are not familiar with. Management contracts do not last forever. What to do at the end of the Golden Parachute period needs to be determined. Also, what happens when an additional executive joins the top management team currently covered by contracts? Are these conditions extended to the newest member?

The elite nature of golden parachutes had led to corporate secrecy. SEC rules require the disclosure of employment agreements for the executives whose compensation must be reported in the company's proxy statement, usually the top five. Most rules are subject to a certain degree of interpretation, however, and management and counsel can sometimes design arrangements that escape detection.

In conclusion, I believe that takeover and merger agreements, or golden parachutes, can serve valid business purposes, but are sometimes subject to abuse and designed for the wrong reasons and in the wrong way. Before implementation, the entire issue must be examined. The purpose of the agreement must be defined explicitly, and alternatives should also be examined. One should not adopt golden parachutes because it seems as if everyone else is. Most importantly, do not allow these contracts to upset current ongoing compensation arrangements and benefit plans; rather, make sure they are designed to complement and enhance the corporation's overall compensation policy. Be sure to examine the broad-based definitions of compensation in the benefit areas, to be assured they will not be adversely affected by these management contracts. Above all, recognize the golden parachute phenomenon as the complex policy issue that it really is.

MR. JAMES MCJOHN: My presentation will address the topic of the TEFRA limitations that apply to qualified plans. Since TEFRA was enacted about a year and a half ago this material is not brand new and so I hope to cover ground in detail but fairly quickly. I will also summarize the legislative activity which is currently pending in Congress relating to these limitations.

First, the flat dollar maximum permissible annual addition for profit-sharing and other defined contribution plans is reduced to \$30,000. Prior to TEFRA this amount was \$45,475. Under TEFRA the \$30,000 limit is scheduled to be subject to cost-of-living increases beginning in 1986. The additional limitation of 25% of pay is not changed.

Next let us review the limitation for a defined benefit plan. You will recollect that this started out with ERISA as an annual pension of \$75,000 and that with cost-of-living increases this had reached \$136,425 in 1982.

TEFRA reduced this figure to \$90,000. As previously, this can be paid in the form of a life only annuity or a qualified joint-and-survivor annuity. Any other optional form would require an appropriate adjustment factor.

The \$90,000 figure is subject to future cost-of-living adjustments, but they will not commence until 1986. At that time the limit will be adjusted for post-1984 cost-of-living increases. The increase will be based on the cost-of-living increase granted for Social Security benefit payments. This is in contrast to the procedure under ERISA where the increase was based on the increase in the average annual wage.

Under ERISA a person could retire as early as age 55 without suffering a reduction in his maximum permissible benefit. Not so under TEFRA. There is no reduction for early retirement at age 62 or after. Prior to age 62 the limit is actuarially reduced so that it is equivalent to the age 62 benefit; however, in any case it is not reduced below \$75,000 (unless retirement is before age 55).

Incidentally, note that the \$75,000 amount is not subject to cost-of-living increases.

The actuarial reduction for early retirement is to be computed using an interest rate which is not less than the greater of the interest rate specified in the plan or 5%.

ERISA also provided an additional defined benefit limitation equal to 100% of pay and this is not changed by TEFRA. It is not subject to reduction for early commencement (at age 55 or after). Here pay refers to the employee's average compensation for his highest three consecutive years of active participation in the plan.

TEFRA does permit an actuarial increase to be made in the dollar amount limitations in the case of late retirement after age 65. Here the interest rate used is not to exceed the lesser of the rate specified in the plan or 5%. The idea is, of course, to prevent excessive actuarial increases.

Incidentally, this provision is of interest because it suggests that an interest rate of less than 5% can be reasonable for qualified plan purposes. In plans where the tax effect is a significant factor in the plan sponsor's motivation for installing a plan, it may well be desirable to use a relatively low interest rate and this provision in TEFRA would seem to say that 5% or even lower can be acceptable.

In the event of early retirement prior to age 55, the maximum permissible benefit is the actuarial equivalent of the age 55 benefit.

The defined benefit dollar amount limitations which apply at various ages based on a typical set of actuarial assumptions are as follows:

| <u>Retirement Age</u> | <u>Maximum Annual Defined Benefit</u> |
|---------------------------|---|
| 70 | \$ 156,000 |
| 67 | 110,000 |
| 65 | 90,000 |
| 62 | 90,000 |
| 61 | 82,000 |
| 60 | 75,000 |
| 55 | 75,000 |
| 50 | 52,000 |

In the case of retirement at age 70 the actuarial increase has a very significant effect, raising the dollar amount to \$156,000. The \$90,000 amount applies at ages 62 through 65, of course. The \$75,000 amount prevails over a wide range of ages from 55 to 60.

As a transitional provision a person's current accrued benefit under the prior rules as of the effective date of the TEFRA limitations for his plan is preserved if it is higher than the new limit.

Next I will discuss the situation where there is both a defined benefit plan and a defined contribution plan.

Under ERISA there was the rule that you could provide 100% of the permitted defined benefit plus 40% of the defined contribution limit, or vice versa, or 70% and 70%, or any other combination so long as the sum of the percentages did not exceed 140%. This was called the 140% rule or the 1.4 rule.

For this purpose two fractions were defined namely the defined benefit fraction and the defined contribution fraction. Benefits had to be restricted so that the sum of these two fractions did not exceed 1.4.

The definition of the defined benefit fraction was simply the projected benefit for the person divided by the maximum permissible defined benefit currently in effect.

The defined contribution fraction was a little more complicated since it was calculated on a cumulative basis. In essence the numerator of it was all the annual additions that had been made to the person's account. The denominator was the sum of all the maximum additions that would have applied for all the person's past years of service.

Note that both these fractions under ERISA treated the dollar amount limitation exactly the same as the percentage-of-pay limitation.

TEFRA introduced a new manner for calculating these fractions, and a new rule. The overall idea is that Congress wanted to continue to permit a 140% combination for people whose limits were based on the percentage of pay limits, but to cut the permissible combination to 125% for people who reached the dollar amount limits.

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The rule is mathematically expressed as a 1.0 rule instead of a 1.4 rule.

The next table shows the new defined benefit fraction. The numerator is the same as before. But now the denominator is multiplied by either 1.25 if the dollar amount limit applies or by 1.40 if the percentage-of-pay limit applies.

$$\begin{array}{c}
 \text{New Defined Benefit Fraction} \\
 = \\
 \frac{\text{Projected Annual Benefit}}{1.25 \times \text{dollar limit}} \\
 \text{lesser of} \qquad \qquad \qquad \text{or} \\
 1.40 \times \text{percentage limit}
 \end{array}$$

A similar modification is made in the defined contribution fraction. The numerator is the same as before, but a factor of 1.25 or 1.40 as appropriate is applied to each component in the denominator.

$$\begin{array}{c}
 \text{New Defined Contribution Fraction} \\
 = \\
 \frac{\text{Cumulative Annual Addition}}{1.25 \times \text{dollar limit}} \\
 \text{sum of lesser of} \qquad \qquad \qquad \text{or} \qquad \qquad \qquad \text{for all service years} \\
 1.40 \times \text{percentage limit}
 \end{array}$$

In the case of a plan which is super top heavy, in other words where the accrued benefit values of the key employees amount to 90% or more of the total, instead of a 1.25 factor only 1.0 can be used.

A special transitional rule can be used for calculating that portion of the cumulative denominator which applies to pre-1983 years. This adjustment prevents inequities for people in a certain pay range (as measured by 1981 pay). In the absence of this adjustment, they could only apply a 1.25 factor to the pre-1983 denominator components even though 1.4 times the percentage-of-pay limitation would be more favorable.

Cumulative Denominator as of December 31,1982 under old law

X

Lesser of \$51,875 or 1.4 x 25% of 1981 compensation

Lesser of \$41,500 or 25% of 1981 compensation

As already mentioned, under TEFRA as it currently stands, cost-of-living increases are scheduled to resume in 1986.

The effective dates required by TEFRA for these limitations are as follows:

1. For plans in existence as of July 1, 1982 the effective date is the plan anniversary in 1983.
2. For plans not in existence as of July 1, 1982 the rules go into effect immediately upon the inception of the plan.

The remainder of my comments on the TEFRA limitations will describe changes which would be made by legislation which is currently pending in Congress.

A bill called the Tax Reform Act of 1984 has been reported out of the Ways and Means Committee in the House of Representatives. This bill includes one provision relating to the maximum limitations for qualified plans. The cost-of-living increases currently scheduled to begin in 1986 would be postponed until 1988.

The Senate Finance Committee has also finished its markup of its bill. This markup contains several provisions relating to the maximum limitations.

First, the special limits on benefits and contributions under super top heavy plans would be inapplicable if non-key employees are provided with additional minimum benefits.

The Senate bill would also freeze the cost-of-living increases until 1988. Since this provision is found in both the House and Senate bills, it would seem to have an excellent chance of being enacted.

In addition, in the case of an employee participating in both a defined benefit plan and a defined contribution plan the sum of the fractions would be raised to 1.4 if the employer does not maintain a top heavy plan or a plan integrated (on or after July 1, 1982) with Social Security. I have not seen the specific legislative language and presumably this means that a 1.4 factor could be used in the denominator instead of 1.25.

The legislative focus these days is undoubtedly oriented to cutting the deficit. For this reason there can be no doubt that the trend will be to reduce the extent to which executive pensions can be provided through the qualified plan vehicles. \$90,000 today is much less valuable than \$75,000 when ERISA was enacted. Of course, it is still possible now to live in comfort on \$90,000 a year. But, if the next ten years are like the last, it may be that ten years from now \$90,000 will be a middle management income. This trend to restrict qualified plan benefits can only mean that more and more use will be made of the various executive supplemental arrangements.

Does anyone have any questions or comments on the topics discussed this afternoon?

MR. RICK MULLEN: You mentioned earlier in the presentation on deferred compensation that primarily participating plans were used. Is there a reason for that?

MR. LANE WEST: Several plans could be used. A participating plan, particularly when the dividends are used to provide paid up additions, allow the death benefit to continue to increase. In a nonqualified plan the object of funding with life insurance is that the proceeds will at least equal the investment in the contract plus the benefits plus the value of future benefits. Generally, a life insurance policy with an increasing death benefit is needed because the cost of the plan continues to increase. There are other plans, either plans with paid up additions or increasing whole life plans, that can be used. Now some of these plans do not meet the definition of insurance under the new law; so the insurance companies are going to have to determine what can be used to meet this need.

MR. RICK MULLEN: It is also possible to use a nonparticipating universal life type product with an increasing death benefit option rather than a level death benefit option.

MR. LANE WEST: That is true as long as it meets the definition of insurance. One of the other problems, for which you may have the answer, of universal life is that premium is not really defined and you do not know whether they have paid the first four out of seven premiums; whereas, with the traditional whole life policy there is no question that they have been paid.

MR. RICK MULLEN: You can fix the premium. We have such a product and there are a number of others out on the market.

MR. BOB BOSTIAN: Could you describe how the tax leveraging works when you fund these plans with insurance? It is an area I am not familiar with. It seems to me, if it works as well as you stated, that a company would be wise to go out and hire a lot of executives and put insurance on them and get an 18% return.

MR. LANE WEST: In theory if a corporation could afford the cash flow, its business could be buying whole life insurance and taking advantage of the tax advantage. I had a client in a meeting suggest his company buy a tax shelter simply for the tax advantage because it created so much of a tax credit. This is the same kind of problem.

Let me explain the tax leveraging. It works best with an indexed policy, that is a policy in which the interest on the cash value is tied directly to the interest paid on the loan. For example, let's say the loan interest rate is 8%. The company borrows everything except the four premiums and even borrows those in the eighth year. The company pays 8% interest, which, if it is in a 50% tax bracket, means an after tax cost of only 4%. The insurance company says that of the 8% paid only 1% is needed to cover expenses and margins and the remaining 7% will be credited to the cash value. Now the cash value accumulates on a tax deferred basis. The company receives an interest credit of 7% but only pays 4% for it. That is called an arbitrage. The company is earning 3%. That was the procedure used in policy A example.

The policy B example is an indexed policy which provides a variable loan rate. The rate is equal to the Moody 20-year AA bond index. Let's say a company is charging a 12% interest rate. If the company pays 12% interest, the after tax cost is 6%. Now that particular insurance company only charges 3/4%, so they will credit the cash value with 1 3/4%. It is only

costing 6% so 5 1/4% is earned. That is how tax leveraging works.

You must hold the policy until the individual dies. As you know, if you surrender a policy, you must pay tax on the difference between what you receive and what you paid. You never draw out the cash value, that is you borrow it, but do not draw it out as you would in a universal policy.

MR BOB BOSTIAN: Is this being addressed in any of the tax reform packages in Congress?

MR. LANE WEST: To my knowledge it is not.

MR. BOB BOSTIAN: They are missing a good one.

MR. LANE WEST: It is a strange one. I did attend the session on life insurance taxation and they said there were some considerations but there was a lot of lobbying. It has been dropped from either the House or the Senate and probably will not be included.

