The Evolution of Executive Benefits

Eastern Wisconsin

Financial Executives International

November 14, 2024 Meeting

Presented by:
Eric Wittenmyer
Aon Executive Benefits

Agenda

AON

1

Overview

Aon

Overview of Broader Societal Trends

Proxy disclosure

Widening of the pay gap between top executives and the average employee

Internet

Increasing egalitarianism

Main Categories of Focus

Executive Life Insurance

- Shift in plan types due to “clarification” of tax and accounting rules
- Effects of Sarbanes-Oxley Act

Executive Retirement

- Trend from Defined Benefit Plans to Defined Contribution Plans

Executive Disability Insurance

- Effect of aforementioned widening of pay gap

2

Executive Life Insurance

Split Dollar Life Insurance

Employers and employees share the costs and benefits of a life insurance program	**Benefits of Split Dollar Life Insurance**
	Tax Advantaged Mechanism: Tax deferred accumulation pre- and post-retirement; retirement distributions and death proceeds income tax-free if structured properly
Provides meaningful tax efficient benefits for executives	**Non-compensatory plan**
	Can be an effective retention tool
Cost recovery mechanism for employer investment in program	**Existing benefit investments can be used to provide enhanced benefits**
	Potential benefits for estate planning, etc.

Shifts in Split Dollar Plans

Economic Benefit Split Dollar

- Pre- and Post-Retirement Benefits
- "Roll-out" at retirement tax-free
  - May be impossible in low-interest rate environment
  - Employer may have to remain invested until death
- Accounted for asset, but not liability
- "Less expensive" than group term life insurance
- Notice 2002-8 (2004)
  - Treasury says roll out is not tax-free
  - Restrictions on use of carrier rates to value economic benefits
- GAAP clarification (EITF 06-10 → Subtopic 715-60)
  - Now must account for the liability too
- EBSD is dead . . . but not forgotten
  - Legacy plans create challenges
  - Imputed income is significant
  - Funding for taxes in roll-out?

Loan Regime Split Dollar (LRSD)

- Pre- and Post-Retirement Benefits
- Premiums treated as loans for tax purposes
- Employer is repaid out of policy values upon insured death or an earlier specified date
- The Sarbanes-Oxley Act's prohibition on loans to Named Executive Officers killed LRSD for publicly traded companies (2002)
- Many publicly traded employers converted to Economic Benefit Split Dollar
- LRSD is now prevalent for tax exempt organizations

Modern Executive Life Insurance Plans

- Programs can be pre-retirement only or permanent
- Trend toward providing pre-retirement coverage only
- Utilize individually owned, term or permanent life policies
- Higher issue limits than a group-term plan
- Universal Life or Variable Universal Life Insurance
- Most cost-efficient method of providing enhanced pre-retirement life insurance coverage
- Employee tax costs can be 10%–40% less compared to group term insurance (value of premium vs. imputed income)

Universal Life

- Flexible premiums; adjustable life insurance amounts
- General account product
- Transparent product design
- More flexible and lower initial cost than whole life products
- No-Lapse Guarantee feature can keep coverage inforce with minimum premium

Variable Universal Life

- Transparent pricing like UL, but utilizes a "Separate Account" for investment element
- Wide variety of investments available under many asset classes
- Ability to earn market returns in a tax deferred environment
- Investments held in "separate account" protected from a negative carrier credit event

AON

Executive Life
Benchmarking Data

95%

Eligibility

Based on position or title

90%

Plan Design

of plans provide a benefit based on a multiple of earnings

36%

Benefit Formula

- Provides a benefit equal to 2x salary
- 3x salary is the next most common benefit

$2 Million

Benefit Formula

- Average maximum guaranteed issue coverage
- Ranges from $500k up to $5M

Source: Based on an Aon private benefits survey

AON

Tax-Exempt Employers

Continuation of Loan Regime Split Dollar Plans

Challenges for Tax-Exempt Employer's Executive Retirement Plans

457 Taxation	409A Limitations	Form 990 Reporting
• No maximum deferral amount; however, IRS does not allow purely elective plans • Organization must provide a match of at least 25% • Substantial Risk of Forfeiture (SRF) is required • If participant leaves employment prior to the vesting date, the account balance is forfeited • Balance taxed upon vesting/constructive receipt, when the SRF lapses, whether benefits are distributed or not	• In general, a plan may not permit acceleration of commencement of payments • Restrictions to changes to time and form of payment • Only permits distribution upon the occurrence of six events (separation from service, fixed date, disability, death, change in control, unforeseeable emergency)	• Lump sum deferred compensation payouts, coupled with short- and long-term incentives, often results in overstated annual compensation reported on Form 990. • In lieu of attempts to cap compensation, the new tax bill levies a 21% excise tax (equal to the new corporate rate) on all compensation paid above $1 million in any calendar year

LRSD Solution

- LRSD is a loan for tax purposes only and does not violate loan prohibitions
- Not considered compensation by the IRS and when structured properly
- Not subject to income taxation nor is it reportable as compensation on Form 990 (Sched. J)
- LRSD avoids 457(f) and 409A regulations or SRF provisions and provides flexibility in developing long-term vesting requirements

3

Executive Retirement

Executive Retirement: Plan Prevalence

Up to 91% prevalence of nonqualified retirement plans

42% offer DC SERPs

22% offer DB SERPs

58% provide higher levels of post-retirement benefits than basic plan

78% offer voluntary deferred compensation plans

18% offer DB restoration plans

Significant trend to move to DC plan from DB

Defined Benefit Supplemental Executive Retirement Plans
(DB SERPs)

Appeal of DB SERPs

- Like DB Pension, but better
  - Extra years of service
  - Earlier retirement age
  - Includes additional pay types (bonus)
  - COLI Funding – Leveraged WL

Complications with DB SERPs

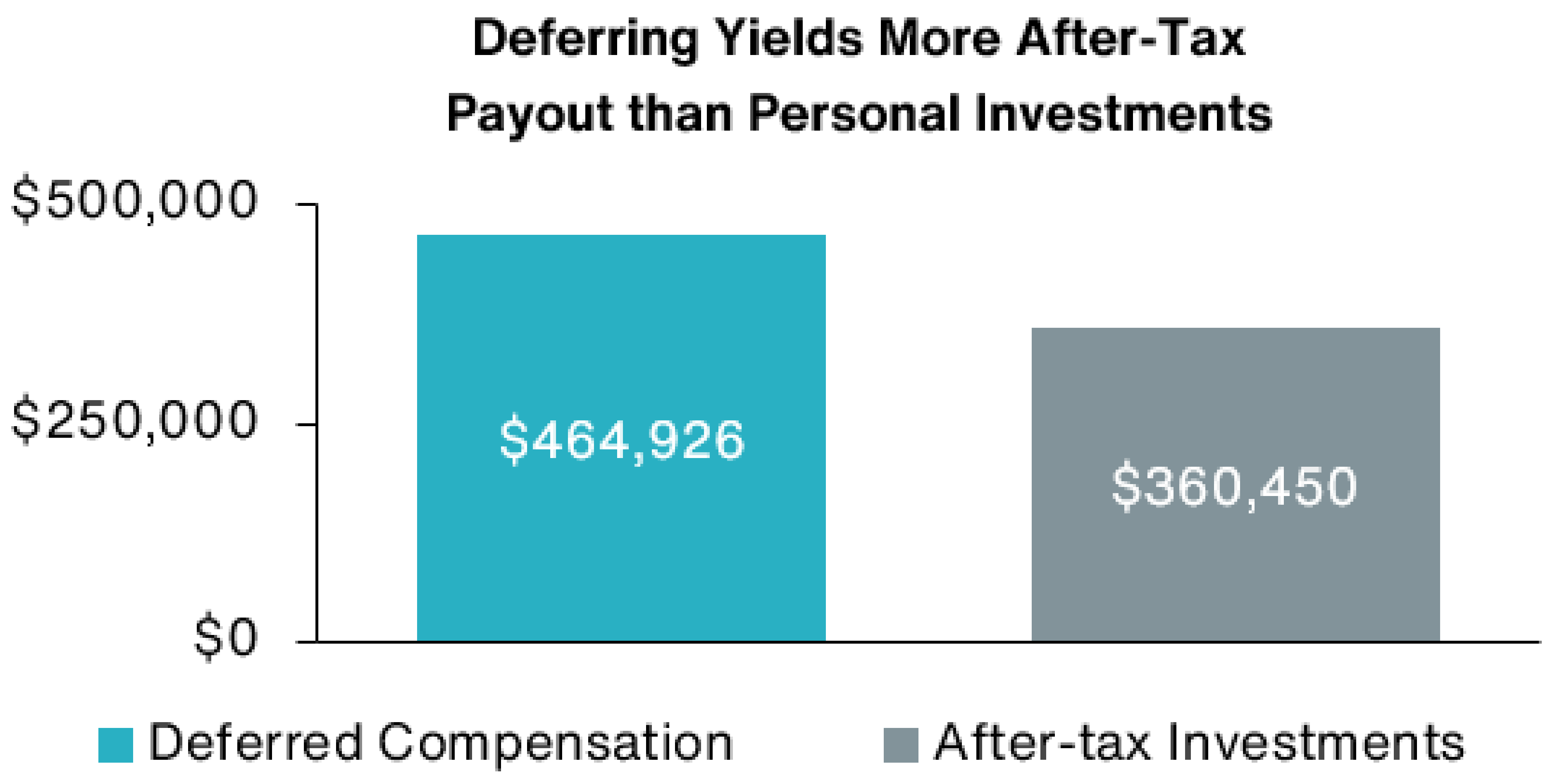
- DB SERPs have become less prevalent:
  - Increasingly negative optics of rich SERP benefits
  - Market volatility and turmoil impacting pension asset performance
  - Changes in discount rates
  - Pension Protection Act funding rules

Rise of Nonqualified Deferred Compensation Plan

1 Renewed interest in voluntary Nonqualified Deferred Compensation Plan (NQDCP)

2 Above market interest rates

3 Often funded with Corporate-Owned Life Insurance (COLI) – whole life or universal life for fixed rate plans



Assumptions

- 45-Year-old
- $10,000 annual deferral, or $6,000 investment
- 20 Year deferral period
- 10 Year payout period

Focus on 401(k)

Popularity of 401(k) Plans Resulted in Changes to NQDC Programs

- Hypothetical investment funds in DCP and daily valuation
- Internet and enhanced DCP administration platforms and websites
- COLI financing still prevalent, but shift to VUL products with COLI investments aligned to participant investments

401(k)		DCP
All employees	**Eligibility**	Some set of highly compensated – flexibility around who is eligible
Pre-tax basis	**Contributions**	Pre-tax basis
Tax deferred until paid	**Earnings**	Tax deferred until paid
Typically, multiple investment options covering different asset classes	**Crediting mechanism**	Typically, multiple investment options covering different asset classes
• $23,500 Annual contribution limit • $350,000 Compensation limit	**Limitations**	None
• Loans permitted • Withdrawal penalty before 59½ • Mandatory withdrawals at 72 • No in-service withdrawals	**Distribution options**	• No loans permitted • No withdrawal penalties or mandatory withdrawals • In-service withdrawals (pre-retirement) permitted
Plan is formally funded; protected from company creditors	**Plan asset**	Plan cannot be formally funded; not protected from company creditors
Tax deduction at time of deferral	**Company financial impact**	Tax deduction at time of distribution

Enron and 409A Regulations

Impact on DCP Design Features

Origins of 409A

- Enron scandal
- History of IRS losing cases
- Industry practices prior to 2004

Restrictions on changes to distributions

- Subsequent elections must be made no less than 12 months before scheduled payment
- Must defer payment for no less than 5 years from date the first payment would have otherwise been made

Shorter-term deferrals

In-service distributions

- Payments limited to 6 “distribution events” including separation from service, disability, death, specified date/schedule, change in control, and unforeseeable emergency

Class-year plan

AON

Accounting for Deferred Compensation Plans
Accounting Implications

Significant operating expense and volatility

- Expense impacts operating earnings
- Informal funding produces other comprehensive income
- Efforts to mitigate
  - Hedging transactions
  - Net expense and income
  - Treat DCP as a DB plan

AON

Emerging Trends

Can we get rid of our old DB SERPs and above market DCPs

Are there any good alternatives to Nonqualified Deferred Compensation

Terminated the Pension Plan, but still have the SERP?

Ability to get rid of DB SERPs and above market DCPs

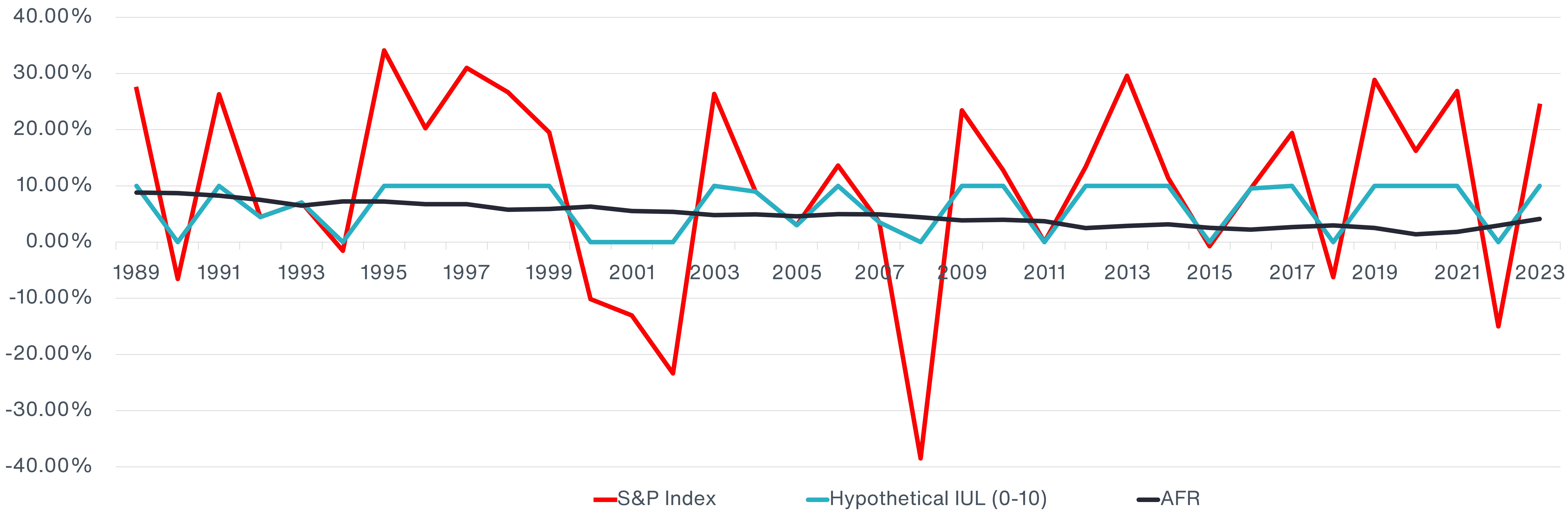
- Key question is whether the plan is grandfathered for 409A
- Easier to terminate a grandfathered plan
- May also be able to bifurcate a plan and terminate the grandfathered portion

Alternative to DCPs: After-Tax Life Insurance Plans

- Been around a long-time
- Returns on UL have been less than impressive
- Favored among private companies
- Higher benefit security than NQDCP
- Typically funded to emphasize cash accumulation rather than death benefit
- Generally, include some level of company contributions
- Indexed Universal Life is often considered for these plan designs due to potential for higher returns and downside protection (see next slide)
- Adding third party leverage may enhance economics of program

Indexed Universal Life Insurance

Indexed Universal Life (IUL) is becoming a popular product in today's volatile economy because of the downside protection it can provide. The IUL is indexed to a market driven index but is subject to a specified cap and floor rate. In the example below, we are comparing a hypothetical Indexed UL product with a cap rate of 10.00% and a floor rate of 0.00% to the actual S&P Index annual returns (excluding dividends) from 1989–2023. Floor and cap rates will vary by insurance carrier and product.

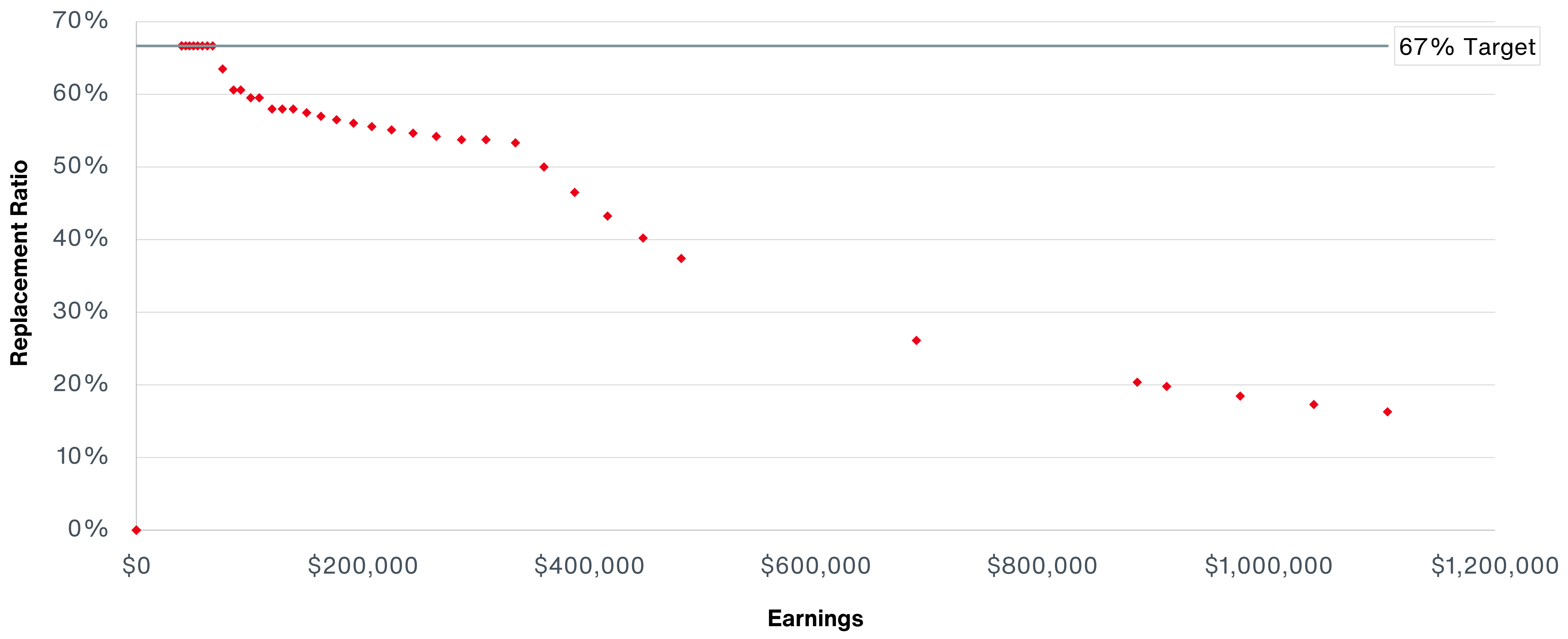


* Long term AFR is updated monthly and the AFR graph reflects the average of the 12 rates released during each year

4

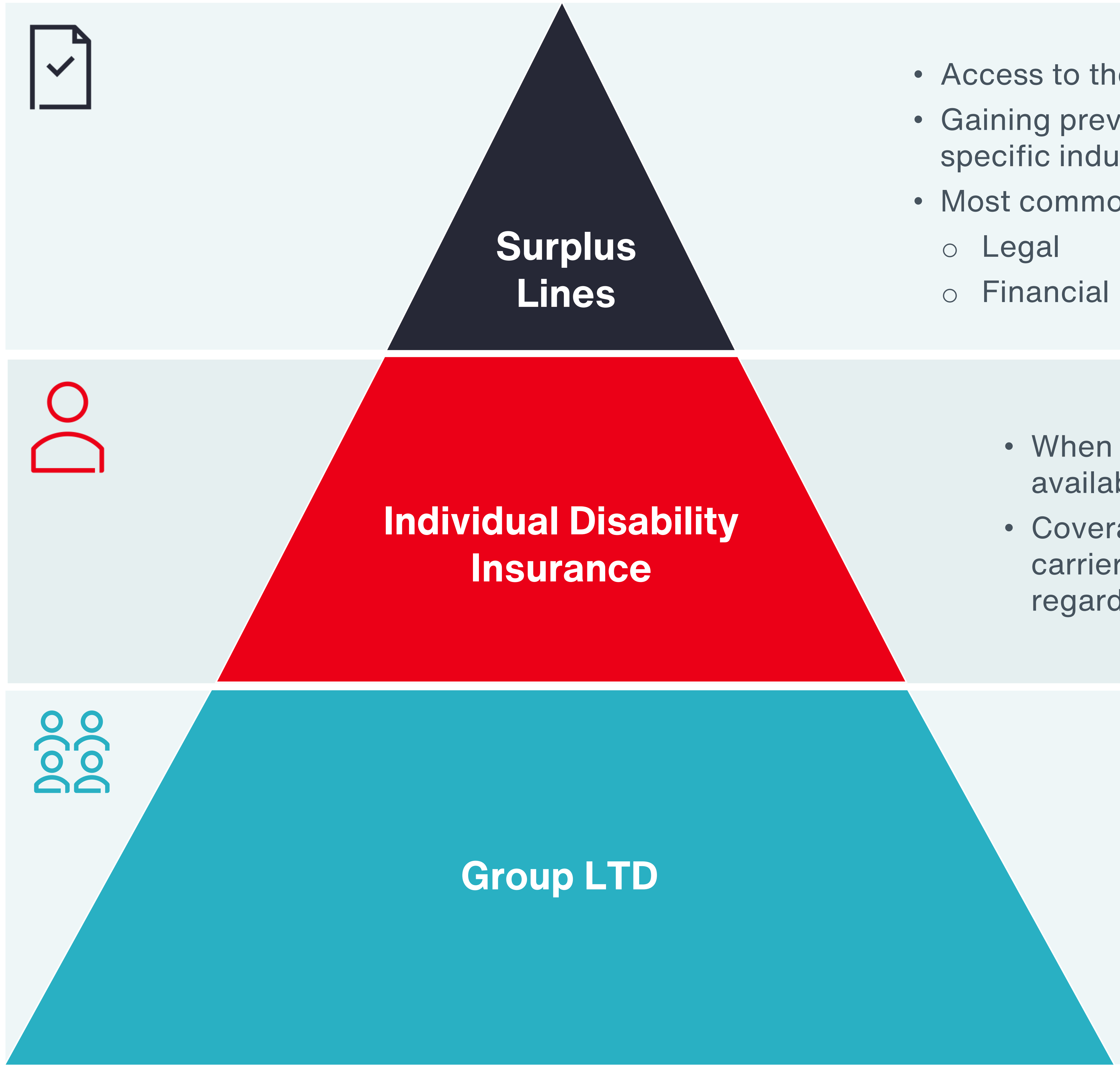
Executive Disability Insurance

Actual Group Long Term Disability Plan Income Replacement



- The chart above illustrates the actual income replacement percentage, based on total compensation, for a group long-term disability plan covering 67% of base salary to a maximum of $15,000/month
- Group LTD underwriters slow to react to this
  - Not willing to increase maximums or charging significant risk premiums to do so
  - High earners disrupt the risk profile of the group

Building the Appropriate Long-Term Disability Program



Surplus Lines

- Access to the very highest limits
- Gaining prevalence, especially in specific industries.
- Most common in professional services
  - Legal
  - Financial
- May have some coverage restrictions due to the level of indemnity:
  - Renewed every 3 to 5 years based on experience
  - Group LTD/IDI carrier sign-off
  - Limited policy features: pre-ex included, shorter duration, etc.

Individual Disability Insurance

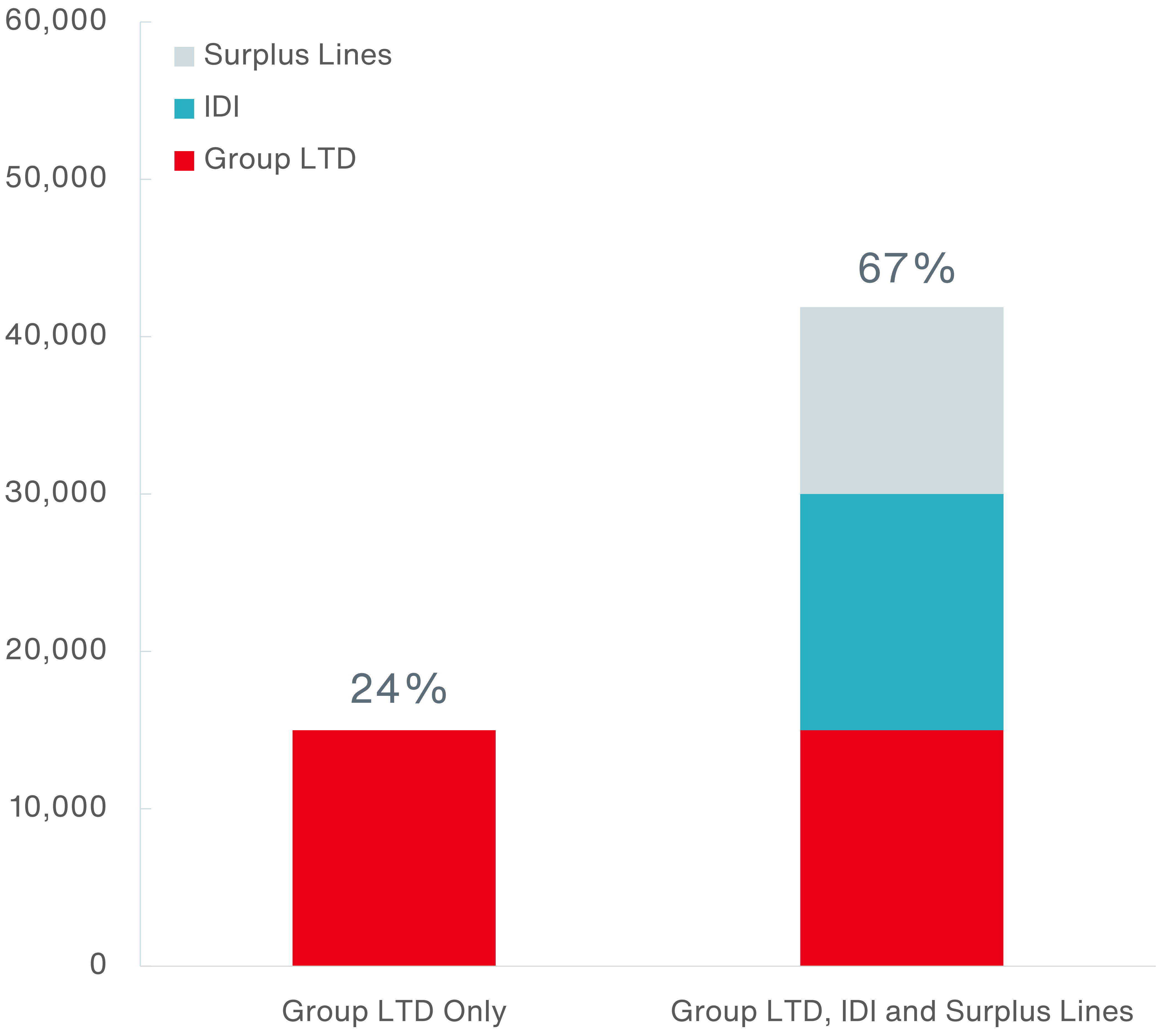
- When paired with group LTD, higher limits are available without adding risk to the group program
- Coverage is non-cancellable by the insurance carrier with premiums locked-in until age 65, regardless of plan experience
- Significant discounts[1] when purchased through employer
- Offered on a GSI[2] basis
- Prevalent in about 40%[3] of the marketplace
- Large law firms are early adopters, but use spreads across industries

Group LTD

- Solid start to coverage and benefits may be "appropriately limited"
- Inexpensive but subject to experience and limited rate guarantees
- Typically includes pre-ex
- Offered to virtually all employer groups

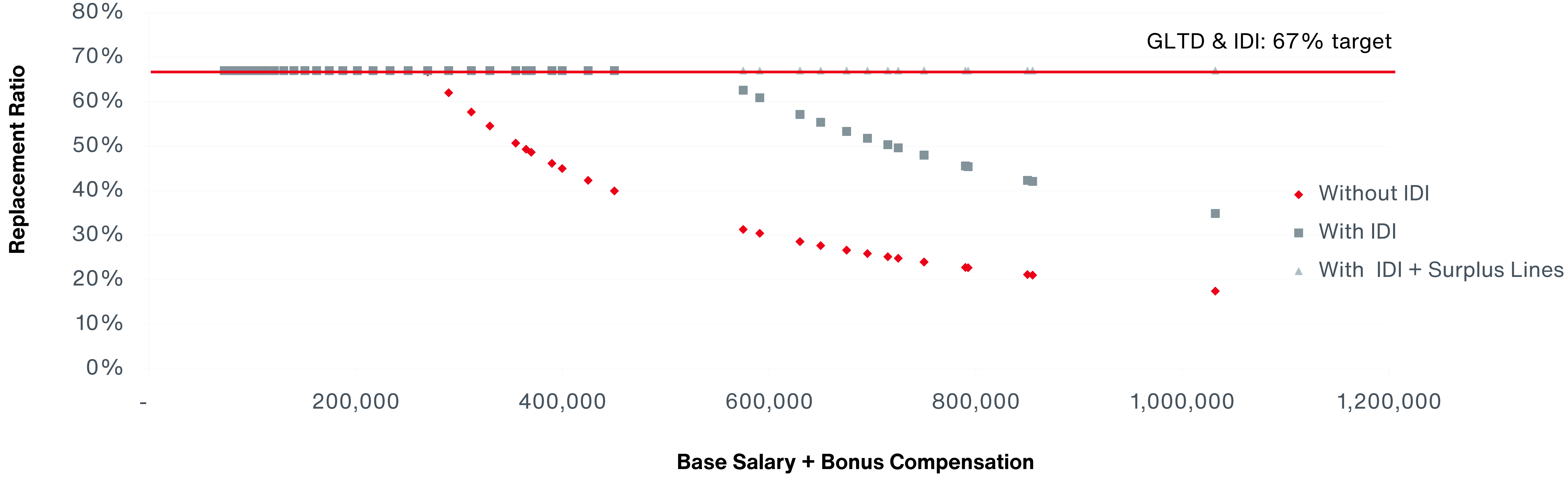
[1] 25%–35% discounts compared to purchasing individually; Individual coverage is more expensive than Group LTD coverage.
[2] Guaranteed Standard Issue – Requires confirmation that individual has been actively working for a specified period of time, either through an employer-provided census or an application.
[3] Excludes companies with non-disclosed plans and self-insured risks with no benefit cap.

Example: Salary of $500,000 plus Bonus of $250,000



Feature	Group LTD Only	Group LTD, IDI and Surplus Lines
Annual Compensation	$500,000 base salary plus $250,000 bonus	
Total Monthly Compensation	**$62,500**	
Group LTD assuming 67% of salary to $15,000/month	$15,000	$15,000
IDI assuming 67% of total compensation, less Group LTD, to $15,000/month	$0	$15,000
Surplus Lines assuming 67% of total compensation, less Group LTD and IDI, to $30,000/month	$0	$11,875
Total Coverage	**$15,000**	**$41,875**
Replacement Ratio (% of Total Compensation)	**24%**	**67%**

Before and After IDI

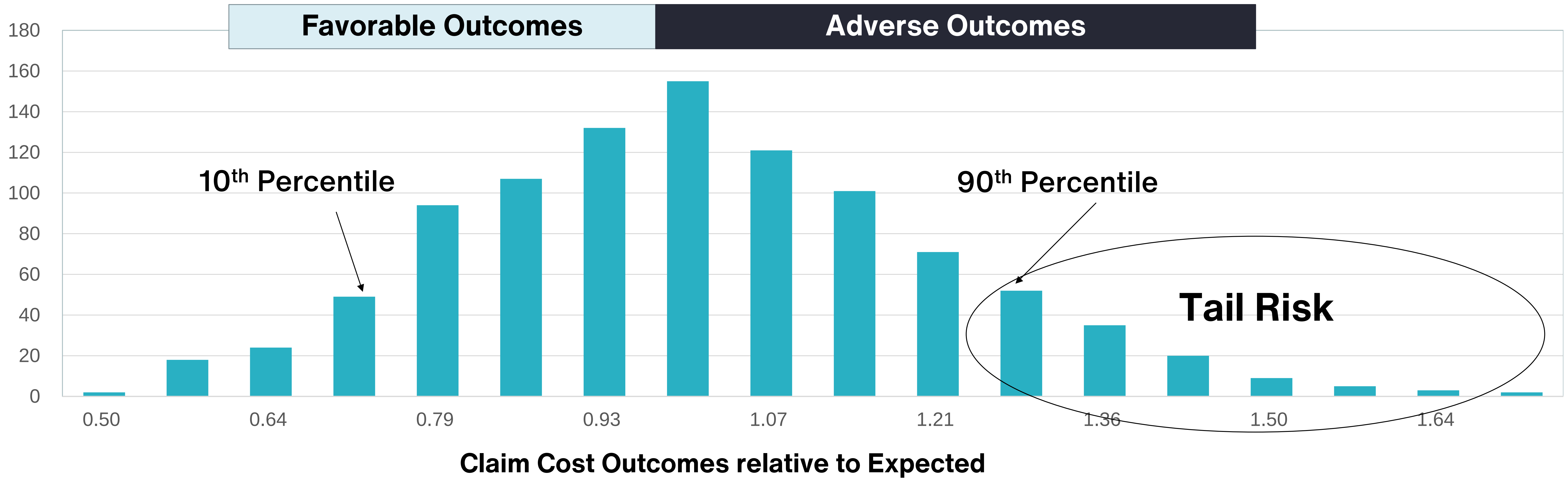


	Min RR	Average RR	# with Gap
Group LTD Only	17%	48%	28
Group LTD + IDI	35%	61%	17
Group LTD + IDI + Surplus Lines	67%	67%	0

AON

LTD Volatility Risk

Claim Cost Frequency Distribution*



- Since LTD is extremely volatile, a self-insured LTD program with an unlimited maximum subjects a company to significant liability leading self-funded LTD to lose popularity.
- Greater Downside Risk: Adverse outcomes are more likely, and the magnitude of loss is greater than favorable outcomes
- Tail Risk: Once every ten (10) years, LTD claim costs are expected exceed average by 40%'

* Based on 1,000 simulated annual claim results

Impact

Fully insured products eliminate adverse outcome risk by shifting it to the carrier.

Insured premiums include a risk charge and premium taxes, resulting in higher expected costs compared to self funding.

Higher cost of an insured solution may be offset by more rigorous claims management.

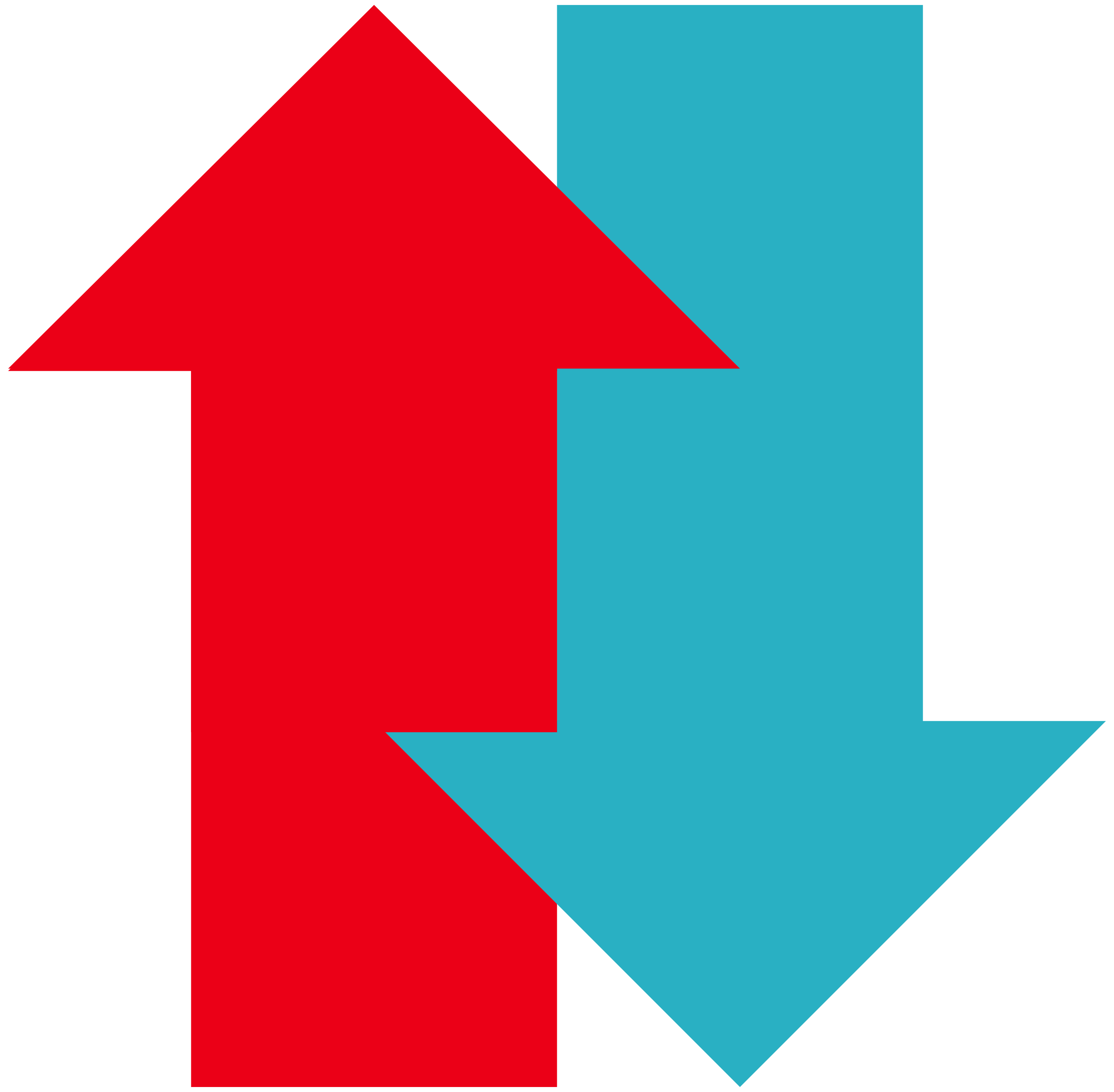
5

Executive Perquisites

Executive Perquisites: Marketplace Trends

Benefits which focus on “wellness” both physical and financial, maintain high utilization

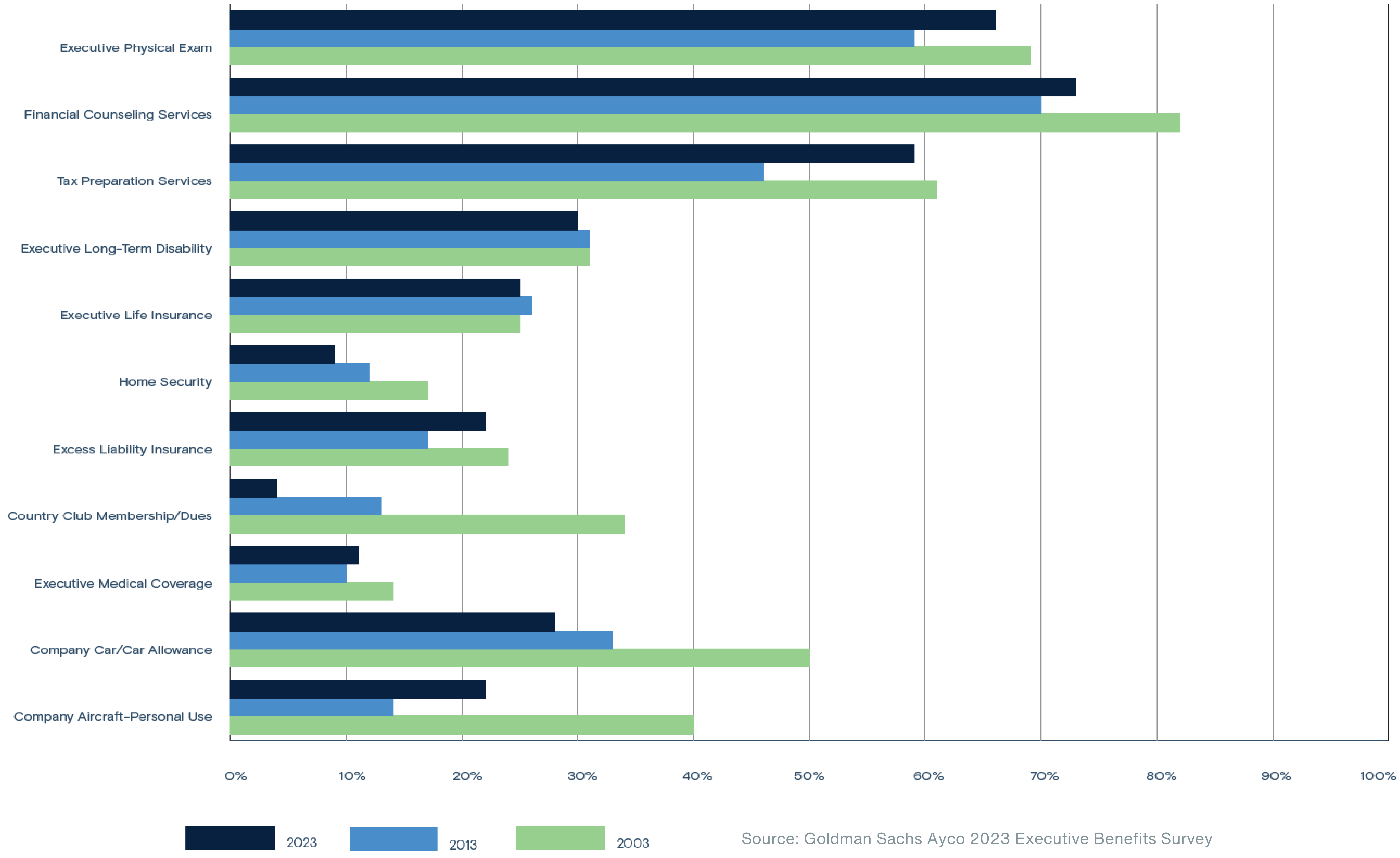
Executive Physicals
Financial and Tax Counseling



Most other perquisite offerings have declined over the last 10 years

Exception: Use of company plane and flexible perquisites plans

Executive Perquisites: Prevalence over 20-Year Period



Source: Goldman Sachs Ayco 2023 Executive Benefits Survey

Wrap-Up

Widening pay gap makes core benefits inadequate

Enhanced visibility through proxy disclosure and transparency improvements put pressure on companies and regulators to restrict executive benefits

Makes for an ever-evolving landscape

Many of these plans have long footprints – Have to manage the old along with the new

6

Q&A