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Executive Benefits Under Scrutiny: How to Reward and Retain Top Talent

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Executive compensation unquestionably is a hot-button topic. The recent focus is hardly unexpected in a time when multi-billion dollar bailouts have become the norm. Corporations are experiencing a backlash of shareholder and public outcry regarding lavish pay and bonuses. This heightened scrutiny is not limited to bailout beneficiaries: shareholders of businesses at all levels are examining how their upper-level management is being compensated and whether that compensation bears a relationship to results.

But compensation is not the only target. Perquisites such as deferred compensation, retiree life insurance, stock options and any benefit viewed as an expensive "add-on" in this leaner climate will come under the microscope. Companies are cutting costs and are looking to freeze and even reduce salaries and 401k matches and eliminate bonus programs and profit sharing entirely. Other companies are laying off employees by the droves and enforcing unpaid furloughs.

On the other hand, top-level executives occupy a unique role in the corporate structure. Their responsibilities are more demanding and the pressures upon them greater than those experienced by workers in the general population. While CEOs are sensitive to the new scrutiny, these performers still are expected to devote more of themselves to their responsibilities and expect more in return to meet their status. Top talent rightly requires enhanced reward in recognition of enhanced contribution. Businesses that fail to acknowledge this perception may suffer the loss of talent to other employers that do.

These circumstances pose a unique challenge for compensation professionals: how to best reward and retain top talent while avoiding the appearance of immoderation? Now, more than ever, compensation professionals should consider the long-term care ("LTC") insurance option.

What is Long-Term Care?

A Definition: While often associated with the aging process, long-term care includes those services designed to meet the medical and non-medical needs of persons afflicted with chronic illnesses or disabilities, rendering them unable to care for themselves over periods of time. Services include custodial and non-skilled care, assistance with tasks of daily living and medical help. Care can be provided in the home, in assisted living facilities or in nursing homes.

The need for long-term care does not discriminate: people of any age and socio-economic class can fall prey to a long-term care event. According to the Centers for Medicare and Medicaid Services ("CMS") and the U.S. Department of Health and Human Services, more than 12 million older Americans will need long-term care by the year 2020.[i] Currently, family and friends are the sole caregivers for approximately 70% of those needing care. Per the U.S. Department of Health and Human Services, there is a greater than 40% chance that persons who reach the age of 65 will ultimately enter a nursing home, while 10% of those will remain in a nursing home five years or more.[ii]

A 2006 study[iii] conducted by the Association for the Advancement of Retired Persons ("AARP") determined that most Americans have no sense of the costs associated with long-term care, overestimating amounts available from government programs such as Medicare and Medicaid.

All of this adds up to the pressing need to face probable long-term care exposure at advancing age and possible exposure at any age.

A Plan: Similar to apprehending an earthquake in a quake zone, the "big one" is nearly inevitable, but damage estimates must await the event's occurrence. There are two primary choices for meeting the risk: self-insure the cost of care when an event occurs; or, manage the risk at the front end.

If an individual chooses to self-insure and bear the risk of an event, the afflicted person and his or her family members will be left to raise the funds necessary to meet or approach the lifestyle previously enjoyed by the afflicted person. Even for high-net-worth individuals and top-level executives, a long-term care event can generate a "panic selling" situation. The family may be required to aggressively invade principal and liquidate savings, resulting in tax exposure, market risk and transaction cost with every distribution made. The need for care and cash can go on for months, years or even decades.

If an individual chooses to proactively manage the risk at the front-end, the best option is the purchase of long-term care ("LTC") insurance. Although LTC insurance has been around since the 1980s and gained popularity in the 1990s, it still represents a relatively underutilized resource.

LTC policies compensate for the custodial care needed when a care event strikes. The insurance minimizes the impact on the investment portfolios of the affected individual and his or her family. One hundred percent of the distribution is tax free.[iv] The coverage is flexible, with basic plans covering care in-home, in nursing homes, in assisted living facilities or in hospice care. Some policies pay benefits to a family member or friend who provides care. Often, in-home delivered meals and housecleaning services are included in a basic plan. There are many different options for customizing the coverage.

Most importantly, the policies include health care advocacy in the form of care coordination. Consultants assist the family in locating, securing and organizing care efforts. This service is accessible even before a claim is submitted. Health care advocacy removes uncertainty in identifying necessary services and orchestrating those services for aging parents, whether in the home or in an out-of-home facility in the next town or across the country. The peace of mind such advocacy generates generally is unavailable to those opting to ignore or self-fund the risk.

What is the Risk?

What is the real financial exposure of a care event? A reasonable assumption is that a 50-year-old facing an exposure of $7,500 a month in care expenses today will face an exposure of $43,000 per month in care expenses 30 years from now, at a 6% rate of inflation for long-term care services.[v] However, inflationary rates are not stagnant and many believe that they will continue to rise. With an average care period of 42 months, costs will exceed $1,800,000 in thirty years at the conservative rate.

Take the case of a 55-year-old purchaser of LTC insurance that claims benefits at 85. The example policy is a five year plan with a maximum present value benefit limit of $456,250, a daily benefit of $250 per day or $7,500 per month and a compound 5% inflation rider to ensure policy growth for a premium payment of $3,500 per year. The purchaser will receive $1,080 per day or $32,400 per month and a maximum policy value of $2,179,183 in exchange for the paid premium of $105,000. Compare the impact of a $105,000 payment over thirty years with a $2,179,183 payment over five years.

The importance of leveraging money and mitigating risk is even greater during harsh economic times. Self-insuring the risk of a long-term care event is effectively more expensive when assets available to meet the risk are subject to devaluation and recessionary pressure and the gap between care costs and asset value widens. Employees at all levels will welcome the means to address this widening gap through a company benefit, rather than face an uncertain economic future and a near-certain economic hit from a long-term care event.

Anyone with an estate to protect must answer the questions posed by the long-term care dilemma. Even for affluent individuals, it is one of the greatest personal risk management exposures people face as they near retirement. Compare the after-tax cost of self-insuring the long-term care risk with the cost of the tax-free mechanism of LTC insurance. The economic superiority of LTC insurance in meeting the risk becomes crystal clear.

Why Consider LTC Insurance As an Executive Benefit?

There is substantial value to the corporation in offering the LTC insurance as a benefit to its executives, and even to the entire employee population, on either a partially- or fully-funded basis. LTC insurance is relatively inexpensive due to favorable tax treatment. LTC insurance can be offered legally to select groups of employees, affording an opportunity to provide an enhanced package to top-tier performers. And due to its classification as accident and health insurance under the securities laws, the LTC insurance benefit is not reported in the same manner as compensation and other financial perquisites.

The IRS Code[vi] drives much of the incentive for businesses to offer and fund this employee benefit. LTC insurance is defined in the Health Insurance Portability and Accountability Act of 1996 ("HIPAA") as accident and health insurance and is not subject to ERISA guidelines per IRS Code §7702B(a)(2).

The Code allows businesses to carve out classes of employees to which the benefit is offered to encourage the adoption of LTC insurance plans.[vii]

Depending upon corporate form, the business can deduct 100% of its LTC insurance premium contribution paid for employees, spouses or partners.[viii]

Employer-funded plans can be readily customized and the employee can be offered the opportunity to buy additional coverage subject to plan limits. Programs can be voluntary or employer-funded, and individual or group products can be utilized.

Executive benefit policies purchased through a business differ from individual policies, particularly with respect to premium payment provisions. The former policies generally are paid within 10 years, often with a single premium payment. The shorter the premium period, the larger the tax deduction.

Employees secure an economic advantage through the employer-funded plan. Insurers are more likely to discount coverage to a group. Even under a partially-funded plan, employees are entitled to far more generous underwriting concessions than if they purchased the coverage privately. There is no imputable income to an employee when the company funds all or a portion of the premium.[ix] Upon receipt of LTC benefits, an employee is not penalized because the distribution is not considered taxable income. The LTC insurance contract is portable. If a company opts a ten-pay billing structure or a single premium payment, an employee could leave or retire after that point with a partially or fully-paid LTC insurance contract.

Coverage can also include the parents of employees, an especially valuable provision for those faced with caring for aging parents while still responsible for the care of their own children. Under these circumstances, the health care advocacy component is crucial: picture the demands upon key employees coordinating the care of parents living hundreds of miles away. LTC insurance assists those key employees in the management of their personal obligation and encourages them to remain focused on the employer's business.

Why The Time Is Now

Whether by choice or compulsion, companies across the country are tightening their belts. Political and popular scrutiny of private sector spending is heightened. Yet, executives still require compensation and perquisites that recognize their contribution and lifestyle. The top talent will seek positions that offer maximum benefit.

Compensation professionals are vexed by these seemingly inconsistent considerations. How can these issues be reconciled? How can companies reward their top-tier performers while satisfying the concerns of shareholders and legislators? How can companies faced with massive staff reductions retain their best performers and keep their business viable?

LTC insurance, which has always been a valuable and cost-effective employee benefit, is more important now than it has ever been before. LTC insurance meets the employer's concerns by affording a relatively inexpensive benefit that can be offered to special employee classes without attracting the same attention as expensive compensation and bonus packages and lavish fringe benefits. LTC insurance addresses the individual's concerns about managing a mounting risk to retirement savings that may be dwindling in a tough market. Offering LTC insurance to employees signals that the employer is aware of the daunting issues facing an aging demographic and is offering these employees assistance they can carry with them long past their separation date. In other words, the time is now for the LTC insurance option in employee and executive benefits packages.

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[i] http://www.longtermcare.gov/LTC/Main_Site/Understanding_Long_Term_Care/Basics/Basics.aspx

[ii] *Id*

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[iii] http://www.aarp.org/research/press-center/presscurrentnews/long_term_care_report.html

[iv] IRC §7702(b)

[v] Genworth Financial Cost of Care Survey (2007).

[vi] IRC §7702B

[vii] IRC §105(b)

[viii] IRC §162

[ix] Special rules apply to shareholders of greater than 2% in an S-corporation and to partners.