

# Ayco Compensation & Benefits DIGEST



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## Group Long-Term Disability Survey Updated

Disability insurance is one of the "core" welfare benefits offered to employees at almost all large and medium-size companies. Seventy-one percent of benefit managers say their group long-term disability plan plays an important role in their company's benefits, according to a study conducted by the Boston Research Group for The American College and MassMutual Life Insurance Co. However, the range of coverage varies widely among group plans and not all employers require that employees have coverage.

Few employees plan for a disability and, in fact, most individuals underestimate the risk of becoming disabled. According to the Social Security Administration, almost one-third of Americans entering the work force today will become disabled to some degree before they retire. Yet, it is often easier to convince an employee to purchase life insurance than an adequate amount of disability insurance, despite the fact that the chances of becoming disabled are significantly greater than of dying while employed. Over 60% of workers believe that they have less than a 2% chance of being disabled for at least 3 months during their working career—whereas, the actual odds are about 30%, according to the Council for Disability Awareness.

We recently updated our informal survey of the group long-term disability coverage offered to employees at 400 companies where Ayco provides financial counseling or financial education services. Virtually all of these companies offer a combination of sick leave and short-term disability prior to when long-term disability benefits begin - typically, 180 consecutive days after the employee becomes disabled. A few states (including CA, NJ, NY) require employers to provide disability income insurance. This informal survey focuses on the level of coverage offered under group LTD plans and who pays for that coverage.

### ❖ Amount of Disability Benefit

Group long-term disability plans are structured to replace a stated percentage of an employee's "pay" for a defined period of time – often until the later of five years or until the employee reaches age 65. A plan will define what it means by "pay". For basic coverage, it typically is a percentage of the employee's monthly base salary. However, at approximately 10% of the plans in our survey group, pay includes salary plus target or actual bonus. Amounts payable under basic coverage are reduced by disability-related benefits payable from other sources, including Social Security, Workers' Compensation, and any disability-related benefits payable from the employer.

**Replacement Ratio** - For the plans in our survey group that replace **base salary** only, the highest replacement percentage offered (without regard to the number of coverage choices) is as follows:

| <u>Highest Replacement %</u> | <u>% of all Companies In Survey</u> |
|------------------------------|-------------------------------------|
| 50% of Salary                | 2%                                  |
| 60% of Salary                | 56%                                 |
| 65% - 67% of Salary          | 20%                                 |
| 70% of Salary                | 8%                                  |
| Other (e.g., tiered)         | 2%                                  |

For those companies that replace **salary plus bonus**, the comparable percentages are:

| <u>Highest Replacement %</u> | <u>% of all Companies In Survey</u> |
|------------------------------|-------------------------------------|
| 50% - 60% of Compensation    | 8%                                  |
| 67% - 70% of Compensation    | 4%                                  |

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**LTD Survey** *cont'd...*

**Choice In Level Of Coverage** - At 62% of the plans in our survey group, the amount of coverage is set by the plan and employees have no choice as to the level of coverage. At the remaining 38%, employees can select the level of group disability coverage they wish. Sometimes, this election is under a cafeteria or flexible benefit program. Of the plans that offer coverage choices, there are two choices available at 108 companies (27% of the survey group), three coverage choices available at 33 companies (8%), and four coverage choices available at 4 companies.

**Monthly Maximum Benefit** - Just over 74% of the surveyed plans limit total disability payments to a maximum monthly benefit, with this monthly maximum as follows:

| <u>Monthly Maximum</u> | <u>% of Companies (of those with a Maximum)</u> |
|------------------------|---|
| \$5,000 or Less        | 2%  |
| \$6,000 - \$9,500      | 11%   |
| \$10,000               | 25%   |
| \$11,000 - \$14,000    | 13%   |
| \$15,000               | 21%   |
| \$16,000 - \$20,000    | 10%   |
| Above \$20,000         | 18%   |

A cost-of-living or inflation rider has been incorporated into nearly 3% of the plans surveyed. It provides for an increased disability benefit based either on a pre-established annual adjustment or on actual inflation factors. This inflation rider typically is an alternative coverage choice which an employee may elect at an additional cost.

❖ **Who's Paying The Premium**

Who pays the disability insurance premium is important in determining the tax treatment of disability benefits received. The general rule is that if the company pays the entire cost of coverage, or the employee pays with pre-tax or flex benefit dollars, all disability benefits are taxable. If the employee pays for coverage with after-tax dollars, then benefits will be received tax-free. Under Treas. Reg. §1.105-1(d)(2), if group policy premiums are split between employer and employee, the amount of any disability benefits that will be taxable will be based on the ratio of premiums paid by the employer for the last three policy years over the total premiums during that period. This is called the "three-year look-back rule".

An employer may give employees a choice as to how to pay for coverage. In Revenue Ruling 2004-55 and a series of older private rulings, the IRS confirmed that a plan can be designed so that employees may elect to pay the premium cost on an after-tax basis, whereby any benefits received would be tax free, or have the company pay for coverage, whereby benefits would be fully taxable. A small number of companies pay the premium and impute the cost into income. The IRS has indicated that this is the equivalent of the employee paying the cost of coverage with after-tax dollars. As a result, any benefits would be received income tax-free. From an employee's perspective, the imputed income approach is less costly than paying the entire premium with after-tax dollars – and both result in tax-free benefits. Offering this as an alternative is an underutilized means of enhancing a benefit at a small cost to the company.

In our survey group of 400 companies, the following represents how premiums are paid:

| <u>Who Pays</u>                                       | <u>% of Companies</u> |
|---|-----------------------|
| Company Pays All                                      | 38%                   |
| Employee Pays All on After-Tax Basis                  | 27%                   |
| Employee Pays For Higher Coverage Level Only          | 18%                   |
| Employee May Elect To Pay Either Pre-Tax or After-Tax | 7%                    |
| Employee Pays Pre-Tax or With Flex Credits            | 6%                    |
| Company Pays And Imputes Into Income                  | 4%                    |

**LTD Survey** *cont'd...*❖ **Impact of Disability On Other Benefits**

Qualification for long-term disability benefits does not mean that an employee has terminated employment, as a general rule. While the individual may no longer be receiving their regular pay, he/she should remain eligible for welfare benefits, (including medical insurance and life insurance) and retirement benefits (credited service and vesting for pension and 401(k) – although employee contributions may cease). A qualified retirement plan may have a disability retirement provision that allows the individual to commence payments earlier than would otherwise be the case.

Most compensation plans also provide for a disability situation, although being disabled is not itself a trigger for a distribution from a deferred compensation plan under IRC 409A. Typically, qualified disability does, however, trigger accelerated vesting of equity and performance awards.

❖ **Top-Hat Or Supplemental Coverage**

Many group long-term disability plans provide inadequate disability benefits for higher paid executives due to one or more of the following reasons:

- Basic group plan does not replace incentive pay;
- Plan has monthly maximum benefit cap;
- Benefits are taxable when received, unless premium paid with after-tax dollars.

Any or all of these may mean that an executive might want to consider purchasing additional disability protection. Just over one-quarter (26%) of the companies in our survey group offer supplemental top-hat coverage to key executives. In most instances, these are individual contracts, for which those employees who wish additional coverage will pay the entire cost. (In our soon to be released 2011 Executive Benefits & Perquisite Survey, 29% of the 348 survey respondents reported that they offer an executive disability policy to their senior executives.) Top-hat coverage is a supplement to, and not a replacement for, any group disability benefits. Even if an executive bears the entire cost of this coverage, the ability to have access to such coverage without full underwriting can be valuable to those executives with medical conditions. Furthermore, executives have the option of stopping this coverage as they reach retirement eligibility and usually can continue coverage after termination of employment.

❖ **Conclusion**

Employers should periodically assess the adequacy of the coverage offered to employees, as well as who is paying the cost of coverage. Just one-quarter of companies in the recent MassMutual survey of group disability benefits indicated they are considering making changes to their current group LTD program. The total cost to the employer for incidental and extended disability absences of employees is approximately 8.7% of payroll, according to a 2010 study by Mercer and Kronos Inc.

**The Importance of Reviewing Beneficiary Designations**

When was the last time you checked your beneficiary designations? A beneficiary designation is how an employee can indicate the individual or entity who the employee wishes to receive proceeds payable from a plan or contract upon death. Having the appropriate designation for both a primary and secondary beneficiary is an important aspect of each individual's estate and retirement planning. It doesn't take much time or effort; yet not confirming proper designations is in the "top 10" financial planning mistakes that employees make. Admittedly, the rules for designating a beneficiary can differ by benefit plan and can sometimes be complicated and confusing. There are legal, tax, and administrative differences that can challenge financial planners, as well as the average employee. Here are some of the more important aspects that need to be considered.

❖ **Identifying Plans Allowing a Beneficiary Designation**

Exactly what benefits are payable upon the death of a covered individual should be described in the plan document and any plan description. In most cases, a form needs to be completed by the employee indicating who is the primary beneficiary and secondary beneficiary (a secondary

**Beneficiary** *cont'd...*

beneficiary would receive any death benefits in the event that the primary beneficiary predeceases, waives the death benefit or otherwise is not available to receive the proceeds.) There are a small number of companies that have a unified beneficiary form for most or all welfare benefit and qualified retirement plans. However, most employers now maintain separate forms for each plan. While ten years ago, such designations commonly were made on paper forms which needed to be filed with the employer or plan administrator, increasingly employers require that designations be made online. This helps solve the practical problem of locating the paper beneficiary designation form and confirming that it is the most recent designation. Typically, designations can be changed at any time. Failure to designate a beneficiary may result in death benefits being paid to the estate of a decedent – but, plans can provide for another default such as spouse, children, siblings in a stated order. The following are employee benefit plans that traditionally will allow for a beneficiary designation:

- **Group Life Insurance** - group term, universal life, AD&D, business travel accident;
- **401(k) Plan** - subject to ERISA rules described below;
- **Pension Plan** - depending on type of plan and death benefits offered;
- **Nonqualified Deferred Compensation Plan/Excess Benefit Plan/SERP;**
- **Long-Term Incentive Plan** – entirely dependent on plan terms; approximately 35% of stock option plans permit designation of a beneficiary to exercise outstanding options at death.

Plans that may provide payments following death, but which typically do not allow for a beneficiary designation include annual bonus plans, disability plans, employee stock purchase plans, company-paid death benefits and dependent life insurance. These plans generally mandate who will receive any death benefits. In some cases, if there is no surviving family member, no death benefit is payable (i.e., a company-paid death benefit).

#### ❖ **Reasons For Periodic Review**

Typically, an employee will complete a beneficiary designation form when first enrolling in the plan – and then often never review that designation again. This can be a big mistake. Here are a number of reasons to review and possibly change a designation for one or more benefits:

- Marriage (whether first or subsequent)
- Divorce (of employee or beneficiary)
- Birth or reaching age of maturity of children
- Death of a designated beneficiary
- Disability or serious medical condition of employee or beneficiary
- Change of family circumstance
- Charitable inclination or change of mind
- Change in tax laws, including estate tax

#### ❖ **Legal Issues**

Many of the complications relating to beneficiary designations relate to legal issues. Here are a few examples:

- **Spousal Consent** – ERISA rules mandate that married employees obtain spousal consent to designate someone other than the spouse as beneficiary for certain plans. Exactly who is a legally recognized spouse now can sometimes be an issue with same-sex marriage being recognized in many more states and the Defense of Marriage Act (DOMA) under constitutional challenge. Further complicating consent rules is the fact that some companies request spousal consent even when it may not be mandated due to ERISA. Part of the reason is the complex state property laws, including community property. Companies with employees situated in one of the eight community property states often request spousal consent designations under all plans for purposes of administrative consistency. Failure to obtain proper spousal consent can invalidate a designation – something that may not be discovered until after death.

**Beneficiary** *cont'd...*

- **Proper Completion** – Is a designation valid if an employee completes part of the designation but neglects another part? What if the employee fails to sign a form or have it properly notarized? What if the employee simply states “my spouse” or “my child” – is that sufficient? The judicially created rule of substantial compliance can determine the validity of a beneficiary designation – but, also may mean a lawsuit, with the company or plan administrator in the middle.

Some companies review any designation filed (but many still do not) and return an incomplete designation to the employee. The fact that an employer may outsource the administration of one or more plans does not necessarily resolve these matters. The administration of beneficiary forms can be complicated and inconsistent. A number of companies have created instructions showing how to properly complete designation forms, including examples of how to designate multiple beneficiaries or name trusts or charities as a beneficiary (if you’d like an example, email us).

- **Recent Litigation** – Unfortunately, there are quite a few examples of lawsuits involving death benefits paid following the death of an active or retired employee. Here is a recent example: Emma Boyd, an employee of Delta Airlines, designated her husband Robert Alsager, as the primary beneficiary of her group life insurance, and designated her mother as the contingent beneficiary. When Emma divorced Robert, they executed a property settlement agreement in which Robert released any claims to her estate and property. However, Emma never changed her beneficiary designation, and upon her subsequent death in 2008, the plan administrator, MetLife, paid the proceeds to her ex-husband. Boyd’s mother then sued in federal court claiming that Robert had waived all rights to the death benefits and that she should be entitled to the proceeds. However, a federal court determined that the insurer paid the proceeds to the proper beneficiary. Under the 2009 decision of the U.S. Supreme Court (*Kennedy vs. DuPont Savings & Investment Plan*), plan administrators are to rely solely on plan documents to determine the proper beneficiary. Boyd had an opportunity to change the designation after her divorce; her failure to do so meant the proceeds were properly paid to the beneficiary on file at her death, despite the divorce court order.

In another recent case, a federal court granted 401(k) plan death benefits to a surviving spouse, despite a beneficiary designation in favor of children from a former marriage (*Cajun Industries 401(k) Plan vs. Kidder*). When Leonard Kidder’s first wife passed away, he designated their children as beneficiaries of his 401(k) plan. He later re-married, but passed away six weeks later, never having changed the beneficiary designation. Plan language clearly stated that death benefits would be paid to the spouse of a married plan participant, absent a written waiver of benefits. Although a plan may impose a one year rule before the spousal rights provision kicks in, this is permissive rather than mandatory. The plan in question did not require this; as a result, the spouse’s automatic entitlement trumped the employee’s actual designation in the absence of a valid waiver of spousal rights. This may or may not be what the decedent intended.

**Timing Of Stock Option Income To §16 Insider**

A recent decision by a federal court highlights the tension that exists between the tax code and U.S. securities laws. In the case of *Strom vs. United States*, the 9<sup>th</sup> Circuit Court of Appeals reversed a lower court decision that most commentators felt was incorrectly decided. The taxpayer in this case made an interesting argument which, if confirmed by the appeals court, would have changed the timing of taxation upon the exercise of stock options by insiders (designated executive officers and directors). We’ll summarize the facts and the court’s reasoning.

In 1998, Bernee Strom was hired as President and COO of Info-Space.com, Inc. She received three separation stock option grants totaling 750,000 shares priced at \$15 per share. Two of the grants covering 500,000 shares had a time vesting schedule, whereas the third grant for the remaining 250,000 shares provided that the options would vest six years after grant, but could be accelerated if gross revenue and net income performance targets were met.

## Timing of Stock Option *cont'd...*

About a year after joining the company, Strom announced that she was planning to leave due to ethical concerns about the business practices of the company's founder. However, to avoid market disruption, she agreed to continue working in a different position at the company for a few a period of time and remain on the board of directors. But, on June 30, 2000, she resigned and severed all connections with the company. The market price of Info-Space stock had rocketed to over \$1,000 per share in early 2000 before rapidly declining in value later that year (this was the time of the high-tech bubble). Strom had begun exercising vested stock options in the fall of 1999 and continued to exercise options monthly through July 2000 when all of her remaining options were forfeited due to her voluntary termination. One other important fact was that the company was involved in three mergers during Strom's term of employment and the company had a policy that restricted her from selling stock for a few months before and after each merger.

With respect to all stock option exercises by Strom in 1999, the company withheld income and social security taxes at the time of exercise and reported the income on her Form W-2. Strom reported this as gross income on her 1999 tax return. However, in 2000, Strom did not report any option related income on her tax return - and the company did not withhold income taxes upon exercise (although it did withhold Medicare taxes). Strom filed a claim for refund with the IRS for all income and social security taxes paid in 1999 and for social security taxes withheld in 2000, seeking to recover approximately \$3.7 million. When the IRS refused her claim, she sued.

Strom argued that the proper time for taxing the stock options was not at exercise, but rather when her rights to the stock became secure - that is, when the stock acquired no longer was subject to a substantial risk of forfeiture. In fact, that is the exact language in IRC §83(a) and IRS regulations for the proper time of the taxation of stock options. Strom argued that the stock she acquired upon exercise was subject to a substantial risk of forfeiture because any sale of the stock at a profit **could** subject her to a lawsuit under §16(b) of the Securities Exchange Act of 1934. Section 16(b) allows any shareholder or the company to sue to recover all profits realized upon an insider's "matchable" purchase and sale of company stock within a six-month period. Strom contended that the options should be considered "purchased" for purposes of §16(b) on the date that they became vested. If this were true, she would have been precluded from selling stock from November 1998 (when the first options became vested) until December 23, 2000 (six months after the final vesting date).

She also argued that she was restricted from selling any stock to comply with the "pooling-of-interest" accounting rules applicable to companies entering into mergers. This rule limited her ability to sell stock for a number of months before and after each merger and she argued that this entitled her to defer income recognition on option exercises during these restricted periods. The IRS disagreed with her position, but a federal district court agreed with her. The government appealed and the federal appeals court essentially upheld the position of the IRS.

As a general rule, an employee realizes income for tax purposes upon exercise for any nonqualified stock option that does not have a readily ascertainable fair market value at the time of grant. This general rule does not apply, however, if the stock acquired upon exercise is not transferable and is subject to a substantial risk of forfeiture. This is the legal basis for delaying the taxation upon the exercise of pre-IPO company stock options, absent a §83(b) election, because the stock acquired generally cannot be sold or the company retains rights to it. Whether rights to property are subject to a substantial risk of forfeiture depends upon facts and circumstances. An example of this would be stock options that are to be forfeited if performance targets are not achieved. Another example is contained in §83(c) of the Internal Revenue Code. It provides that so long as the sale of property at a profit could subject a person to suit under §16(b) of the Securities Exchange Act of 1934, that person's right to the property are subject to a substantial risk of forfeiture. So one of the questions in this case is whether Strom could be sued under §16(b) if she were to try and sell any of the stock within six months of her exercise of any options.

## Timing of Stock Option *cont'd...*

The rules in this regard were changed by the Securities and Exchange Commission (SEC) in 1991. Previously, the exercise of a stock option was considered a "matchable" purchase of stock and any sale of that stock or any other company stock at a profit would risk §16(b) liability. (This was also why insiders could not use a cashless exercise method prior to the rule change in 1991). Current rules provide that the reportable purchase for purposes of SEC §16 is the grant date of the option rather than the date of exercise. (Both the grant and the exercise must be reported on a Form 4 within two business days; the grant will generally not be treated as a "matchable" purchase, but rather an exempt transaction). Strom argued that despite these rules, she still **could** be sued under §16(b) if she were to sell any stock. As a result, she argued that she met the threshold requirement to delay taxation from the date of exercise of the options until she would no longer be subject to the risk of a lawsuit – which would be December 2000 (when the price of the stock was substantially lower than at exercise).

The court agreed that the incorporation of a reference of SEC §16(b) in IRC §83(c) makes for "strange bedfellows." At the same time, it does not mean that the risk of any §16(b) lawsuit, including an entirely frivolous one, would automatically delay the tax date. The court stated that there has to be a realistic chance of forfeiture for there to be a "substantial" risk. Thus, a taxpayer may only defer the recognition of income if there is an objectively reasonable chance that a suit under §16(b) would have succeeded. This equates to whether a reasonably prudent and legally sophisticated person would not have sold stock because of the risk of forfeiture associated with a §16(b) lawsuit. In this case, the court determined that there was no real risk that any shareholder or the company would seek to recover profits from Strom. The court rejected entirely her theory that the date of vesting should be considered a purchase date for purposes of §16, a position which is entirely at odds with SEC regulations, which the court found to be controlling.

The court also rejected Strom's similar argument with respect to the options which had a performance requirement. There are a number of no-action letters from the SEC staff that suggest that options which have performance targets will not be considered "derivative securities" until the conditions are satisfied. Stock options that will be entirely forfeited if performance requirements are not achieved are in this category. However, in Strom's situation, the number of options were fixed at the date of grant and the performance conditions simply accelerated the vesting date of the options. Thus, the court agreed with the IRS that these should be treated as derivative securities at grant, and so should be treated as exempt purchases under §16(b) at the time of grant, just as the other options.

With respect to the argument that Strom made as to sale restrictions relating to the mergers, the court sent the case back to the lower court for further proceedings. However, the appeals court did not agree with the lower court's conclusion that the accounting restrictions applied only after a merger occurred. (These accounting rules have been changed since the mergers occurred in this case.) Generally, company imposed restrictions on sale will not be treated as creating a substantial risk of forfeiture that would delay the tax date of stock option exercises.

While the court's decision in this case is not surprising, it should put to rest arguments that virtually any restriction or limitation should delay the date when options are subject to income tax, absent a true risk of forfeiture. It should be noted that a clawback risk, including one associated with a non-competition provision, will not generally be treated as a substantial risk of forfeiture delaying the tax date of an option exercise. Similarly, company imposed stock ownership requirements, as well as retention requirements, which now are relatively common in large corporate America, should not be treated as creating a substantial risk of forfeiture for income tax purposes.

## 2011 InnerCircle Program

We hope that you will consider attending the 2011 Ayco InnerCircle Program to be held on July 27-28, 2011 in Saratoga Springs, NY. Here are some of the topics to be presented at this year's conference:

- A company's successful design and implementation of a wellness program for employees;
- How 401(k) design can help employees achieve a financially secure retirement;
- The challenges of integrating benefit plans following a merger;
- How a company attracts and retains executives around the globe;
- What "say-on-pay" has taught us;
- A creative idea for replacing the fixed income fund in your 401(k) plan;
- Legal and tax challenges facing HR today; and more.....

Contact Jacquie Grande ([jgrande@ayco.com](mailto:jgrande@ayco.com)) for a copy of an invitation and further details.

### Did You Know....

Thirty percent of companies plan to relocate employees in 2011 – the highest percentage in six years, according to Atlas Van Lines' annual relocation survey.

Seventy-six percent of adult commuters listen to music while traveling to or from work, according to a survey by the Workforce Institute at Kronos Inc. (22% enjoy the quiet, 18% talk on the phone or text, 11% converse with fellow passengers, 7% read, and only 4% work). Of those surveyed, 83% travel by car alone to work and 11% use public transportation.

### About This Newsletter

This newsletter is prepared for colleagues and friends of The Ayco Company, L.P. by its Benefits & Compensation Group (BCG) and is designed only to give notice of, and general information about, the developments actually covered. It is not intended to be a comprehensive treatment of recent legal developments or the topics included in the newsletter, nor is it intended to provide any legal advice. The information contained in this correspondence cannot be used, and it is not intended by Ayco to be used, for the purpose of avoiding any penalty that the Internal Revenue Service might assess upon challenging any tax treatment discussed in this correspondence and attachments, if any. For more information on any of the topics covered, contact Richard Friedman, Vice President, BCG (518-640-5250) or email us at [rfriedman@ayco.com](mailto:rfriedman@ayco.com).

**The Ayco Company, L.P.**  
P.O. Box 15201  
Albany, New York 12212-5201  
**Phone**  
(518) 640-5250  
**Fax**  
(518) 640-5249  
**E-mail**  
[rfriedman@ayco.com](mailto:rfriedman@ayco.com)

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 **The Ayco Company, L.P.**  
P.O. Box 15201  
Albany, New York 12212-