TRISCEND NP

Evaluating Executive Benefit Options in the New Non-Profit Tax Environment

Article Series

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Published:

June 2019

The Power of a New Perspective

Evaluating Executive Benefit Options in the New Non-Profit Tax Environment

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With the highly competitive market for senior executive talent and increasing stakeholder scrutiny of compensation and benefit arrangements, non-profit organizations are reviewing and updating their compensation and benefits practices at an accelerating rate. With the addition of §4960 to the Internal Revenue Code and the associated excise tax for excess executive compensation, an already difficult situation has become more problematic. There is heightened pressure to get these decisions right, and making the wrong move could fail to achieve strategic objectives and cost the non-profit organization precious capital.

Most organizations do not have the experience or expertise to fully evaluate the options and make the best choice for their leadership, stakeholders, and the organization. We are frequently asked to guide organizations through the decision process, and we have seen what is useful in the process and what is not. Before a decision is made, the organization should first design a framework for the decision, have a clear vision of the problem to be solved and the factors most important in driving the decision.

Decisions Related to Plan Design and Assets

Once the framework is established, the next step is to evaluate the efficiency of the design and potential asset choices of the available executive benefit alternatives. The plan types available to non-profit organizations are deferred compensation plans [§457(f)], executive bonus plans (§162), and split dollar arrangements. Efficiencies of these plan-types are evaluated in the following areas:

- Taxation
- Achievement of Objectives
- Financial Statement Impact

Taxation[1]

Tax efficiency can be viewed from the perspectives of both the employer and the executive. While deferred compensation and executive bonus plans result in either current or future income inclusion for the executive, split dollar does not if it is structured properly.

Deferred Compensation	Executive Bonus	Split Dollar
Includable in executive income when vested	Includible in income when paid (typically annually)	So long as sufficient interest is charged, there is no income inclusion.
If total executive remuneration (including deferred compensation and executive bonus payments) exceeds $1,000,000, the employer would be subject to the excise tax.		No excise tax exposure[2]

To the extent benefit dollars are lost to taxation, there is less value the executive can invest for retirement cash flow purposes. Regardless of the executive's state of residence, this loss can be significant and negatively impact the efficiency of a plan type. Before deciding upon a course of action, both the employer and executive should evaluate the tax efficiency of each plan type.

[1] Triscend[NP] does not provide tax, accounting or legal advice. Organizations should seek independent guidance on these matters.
[2] As of this writing.

Achievement of Objectives

The purpose of implementing executive benefits is to retain a key executive for a defined period and (often) to reward the executive for substantial years of prior service to the organization. Below are some of the more common goals non-profit organizations seek to achieve.

- **Executive Retention**
  - Because vesting triggers income inclusion, Deferred Compensation Plans provide for partial vesting on a schedule or full vesting some future point in time. Either way, taxation can dictate vesting to a greater extent than the retention objective. In many cases, this may be appropriate, but the parties should fully understand the implications.
  - Executive Bonus Plans provide for current compensation payments that are typically paid into a life insurance policy designed to accumulate value for future purposes. While certain restrictions may be placed on policy value access, these plans are not associated with providing a strong retention incentive.
  - Split Dollar Plans provide the organization with greater flexibility in tailoring the arrangement to meet specific retention goals because taxation and vesting are decoupled.

- **Alignment of Compensation Philosophy and Stated Purpose**
  - Deferred Compensation Plans and Executive Bonus Plans are common executive benefit arrangements in non-profit organizations. They, like Split Dollar, are viewed as necessary elements of an effective compensation plan for senior executives. However, these alternatives result in an expense that is not recoverable by the organization, which could impact the organization's ability to execute on its mission in the future. This is not necessarily a reason to avoid the implementation of these options, but consideration of this factor should be part of the decision process.
  - Split Dollar Plans provide for the organization to recover either its funding amount or the funding amount and accrued interest in the future. These plans introduce some additional complexity and may require a more significant cash outlay, but many organizations are willing to accept this because of the future capital recovery and the more favorable financial statement treatment.

- **Competitive Retirement Benefit**
  In addition to the loss of value to taxation, the efficiency of a particular plan type in generating an appealing retirement benefit relies on the type of financial product that is used in conjunction with the design. Deferred compensation plans are the most flexible in this regard with virtually any product available to the executive for investment. Executive bonus plans and Split dollar plans, on the other hand, are life insurance arrangements by definition. Irrespective of the plan type, the resulting financial products should be evaluated on their ability to efficiently product future cash flow. As part of conducting such an analysis, it is important to judge the financial product on its expected return, the volatility (risk) of those returns, and any associated product expenses.

Financial Statements

We will explore the impact of the various alternatives on the Income Statement, Balance Sheet and Statement of Cash Flows in the next article but below we provide a summary of the treatment of these plans on the financial statements.

Financial Statement	Deferred Compensation	Executive Bonus	Split Dollar
Income Statement	Benefit Expense	Compensation Expense	Other Interest Income
Balance Sheet	Benefit Liability	Reduction in Cash	Other Asset

Cash Flows	Outflow when paid	Annual Outflows	Outflow at Implementation/Future Recovery
Other Matters	Excise Tax Exposure	Excise Tax Exposure	Medical/Financial Underwriting

Financial Statement Impact of Executive Benefit Decisions

Once issues related to the efficiency of the various executive benefit plan designs and assets are fully explored, an organization should shift its attention to the impact of the various alternatives on its financial statements. Each plan type has its pros and cons, and a complete understanding of the financial effect of this choice is an important component in the decision process.

The financial impact of the plan-types is evaluated in the following areas:

- Income/Expenses (Income Statement)
- Assets/Liabilities (Balance Sheet)
- Cash Inflows/Outflows (Statement of Cash Flows)

Income Statement

All plan types will affect the organization's income statement. The key is to determine how and to what extent the effect will be.

- **Deferred Compensation**

  Deferred compensation plans are a contractual promise to pay an amount in the future, typically subject to certain performance or retention conditions. This promise generates a liability on the organization's balance sheet that periodically increases until the payment is made. This accrual to the liability is reflected on the income statement as a benefit expense that increases annually until the benefit is vested and paid.

- **Executive Bonus Plans**

  These plans involve a regular payment (in the form of life insurance policy premium) that is taxable compensation to the executive when made. These payments are typically made on an annual basis and treated as a compensation expense on the income statement.

- **Split Dollar Arrangements**

  Depending upon the design and structure, a split-dollar arrangement can trigger either expenses or income on the income statement. This treatment depends on the facts and circumstances of the arrangement and whether or not it meets certain conditions. These conditions were initially set out in EITF 06-10 and later codified in ASC 715-60.

  At a high level, the arrangement can generate interest income if the amount funded by the organization to the life insurance policy(ies) is subject to an interest rate. This interest (subject to adjustments) is usually recorded as "other" interest income. If the interest is forgiven or the interest rate is zero, the arrangement will not generate income. Any interest the organization could have received is treated as a compensation expense and included in the executive's taxable income.

Balance Sheet

As with the income statement, any executive benefit plan implemented by a tax-exempt organization will affect its balance sheet.

- **Deferred Compensation**

  As mentioned above, the organization will recognize benefit expenses regularly until the payment is made to the executive. These benefit expenses accrue to a benefit liability on the balance sheet. Once paid, the liability is extinguished. As part of the payment, cash is also permanently reduced.

- **Executive Bonus Plans**

  The only effect this plan type has on the balance sheet is a reduction in cash as payments (premiums) made to the associated life insurance policy.

- **Split Dollar Arrangements**

  Since the majority of split-dollar arrangements we see are loan-regime (also known as collateral assignment) structures, we will limit our comments to these designs. These plans are recorded as an asset (receivable) on the organization's balance sheet that, in many cases, will accrue interest. The value of this receivable is limited to the cash value of the assets (life insurance policies) collateralizing the arrangement. That is, the value of the receivable carried on the organization's balance sheet is the lesser of the premiums paid by the organization plus the accrued interest or the cash value of the collateralized assets.

Statement of Cash Flows

Eventually, all executive benefit arrangements will result in an outflow of cash from the organization. Understanding the timing, magnitude, and the potential alternatives providing cash inflows is crucial.

- **Deferred Compensation**

  These plans are associated with permanent outflows of cash, although typically not immediate. Since deferred compensation plans serve dual purposes of retention and retirement cash flow, they typically vest and pay when the executive is at or nearing retirement. As a result, the cash flows associated with deferred compensation plans are usually years in the future. For organizations with limited cash on the balance sheet, these structures can be appealing.

- **Executive Bonus Plans**

  Executive bonus plans result in immediate outflows of cash in all years in which premiums are paid. These cash outflows are permanent.

- **Split Dollar Arrangements**

  Split dollar arrangements provide for both cash outflows and cash inflows. The outflows occur during the years the life insurance policies are being funded. Funding is accomplished most efficiently if completed at implementation, but we also see organizations elect to fund over time (but typically not more than ten years). However, organizations that do not have strong cash positions will want to consider other alternatives or funding over time.

  Split dollar arrangements must, at a minimum, return the premiums funded by the organization to remain compliant and avoid income inclusion for the executive. If sufficient interest on these premiums is accrued and not forgiven, the accumulated interest will be returned as well. In most split-dollar arrangements, these cash inflows occur at the executive's mortality. But, in limited cases, payments (full or partial) can occur earlier.

Next, we will look at non-financial statement costs/gains and other factors that organizations should consider as part of its decision-making process.

Other Costs and Factors Resulting from Executive Benefit Decisions

From here, we move our attention to a discussion of non-financial statement costs and potential gains as well as other qualitative considerations that are part of a decision process. As it is with other decision factors, each alternative has its pros and cons, and a complete understanding of all effects of this choice is an important component.

The non-financial statement impact of the plan-types is evaluated in the following areas:

- Opportunity Costs
- Public Reporting/Disclosure
- Resilience

Opportunity Costs

An opportunity cost is a gain forgone by choosing a particular course of action over another possible alternative. While opportunity costs are not reported on the organization's financial statements, they are an important consideration when evaluating executive benefit plans. No organization has unlimited capital, so understanding the result of these decisions versus the alternatives is crucial.

We tend to look at opportunity costs in the following contexts:

- **Versus Alternative Investments**
  For the most part, organizations deem executive benefits for senior leadership as an integral part of a reasonable compensation package. As a result, it is rare for a decision of this type to come down to whether the arrangement provides returns comparable to alternative investments. That said, we believe it is prudent to understand how these alternatives stack up, but it should not drive, in our opinion, the decision to implement a plan.

  When an organization makes a comparison of this or any type, it is important to ensure the executive benefit alternative is compared to another likely and available option. We have seen organizations attempt to make this comparison against hypothetical investments representing reasonably available options.

- **Versus Other Executive Benefit Alternatives**
  More common, and we believe, more correct is a comparison of returns among the available executive benefit options. As we covered in the other articles in this series, each alternative has a unique combination of cash inflows/outflows, expenses/income, and liabilities/assets and each of these will be important factors in the analysis.

  Assumptions also play a key role in making this comparison accurate, and we recommend testing these assumptions against reality before moving forward.

Public Reporting / Disclosure[3]

Most tax-exempt organizations will report executive benefit arrangements for its highly compensated executives on Form 990. It will either be primarily disclosed on Schedule J (Compensation Information) or Schedule L (Transactions with Interested Persons) depending upon the nature of the plan.

- **Compensatory Plans**
  Deferred compensation plans and executive bonus plans are compensatory arrangements and disclosed on Schedule J of Form 990. While reporting varies, we typically see these values reflected in Columns B(ii) or C of Part II of Schedule J in addition to a narrative description of the Plan in Part III. Strangely, deferred compensation plans are reported as values are accrued, and again when paid.

- **Split Dollar Arrangements**
  While these plans provide for retirement benefits like deferred compensation and executive bonus plans, they are not considered compensatory and reported in a different location on Form 990. Recall, split dollar arrangements are treated as loans for tax purposes. Given this treatment, it follows that these arrangements are reported on Schedule L, Part II, where other loans are disclosed. Similar to the above, there is also a section of Schedule L (Part V) where a detailed description of the plan should be provided.

Some tax-exempt organizations, like federal credit unions, are not currently required to file a Form 990. Instead, these entities file financial reports to the National Credit Union Association (NCUA) on Form 5300. While compensation and most executive benefit arrangements are not specifically reported on Form 5300, the values associated with split-dollar arrangements, and other benefit-related assets, are disclosed on Schedule B.

With the advent of the excise tax on excess executive compensation for tax-exempt organizations, some organizations will be required to report such excess compensation on IRS Form 4720. Our understanding is this form only needs to be filed if an executive has more than $1,000,000 in remuneration, which will include vested deferred compensation arrangements. As of this writing, split dollar arrangements are not included in the definition of remuneration for excise tax purposes.

Regardless of the reporting requirements for the available alternatives, organizations should ponder how its stakeholders will view the benefit arrangement within the context of its stated purpose. That is, no organization has limitless capital, so is it important to ensure the amount funded by the organization is returned? Or, is the environment such that plans increasing reportable compensation are not viewed favorably. Either way, organizations should take the time to understand their stakeholder's perspective.

Cost of Volatility

When comparing options, it is common for organizations to judge alternatives based on the rate of return the organization expects to receive on its existing assets, as well as new assets which may be purchased in connection with a plan. We find that while organizations know with relative certainty their portfolio rates and specific asset returns, they tend to pay less attention to the risk of returns when comparing various assets.

If return risk and volatility are not taken into account, it could result in a poor decision. We recommend organizations attempt to normalize these returns by using either the Sharpe Ratio or the Sortino Ratio, which measures only the volatility associated with negative returns.

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Finally, as an executive begins to draw down on his/her retirement assets, the order in which investment returns are received can have a dramatic effect on the amount of retirement cash flow realized. The uncertainty associated with this ordering is referred to as sequence risk. As a result, in addition to adjusting expected rates of return for volatility, both executives and organizations should consider the impact of return sequence (especially post-retirement) on the effectiveness of the plan alternative in delivering the desired result.

Given the significant capital required to implement executive benefit arrangements, the decision of plan type is strategic. Not only are significant cash flows associated with each option but the necessity to secure the organization's top leadership raises the stakes. Because of these factors, we believe organizations should have established processes for gathering data, synthesizing the data into actionable information, and making an informed decision which is executed by the organization.

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USE OUR EXPERTISE FOR YOUR BENEFIT

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