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A More Responsible Approach to Retention Planning

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Legislators, regulators, unions, the media and the general public are increasingly pushing for more transparency of nonprofit healthcare organizations. Public reporting requirements, such as the IRS Form 990, help to ensure financial practices are visible to the public. As a result, non-qualified benefit plans, such as Supplemental Executive Retirement Plans (SERPs) or 457(f) deferred compensation plans, are attracting higher levels of scrutiny due to the permanent loss of funds. The public tends to look unfavorably upon large sum payouts to executives when instead those funds could have been allocated to resources directly benefiting the organization's mission, such as health care programs, charitable care and research.

While public scrutiny is nothing new, healthcare organizations must continue to review their compensation philosophy to ensure alignment of pay and performance. The board must demonstrate that every decision is made in the interests of the community and ensure that the organization continues to meet its charitable mission. It is important to be transparent through the organization's written compensation philosophy by establishing a clear connection between the executive's pay and the organization's mission and performance.

Now more than ever, it is vital to retain administrators of hospitals and health systems. Healthcare is leading all sectors in CEO turnover with 151 changes since the beginning of 2013, up from the 140 recorded in the same period in 2012, according to a report from executive outplacement firm Challenger, Gray & Christmas. In the face of health care reform and diminishing resources, Hospitals and health systems have been challenged to retain top leadership responsible for improving services and quality of care. They are in need of retention plans to secure stable leadership of the organization. Yet, these same organizations are expected to advance their mission by optimizing funding for health care programs and charitable services, not for executive benefit expenses.

There is an alternative benefit structure which naturally appreciates the unique purpose of a non-profit organization to serve its community. Split-dollar plans have been used as a retention planning strategy since the 1950s. When properly structured and administered, split-dollar plans may be used to ultimately return all funds, plus interest, back to the employer, while providing a competitive retirement benefit to key talent. The equitable nature of this approach provides for better stewardship of limited resources to more effectively meet the needs of the organization and its stakeholders.

Split-dollar is a method of purchasing life insurance in which the ownership, costs and benefits are shared in a predetermined way. An employer and the executive/physician may commonly establish this arrangement as a way to provide key talent a benefit. Split-dollar plans may be classified into two structures: economic benefit regime and loan regime. Economic benefit regime is most commonly used when the provision of a death benefit is the main goal of the transaction. Loan regime is used when the goal is to maximize supplemental income during retirement.

In a loan regime structure, the executive/physician owns the life insurance policies and the employer loans funds equal to the value of the premium to the insured. As collateral for the loan, the insured assigns a portion of the cash value and/or death benefit to the employer. The insured is to repay the loan with accrued interest at a future point, typically at the time of their death, in order to make tax-free withdrawals from the policy for use as retirement income. The employer has the option to forgive the interest, which would result in current taxable income to the executive/physician. Accrued interest does not result in current income tax so long as sufficient assets are in place and a "reasonable person" would expect the loan to be paid back in full. It is critical to make sure that assets are in place that will be sufficient to repay the loan and accruing interest.

The advantage to this approach is that the plan creates a growing asset for the employer; not an expense as is the case with most SERPs, like 457(f) deferred compensation plans. Additionally, it may, depending on the circumstances, require less upfront capital than a traditional deferred compensation plan for the same retirement benefit. Furthermore, the plan enables the executive/physician to make tax-free withdrawals, which helps to provide greater income levels during retirement. The structure accommodates high levels of customization to suit the objectives of the employer and the executive/physician, such as tying the benefit to vesting provisions to improve retention. Any vesting provisions do not require "risk of forfeiture" limitations, whereas it is currently required in deferred compensation arrangements.

Loan-regime split-dollar is considered a non-compensatory arrangement because it is a loan, whereas most retirement plans are compensatory in nature. The public tends to look more favorably upon a retention plan which loans funds that are returned plus interest back to the organization. It may be seen as a more direct contribution to helping the organization meet its charitable mission.

As with all retention planning strategies, there may be inherent risks. When approached with proper care and due diligence, these risks can be mitigated with responsible design, implementation and administration. However, if the associated risks are not properly managed, it could result in unanticipated consequences to the executive/physician and lesser income levels during retirement, as well as adverse accounting implications to the employer.

Of all the potential risks, administration service is the factor that may most significantly affect the plan's success or failure. Historical uses of split-dollar demonstrate that poor administration and risk management can significantly compromise its ability to provide secure benefits to the executive/physician and the organization. When implementing a split-dollar plan, it is strongly advised to designate a service provider to regularly monitor compliance, asset performance and pertinent regulatory developments for the life of the plan.

When properly designed, implemented and administered, split-dollar plans may extend equitable advantages to the executive/physician, the organization and its stakeholders. It is these types of sustainable business practices that encourage long-term financial security and promote the success of the healthcare organization.

Robert "Bob" Gutherman, principal of The CAP-Ex Group, has more than 40 years of experience in financial services. Having previously established a financial services firm in 1996, Mr. Gutherman has extensive experience providing key services in estate and tax planning, as well as in the executive compensation arena, to accounting and legal firms around the country for high net worth clients, closely held businesses, and not-for profit entities. He has also *formed strategic relationships with organizations like Hospital Association of Southern California, Hospital Council of Northern and Central California. www.thecapexgroup.com*