Making Better Executive Benefit Decisions: How Do You Make the Right Call?

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With the advent of Pub. L. 115-97 and the addition of §4960 to the Internal Revenue Code, imposing an excise tax on "excess" executive compensation and increasing competition for senior executive talent, tax-exempt organizations are reviewing their executive benefits practices at an increasing pace. As these reviews progress, we see these organizations struggle with the best way to understand the implications of their existing approach (if any) and compare the status quo to alternatives that may be a better fit, given the new tax, regulatory and stakeholder environments.

We are frequently asked to guide organizations through this type of decision process, and we have seen what is useful and what is not. Before making a decision, first design a framework for the decision and have a clear vision of the problem to be solved and the factors that are most important to your organization in driving the decision. Next, develop a set of realistic options for consideration. The decision will only be as good as the best option available for review, so take care to develop a comprehensive list, and seek outside counsel to the extent necessary to make sure all options are being considered.

Once the options are defined, the focus then turns to the best way to evaluate and compare those options and make a decision that is congruent with your organization's mission. As with most decisions, there are qualitative and quantitative considerations from the perspectives of both tax-exempt organizations and executives. While each decision has its own unique set of circumstances, we believe a disciplined decision process should contain an evaluation of the following, at a minimum: 2

Qualitative Matters

Although these factors cannot be reduced to a numerical comparison, they are essential in making a smart decision. In most cases, organizations are trying to achieve specific objectives, and alternatives should be evaluated on that basis. Common goals include:

Retention: The purpose of implementing executive benefits is not only to reward but to retain a key executive or executives for a defined period. Any review of new or existing arrangements in light of the excise tax should seek to achieve the desired retention objective. Understanding an executive's view of the various options will be important in judging a plan's effectiveness in meeting retention goals.

Public and Regulatory Disclosure: Regardless of the type of executive plan chosen, there will be some disclosure -- most likely on the organization's Form 990. With the increased scrutiny on executive compensation packages, consider the effect of various plan types on this disclosure. Tax-exempt organizations should study and understand the implications of this reporting, as some arrangements are received more favorably than others by their stakeholders.

Quantitative Matters

Unlike the qualitative factors above, these metrics are numerical in nature, lend themselves to an objective comparison and typically involve the following:

Financial Statement Impact

Income Statement: All executive benefit arrangements affect the income statement. Some alternatives result in benefit expenses, compensation expenses and, if substantial enough, excise taxes. In certain circumstances, there are plan types that can provide accrued returns that offset these expenses. A full understanding of the current and future effects of the options should be obtained before deciding on a course of action.

Balance Sheet: Eventually, all plans will affect cash on the balance sheet. Also, many arrangements result in benefit liabilities that accrue annually until retirement or the payment of the benefit. Some options are accounted for as assets that are either exclusive of or offset by benefit liabilities.

Statement of Cash Flow: Whether now or in the future, all benefit plans will result in a use of cash (cash outflow) from the organization. The timing and magnitude of that cash flow is a vital consideration when evaluating options, as some plans are funded at implementation and others over an extended period. At least one alternative available to tax-exempt organizations provides for a future source of cash (cash inflow).

Non-Financial Statement Factors

Opportunity Costs: When an organization elects to allocate funds to an executive benefit plan, or anything else for that matter, it is making a conscious decision not to invest funds in another opportunity. While this “cost” will not show up on financial statements, it is important to quantify it and understand it, as this may steer your organization toward a particular alternative.

Risk of Returns: 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 that 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 ignore the risk of returns when comparing various asset classes.

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.

Conclusion

Once these factors are fully explored, tax-exempt organizations and their advisers should organize the results in a manner allowing for comparison based on organizational goals. This diligence equips organizations and leadership to make the best possible decision.

Lastly, both boards of directors and senior leadership will evolve and change over time. As a result, it is imperative for the decision process and results to be documented, so future boards and leadership can understand the rationale and method by which the decision was made.

Evaluation and implementation of executive benefit arrangements is a capital-intensive process with strategic implications. As such, it's important to have a disciplined and rational approach for evaluating the impact to the organization and executives, ensuring the final decision allows the parties to achieve their respective objectives while furthering the organization’s mission.

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