Decisions Related to Plan Design and Assets

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.

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

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

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.

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

Given the significant capital required to implement executive benefit arrangements, the decision as to plan type may be a strategic one. Not only are significant cash flows associated with each option but 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 that data into actionable information and making an informed decision that is executed by the organization. Critically evaluating the efficiency of the design and assets is one step. In our upcoming article, we will build on this analysis by looking at the impact of these plan options on the Income Statement, Balance Sheet and Statement of Cash Flows. We will close the series with a look at other costs and factors that organizations should consider as part of its decision-making process.

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