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Five Executive Benefit Plans that can be Used with Nonprofit Organizations

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There is a key question on the minds of nonprofit and tax-exempt organizations. It is the same question facing all successful businesses: How do we keep our most talented people from leaving to work elsewhere?

Just like their for-profit counterparts, nonprofit organizations are seeking ways to recruit, reward, and retain key executives. But the challenge to keep executives is even greater for nonprofit organizations. Like for-profit businesses, nonprofit and tax-exempt organizations are limited as to the types of benefits they can offer key executives. Qualified retirement plans (e.g. 401(k), profit sharing, and 457(b) plans) have contribution limits and nonqualified benefits must meet the requirements of ERISA and § 409A. But unlike ordinary corporations, benefits offered by nonprofits must, with some exceptions, also meet the restrictions of IRC § 457. For deferral plans that want to exceed the § 457(b) contribution limits, nonqualified benefits for executives and directors must be subjected to "a substantial risk of forfeiture."

Fortunately, there are compensation alternatives which can help nonprofit and tax-exempt organizations retain their most-valued executives and directors. Depending on the needs of the executive or director involved, nonprofit organizations should consider the following five plan designs for offering nonqualified benefits:

- § 457(f) Plans;
- Split-Dollar Loans;
- Split-Dollar Loan/§ 457(f) Combo arrangements;
- Executive Bonus plans; and
- Restricted Executive Bonus Arrangements ("REBAs").

Factors to Consider

The key to selecting a retirement benefit will be to determine which of the following factors are most important to the organization and the executive: (i) tax deferral for the executive; (ii) avoiding a "substantial risk of forfeiture"; (iii) flexibility; (iv) "golden handcuffs"; or (v) providing cost recovery to the organization.

Tax Deferral: Sometimes the primary reason for implementing a nonqualified plan is to allow executives to defer taxation on income until the money is actually needed (i.e., not pay taxes on a benefit until retirement). For executives of nonprofit and tax-exempt organizations, benefits which offer tax deferral must generally comply with IRC § 457.

Avoiding "Substantial Risk of Forfeiture": The price for unlimited contributions and tax deferral when working for a nonprofit or tax-exempt organization is that the benefit must be subject to a "substantial risk of forfeiture." Many executives and directors may prefer to seek a benefit arrangement which avoids this requirement.
In order for a nonqualified benefit that exceeds the § 457(b) contribution limits to provide tax deferral for executives or directors of nonprofit organizations, § 457(f) requires the benefit to be subject to a "substantial risk of forfeiture." According to § 457(f)(3)(B), a benefit is "subject to a substantial risk of forfeiture if such person's rights to such compensation are conditioned upon the future performance of substantial services by any individual." In practical terms this means that tax deferral is available to executives and directors of nonprofit organizations only where the benefit does not vest until it is paid out and the benefit is likely to be paid out in a lump sum.

Flexibility: As was indicated above, for all practical purposes, benefits which allow executives of nonprofits to defer taxation will be paid out in a lump sum. This is because such benefits will be fully taxable under § 457(f) as soon as there is no longer a substantial risk of forfeiture. Thus, once a benefit has vested, the IRS will require the executive to recognize the full amount of the benefit as ordinary income even if the benefit is scheduled to be paid out over a period of years. Executives and directors who want to be able to take payments in forms other than a lump sum, or who want the ability to change the schedule of payments, will seek a plan design that is not subject to the restrictions of § 457(f).

“Golden Handcuffs”: One of the primary reasons for employers to implement nonqualified plans is to provide incentives that will help retain key executives. Where a benefit is tied directly to a requirement that the executive continue working for the employer, the arrangement is said to have “Golden Handcuffs.”

Cost Recovery: Sometimes a nonprofit or tax-exempt organization will not be interested in offering a benefit to key executives unless it can recover some or all of the costs of providing benefits.

Plan Types

Depending on which of these factors is most important to the organization and executive involved, you may want to consider one of the following designs: (i) § 457(f) plan; (ii) split-dollar loans; (iii) split-dollar loans/§ 457(f) combo arrangement; (iv) executive bonus arrangement; or (v) restricted executive bonus arrangement (“REBA”).

§ 457(f) Plans

Sometimes referred to as an “ineligible plan,” a § 457(f) plan is a nonqualified deferred compensation arrangement for non-profit and tax-exempt organizations which provides tax deferral on unlimited contributions to executives who are willing to subject benefits to a “substantial risk of forfeiture.”

These plans will best fit situations where:

- The nonprofit organization wants to give the executive or board member an incentive to remain with the organization (“Golden Handcuffs”);
- The incentive will exceed the § 457(b) limits;
- The executive wants tax deferral; and
- The organization wants a source of cost-recovery for the benefit.

Section 457(f) plans are arrangements where an employer promises to pay an executive a future benefit. The benefit may be based on deferrals made to the plan by the executive or may promise a benefit amount based on years of service, reaching retirement age, or at death. In both types of arrangements, the executive does not pay income taxes until the benefits are vested. Organizations will typically purchase a life insurance policy to provide funds that will be needed to pay the promised benefits. These plans are subject to the requirements of IRC §§ 457(f) and 409A.

Split-Dollar Loan Arrangements

A split dollar loan is an arrangement where an employer helps provide an executive with retirement and death benefits by providing funding for the ownership of a life insurance policy. The employer pays premiums on a life insurance policy owned by the executive, but retains a collateral assignment interest in the policy equal to the sum of the premiums it has advanced. The premium advances are treated by the IRS as loans and the executive pays taxes annually to the extent interest on the loan is below market (AFR). The life insurance policy can be used by the executive for death benefit protection and as a potential source of supplemental retirement income.

These plans will best fit situations where:

- The executive wants flexibility;
- The executive wants control of the policy; and
- The organization wants a source of cost-recovery for the benefit.

In a split-dollar loan arrangement, the organization rewards the executive by sharing the costs of purchasing a life insurance policy for the executive. The executive purchases a life insurance policy and the organization pays the premiums. The executive owns the policy, but gives the organization a collateral assignment for an interest in the policy equal to the sum of premiums the organization has paid. The organization’s premium payments will be reimbursed at the termination of the split-dollar loan arrangement. Unless the executive uses outside funds to reimburse the organization, this will reduce the cash value of the policy (or the death benefit, if the executive’s death terminates the arrangement). .

Split-Dollar Loan/§ 457(f) Combo Arrangements

A split-dollar loan/§ 457(f) combo arrangement is essentially a split-dollar loan arrangement where the organization makes an additional promise to release its interest in the split-dollar life insurance policy at retirement or some other specified date. This technique is sometimes referred to as a split-dollar “rollout.”

These plans will best fit situations where:

- The executive wants flexibility;
- The executive wants control of the policy; and
- The nonprofit organization doesn’t need cost-recovery.

In a split-dollar loan/§ 457(f) combo arrangement, the organization rewards the executive by sharing the costs of purchasing a life insurance policy for the executive. The executive purchases a life insurance policy and the organization pays the premiums. The executive owns the policy, but gives the organization a collateral assignment for an interest in the policy equal to the sum of premiums the organization has paid.

Additionally, the organization and the executive enter into a § 457(f) arrangement that promises the executive a benefit equal to the amount of premiums the organization will pay on the life insurance policy. According to IRS Notice 2007-34, this arrangement must be in writing and meet all of the requirements of § 409A.

At retirement, the executive uses the § 457(f) benefit to satisfy his or her obligations under the split-dollar collateral assignment. The § 457(f) benefit (an amount equal to the premiums paid on the policy) will be treated as taxable income to the executive. This rollout arrangement vests the executive in the full cash value of the split-dollar life insurance policy at retirement. The life insurance policy can be used by the executive for death benefit protection and as a supplemental source of retirement income.

Executive Bonus Arrangements

An executive bonus arrangement provides a cash value life insurance policy for executives using after tax dollars contributed by the organization. The organization pays premiums on a life insurance policy owned by the executive and treats the premium payments as bonuses to the executive. The executive uses the premium to purchase a life insurance policy, which can provide income-tax free cash value build-up that can be accessed (via withdrawals and loans) for supplemental income as well as death benefit protection on an after-tax basis.

These plans will best fit situations where:

- H The executive wants flexibility;
- H The executive wants control of the policy; and
- H The parties want a simple arrangement.

Bonus arrangements fall outside the purview of §§ 457 and 409A because they are not plans of deferred compensation. Bonuses are taxable in the year they are paid.

When used to purchase life insurance, bonus arrangements provide an excellent alternative to nonqualified deferred compensation arrangements for funding retirement needs. While the executive is taxed on the bonus, the funds are directed to a life insurance policy which will grow tax deferred. With planning, the funds can be accessed during retirement on a tax-preferred basis. Withdrawals are tax-free up to basis and the executive can withdraw further funds from the policy using non-taxable loans. Finally, any death benefits received are income tax free because the executive is the owner of the policy and was taxed on the premium payments.

Income tax free distributions are achieved by withdrawing to the cost basis (premiums paid) then using policy loans. Loans and withdrawals may generate an income tax liability, reduce available cash value and reduce the death benefit or cause the policy to lapse. This assumes the policy qualifies as life insurance and is not a modified endowment contract.

Restricted Executive Bonus Arrangements ("REBAs")

A restricted executive bonus arrangement ("REBA") is an executive bonus arrangement which uses a supplemental employment agreement to tie the executive closer to the organization. The supplemental agreement may require the executive to pay back some or all of the organization's premium advances in the event the executive leaves within a certain specified period of time. A restrictive endorsement can be placed on the policy limiting the executive's ability to access cash values without the consent of the organization.

These plans will best fit situations where:

- The executive wants flexibility;
- The executive wants control of the policy;
- The parties want a simple arrangement; and
- The organization wants "Golden Handcuffs" for the executive.

A REBA is an executive bonus arrangement that makes use of a supplemental employment agreement to bind the executive to the organization. The REBA provides the same flexibility and tax treatment as an executive bonus arrangement but adds the ability to provide an incentive to the executive to remain with the organization for a period of years.

The REBA has two primary components:
1. A life insurance policy with a restrictive endorsement; and
2. A supplemental employment agreement.

The organization pays the premium on a life insurance policy owned by the executive. In conjunction with this purchase, a restrictive endorsement is placed on the policy. The restrictive endorsement states that the executive has all ownership rights in the policy, but restricts the executive's access to cash values without the consent of the organization.

The organization and the executive also execute a supplemental employment agreement. The agreement provides that the organization will pay the premium bonuses for the policy in exchange for the executive's promise to continue working for the organization. The agreement provides that if the executive does not fulfill the promise to continue

working for the organization, he or she will repay some or all of the bonus back to the organization as "liquidated damages." This provision protects the organization's investment and gives the executive an incentive – or "Golden Handcuffs" – to stay with the organization. Please note that REBA is subject to 409A.

Summary

With these five plan designs, you can help nonprofit and tax-exempt organizations design plans to help meet their goals for recruiting and retaining executives. Where the organization wants cost recovery and "golden handcuffs," and the executive wants tax deferral, consider a § 457(f) plan. Where the organization wants cost recovery and the executive wants flexibility, consider split-dollar loans. Where the organization wants "golden handcuffs" and the executive wants flexibility, consider using either a split-dollar loans/§ 457(f) combo arrangement or a REBA. Or where the parties want a simple arrangement that gives the executive maximum flexibility, consider an executive bonus arrangement.

To learn more about executive benefits for nonprofit organizations and life insurance products which can be used to fund them, go to the ING Virtual Financial Center (www.ingvfc.com) and look under either Advanced Marketing or Corporate Markets, or call the ING National Sales Support Team at 866-ING-SELL (866-464-7355).