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Executive Retirement Benefits in the Non-Profit Sector — A White Paper
"Managing Expectations When There Is No Perfect Answer"

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Key executives who work in the non-profit sector today are extremely concerned about non-qualified deferred compensation (NQDC), and supplemental executive retirement plans (SERP). This white paper explores the origins of the current situation and develops a potential solutions matrix. As a practical guide, this white paper is intended to help the human resources professional:

1. Understand the nuances of the executives' deferred compensation dilemma;

2. Explain to the executives the subtleties of the new NQDC and SERP environment, so as to properly manage their expectations about what can and cannot be done.

A starting point for the discussion is a review and analysis of the exact hows and whys of the current state of NQDC plans for non-profit executives. As tools to navigate this virtual minefield, we explore:

1. What exactly is the problem executives face in deferring income?

2. Is it truly problematic, or more of a perception in the mind of the executive?

3. Does history give us any insight into how to best resolve the dilemma?

For a human resources professional, managing such a situation with no readymade or relatively straightforward solution depends on "properly positioning" the issue to the executive. In other words, background information establishes some direct context. The complexity of legislative changes over the past decade has radically transformed the landscape. In discussions with a Chief Executive Officer, Chief Financial Officer or Chief Operating Officer, or other senior executives of the "C"-Suite, it may help to examine the reasons for the current state of NQDC and SERPs and it may help to present the real implications to them.

When broaching this topic, it is worthwhile to keep mind that there have been enough legislative and environmental changes in the past decade to whip up a nearly perfect storm.

The Road to No Benefit - Regulatory Changes

Back in the day, ten years ago and earlier, life was sweet for C-Suite executives. That was before corporate disasters such as Enron and Tyco, and before some of the excessive compensation issues that came out in the non-profit world, like those at The United Way. Many executives at that time were receiving unreasonably high total compensation packages, which included the non-qualified deferred compensation component.

There were then, and still are, two primary reasons that NQDC is important to C-Suite executives. First,

most executives defer income in the hope that they will pay less in taxes when they receive the money, and that investment income earned will also be tax-deferred, meaning higher net returns of invested capital. Second, executives in the non-profit sector were sensitive to the community's perception that their cash compensation package was excessive. For example, a CEO earning $750,000 might want to defer $250,000, so that his base compensation would appear to be "only" $500,000. Back in the day, NQDC and SERPs could meet both of these objectives. That is no longer the case. Several primary drivers account for how and why the environment for executive deferred compensation has tightened.

Rolling back the clock to the year 2000, we see a non-qualified deferred compensation environment that was still wide open for many reasons:

1) The typical volunteer who served on non-profit organizations' boards of directors did not regard compensation matters as part of the job, and few had the background to truly understand compensation issues or question the CEO about them. In addition, the executive directors at many non-profits had built them from the ground up. They were the visionaries who had made a particular organization what it was. The directors who sat on the board did not question or challenge the authority of those who ran the non-profit. They considered their own role to support the organization and, in some cases, provide a sense of oversight legitimacy.

2) The Sarbanes-Oxley Act ("Sox"), enacted on July 30, 2002, radically changed the approach to executive compensation by creating a new quasi public agency called the Public Company Accounting Oversight Board, which oversees and regulates the accounting firms that audit public organizations. Sox covers issues such as auditor independence, corporate governance, internal controls and financial disclosure. Although most of Sox does not directly apply to non-profits, since they are not publicly traded organizations, several sections do have a direct impact on non-profit organizations. In addition, much of the thinking and behavior which Sox promulgated transcended public companies and have become the appropriate business standard for any organization. Moreover, many of the prophylactic measures embodied by Sox have come to be seen as best practices that should be adopted by non-profits. In some instances, the adoption of such practices has been required by state legislation, but, even when legislative proposals have failed to be enacted, they have motivated boards to exert greater control over compensation matters.

3) For the 2008 tax year, IRS Form 990 was revised to require a significant amount of reporting and disclosure relative to corporate governance, as well as boards of directors' activities. The new IRS Form 990, which will be filed for the first time in 2009, "strongly encourages" boards of directors to adopt a variety of board policies, including executive compensation policies, regarding appropriate governance protocols. The suggested protocols go beyond the Sox requirements for non-profits to adopt certain procedures related to document retention and whistleblower activities. The IRS has clearly indicated that it will be using the requirements associated with IRS Form 990 as an enforcement tool "particularly regarding executive compensation."

4) Ten years ago, the regulatory environment for certain types of whole life insurance policies was relatively stable and, by today's standards, open to very aggressive interpretation. Notably, a split dollar insurance policy was a way for an employer to loan premiums to the executive with a tax cost to the executive that was less than its economic value. Split dollar plans have traditionally been one of the most significant tools for informally funding an executive's deferred compensation program. In September 2003, the Treasury Department finalized proposed regulations on the taxation of split dollar insurance programs. The new tax guidelines associated with split dollar insurance all but eliminated previous critical tax and financial benefits. The precursors to the 2003 regulations had been IRS Notices 2001-10 and 2002-8. Most insurance practitioners, who had used split dollar arrangements for years to provide executives with deferred compensation and supplemental retirement benefits, found that the traditional equity-type split dollar arrangement had literally become obsolete.

5) The restrictions on split dollar insurance were anticipated by final regulations under § 457 of the Code issued in July of 2003, the preamble of which confirmed that an equity split dollar arrangement governed by the economic benefit regime constitutes a deferred compensation arrangement subject to § 457 rather than an exempt death benefit plan. As a result, an executive may be required to include an amount in gross income earlier than he or she would under the split dollar rules, because § 457(f) taxes deferred compensation that does not meet the requirements for an eligible plan under § 457(b) in the year the compensation becomes vested.

However, the impact of the new § 457 rules was more wide ranging than its effect on split dollar plans. The new rules also effectively shut down a popular compensation device for tax-exempt executives that involved granting deeply discounted options on mutual fund shares or other property. As noted, the 457 regulations limit the scope of the definition of a bona fide death plan exempt from potentially unfavorable treatment under 457(f). Similarly, the preamble to the final version of the § 457 regulations began the process of defining the terms of the exemption for bona fide severance pay plans by requesting comments on the issue. In Notice 2007-62, the IRS indicated that more restrictive rules were likely on this issue, as well as in the matter of rolling vesting, a technique that arguably allowed tax-exempt executives to defer taxation by postponing the vesting date of deferred compensation.

6) In addition, passage of new Internal Revenue Code § 409A in 2004, effective January 1, 2005, significantly limited the ability of executives to choose the time for receiving deferred compensation. These new rules expressly targeted all types of non-qualified deferred compensation. Of all the changes in the rules and re-

quirements associated with executive NQDC and SERPs, the new § 409A rules have had the most immediate and direct impact on the design and administration of executive deferred compensation programs.

On April 17, 2007, the Department of Treasury adopted final regulations under § 409A. These new rules apply to all non-qualified deferred compensation that a person earns in one tax year, but does not actually receive until a future tax year. Section 409A does not apply to qualified deferred compensation plans such as § 403(b), and § 401(k) or to governmental § 457(b) plans.

The details of § 409A go beyond the scope of this white paper. Suffice to say that the sometime ambiguous guidelines relate to how and when executives must elect to defer income; the detailed language associated with the "substantial risk of forfeiture" requirements; the new distribution rules that dictate when and how an executive may take his/her money out of a NQDC plan; and, most importantly, the severe tax penalties that can be levied if there is non compliance with these new rules. Thus, § 409A eliminates the tax and behavioral "loopholes" that had been associated with executive deferred compensation for many years.

The six areas discussed above deal with changes in legislative attitudes and activity. The paradigm shift since 2001 has been for Congress and Treasury to make executives, boards of directors and organizations more accountable and responsible for their behavior. This development has also prompted more regulations that eliminate "gaming the system" and impose more draconian penalties for non-compliance. Just in case all these new requirements did not make executive compensation difficult enough, on the heels of these governmental regulatory changes came the greatest drop in the capital markets in the past 70 years.

The Road to No Benefit - Market Changes

Over the past 15 years, with the exception of the tech bubble bursting in 2000, the US economy was thriving. The market turmoil that began in the 4th quarter of 2008 changed everything. How did that market turmoil affect NQDC and SERPs? Regardless of whether the executive was invested in insurance contracts, stocks or mutual funds, a 30% to 50% drop in his portfolio meant that the dollars that had been set aside by the employer for the past ten years were not going to meet the implied or actual promise made by the employer to replace or supplement an executive's retirement income.

For example, for the past ten years, the insurance policies that were sold to informally fund the executive non-qualified deferred compensation had not been a source of angst for those executives who had them. Today many of these insurance contracts are "underwater," which means the premiums paid by the employer are more than the net cash surrender value of the policy.

Most executives tended to invest these funds in more aggressive portfolios or other speculative investment products. If an executive had a NQDC with a one-million dollar account balance that was aggressively invested in October 2008, by February of 2009 the value of that account could have fallen to $600,000 or less. As a result, many C-Suite executives quickly came to the unhappy realization that they might need to go back to their boards of directors with hat in hand to ask for more money. Given the hard financial times and the tough questions that were likely to be posed, the prospect of such discussion was uninviting.

It is curious to note that many NQDC and SERPs that were set up before 2003 did not clearly articulate whether the executive or the employer carried the investment risk associated with rates of return and the guaranty of principal. So this past year, when some executives did go back to their boards, there was disagreement as to the substance of the employer's original commitment. Between the government's tightening up on the rules, the elimination of loopholes, and the market's plunge, C-Suite executives faced an ugly reality. Many who thought they had a nice supplemental retirement nest egg, found themselves thrown out of the nest altogether! In addition, executives found that boards of directors have become much more concerned with organizational sustainability and how their nonprofits are viewed in the community. Today's directors are more sophisticated and better educated in executive compensation and benefits matters and are much less likely to give even the most talented executive a carte blanche.

No wonder that, by April of 2009, many CEOs, CFOs and COOs were calling their HR professionals and asking: "What are my options? How much will it cost? What do I need from the Board?"

Manage C-Suite Expectations Because There Is No Good Answer.

Before we lay out some actual solutions to resolve this executive deferred compensation dilemma, we need to introduce two caveats. The first is that every organization faces its own set of facts and circumstances and no two employers or executives are in the exact same situation. Therefore, any ideas or suggestions described in this white paper need to be evaluated, and appropriately modified in light of any organization's unique circumstances. Second, this white paper does not intend to provide legal or tax advice. In most organizations, deferred executive compensation involves significant dollars for key executives, and any misstep might result in the executive's incurring a substantial tax burden, including penalties. So it is absolutely vital to have your plan of action reviewed by a qualified attorney or tax specialist.

Notwithstanding what was just said about each situation being unique, at the 30,000 foot level, certain similarities still prevail among organizations. If you are asked to clean up the NQDC mess, you might base your plan of action on five general principles:

1) Get up-to-date information about existing deferred compensation arrangements between the employer and the executive. This includes all information relating to

any applicable insurance policies. What was the promise to the executive? Was it written or implied? What documentation do you have? How much of the benefit has been funded formally or informally? What was the source of that money and where does it reside today?

2) Review your current state of compliance. If you have not amended your non-qualified deferred compensation plans to comply with § 409A requirements you are already late. You need to contact legal counsel and to devise a plan of action. However, if vesting has not yet occurred, there may still be time to act without incurring penalties. Regulations issued under § 409A make it clear that insurance arrangements, such as a split-dollar policy, are part of a plan that is subject to § 409A. So if you want to surrender these policies, consider whether you may be violating the permitted payment rules and/or the payment acceleration rules of § 409A.

3) Develop a viable plan. Based on the goals, and what has been done to date, work with the executives to get the best possible design in light of the new rules and regulations. In too many instances in the past, the people selling the specialty insurance products drove the process. As a result, policies over-insured the life of the executive, were very expensive to maintain and in the end, did not deliver on the economic promises that had been illustrated at the point of sale.

4) The devil is in the details of the transition, from current arrangements to a program that meets the needs of the executives. For example, does it makes sense to do a § 1035 exchange of insurance policies, or would it be better to surrender the policies and buy new life insurance policies for those executives who desire such coverage? Should you buy term or whole life? How much insurance is necessary, and how long should it last? Should you use a rabbi or secular Trust for a § 457(f) plan? How will vesting be handled, and who will control the investments of funds? Or, rather than insurance or a § 457(f) plan, would a § 403(c) annuity program be the better funding alternative?

5) Document all the changes and the ultimate goals, memorializing them in board resolutions, director minutes and plan documents. Executives need to sign off on their program and complete forms that become part of the permanent record.

Conclusion

This white paper has identified three critical areas that have a direct impact on executive deferred compensation and have now come together like a perfect storm. They are:

1) The regulatory landscape for NQDC and SERPs which has changed radically since 2003. In addition, there is the very likely prospect of more regulatory "guidance," specifically in the area of § 457(f) type plans.

2) As noted, for 2008, tax exempt organizations will, for the first time, need to file the new IRS Form 990. The new form discloses total key executive pay more transparently, including the payments from any and all NQDCs and SERPs, as well as the value of such benefits as they are earned over the executive's career. Such additional public disclosure may prompt a "gut check" review of the plans, to verify that they are not excessive.

3) The economic crisis that began in 2008 has put pressure on non-profits to be mindful of C-Suite compensation practices. Non-profits must be sensitive about how they will be perceived in the community. In addition, the IRS has been doing more due diligence on whether tax exempt organizations are truly deserving of their tax exempt status. Excessive executive compensation practices are a definite consideration when an organization is being evaluated as to whether it has fulfilled its tax-exempt purpose.

Going forward, C-Suite executives will still be seeking and expecting some type of NQDC or SERP program. As an organization's human resources professional, you must handle this expectation - keeping in mind the tightrope between executive expectations and what is practicable. Here is a short list of action items to successfully execute this high-wire balancing act.

1. Make sure your C-Suite personnel understand the changes that have taken place. Manage their expectations through education.

2. Perform a market review of your executive compensation practices. If you can demonstrate that your executive pay program is both competitive and well constructed (for example, it is tax efficient), there will be less dissatisfaction, resulting in fewer demands.

3. Review your organization's total executive compensation practice in light of the IRS intermediate sanctions requirements. The IRS requires that total compensation must be reasonable for C-Suite personnel of tax exempt organizations. Of course, total compensation, by definition, includes all forms of NQDC, as well as SERP arrangements. The intermediate sanctions rules permit the IRS to impose an excise tax on an executive who receives compensation deemed to be unreasonable from an exempt organization. C-Suite executives who understand the intermediate sanction guidelines will be less apt to make unreasonable compensation-related demands.

4. Are outmoded, expensive or inappropriate insurance contracts being used to informally fund a NQDC or SERP? Would it make sense for those executives who have an economic interest in these insurance policies to relinquish their rights in them and to transfer those rights to the employer for appropriate consideration?

5. Employers should review the "substantial risk of forfeiture" rules in their § 457(f) plans to ensure that an executive does not inadvertently become vested, and, consequently, taxed on a deferred benefit. The IRS intends to issue guidance under § 457 regarding the definition of "substantial risk of forfeiture" that is similar to the rules under § 409A. The § 409A rules define the term to mean the performance of substantial future services or the occurrence of a condition related to a purpose of the compensation, provided that the possibility of forfeiture is substantial. For this purpose, it is

not sufficient if an executive's entitlement to an amount of compensation is conditioned on refraining from the performance of services, as might be the case if a covenant not to compete were included in his or her employment contract. It is expected that the IRS guidance will be issued in the near future. In the meantime, less draconian vesting rules modeled on those in § 83 of the Code may be acceptable.

6. Consider introducing a § 403(c) Discretionary Annuity Plan, to provide C-Suite executives with a competitive level of retirement benefits. Prior to 2009 only a handful of these programs were introduced because the plans must use annuities contracts as the investment instrument. Typically, annuities were not favored as an investment vehicle until the market turned down in 2008. Throughout 2009, § 403(c) plans have received a great deal more attention, which is not surprising, given the difficult capital market conditions.

7. If the executives are willing to consider using an after-tax approach to eliminate the substantial risk of forfeiture vesting rules, then several innovative design concepts become feasible. A § 457(f) environment can be transformed by use of a secular trust, as opposed to a rabbi trust (which is associated with pre-tax contributions). More precisely, the vehicle would be an employer grantor trust with after-tax contributions, and provided that the rules of IRS Ruling 2007-48 are followed, under this trust the interest income earned can be deferred until it vests in the executive. Especially since this approach is not widespread, and some technical and recordkeeping issues remain associated with after-tax contributions to a § 457(f) plan, legal counsel review is imperative.

There are some knowledgeable employee benefits professionals (as well as some very capable attorneys) who believe that if an executive is given the opportunity to direct the contribution of after-tax amounts to the secular trust and such amounts are used to purchase insurance products, such as a variable universal life insurance policy or a deferred annuity contract, then the interest income earned inside these products is tax deferred. Their rationale is based on the fact that the Internal Revenue Code (IRC) permits certain insurance vehicles to grow on a tax-deferred basis and that this aspect of the income passes through the trust to the employee. Needless to say this is a key advantage to selling these financial products and the insurance industry guards this "inside the policy" tax deferral build-up zealously. What this means to the purchaser of the insurance product is that any earnings, interest income, appreciation and/or dividends paid on the assets in one of these contracts are not taxed until the funds are withdrawn. This, in turn, means that the "inside account" (that is, the account inside the insurance product) compounds more quickly since taxes are not being paid each year and the executive ends up with a larger benefit. This is, of course, absolutely correct when we purchase such a policy as individuals. Our concern is, however, that when such a policy is purchased as a funding vehicle for a NQDC or SERP, it could lose its preferred tax status as insurance and be taxed under a different section of the IRC (§ 402) if the executive is not given sufficient control over the decision to contribute to the trust or if vesting is imposed on the trust assets. If section 402 of the IRC applies, any earnings, interest income, appreciation and/or dividends paid on the assets in one of these contracts are taxed in the year that they are earned. You can see why we say that it is essential to obtain legal counsel's opinion when secular trusts are being utilized.

All the concepts discussed above are available in the marketplace today. These suggestions are a direct response to the IRS tightening the deferred compensation rules and regulations for tax-exempt organizations. Many non-profit organizations will not, however, gravitate to these ideas as mainstream solutions. Still, they offer advantages to an executive who is willing to use a discretionary annuity plan or after-tax plan. By employing these vehicles, an executive can avoid the risk of forfeiting the contributions, and will be protected if income taxes and social security taxes increase in the future, which seems like a real possibility. Also, if the program is set up properly, it may provide added legal protection against the claims of an employer's creditors.

The Final Thought

The keys to managing the expectations of C-Suite executives relative to all the new rules and requirements of executive retirement benefits and deferred compensation are:

1) Educate the executives so that they understand and appreciate how the government has curtailed the ability to design and administer these plans.

2) Make sure the executives understand the new rules and how those rules affect their NQDC or SERP.

3) Learn the pressure points for your executives and for your board of directors, to help understand what is driving the executive deferred compensation program going forward.

4) Consider the available options in light of all the stakeholders' sensitivities and present those options to the interested parties as partial solutions and not as a be-all or end-all.

In the final analysis, if you follow certain procedures and use suitable investment vehicles, you can provide the C-Suite executives with some protection from the hazards of executive deferred compensation. It appears that there is no perfect solution to all the problems that beset executive non-qualified deferred compensation and supplemental executive retirement plans. Human resource professionals can nevertheless anticipate what will be the "hot button" issues through up front intervention and mitigation techniques. If all the individuals who have a stake in the outcome of the restructuring of NQDCs and SERPs understand that goal, they should be satisfied with the results.