Executive compensation

Nonprofit organizations face their own unique challenges when it comes to setting up deferred compensation arrangements for their Executive Director, President or Head of School.

Frequently there is a desire to provide additional deferred compensation to address situations where an employee has exceeded the dollar limits in the retirement plan. Internal Revenue Code (IRC) Section 415 limits contributions to a defined contribution plan to $49,000 in 2010. IRC Section 401(a)(17) limits the amount of compensation that can be taken into account for calculating contributions to $245,000 in 2010. Both of these dollar amounts are indexed annually for inflation. (Certain employees at governmental institutions have more liberal rules under IRC Section 401(a)(17).)

Executive compensation plans are also a tool for providing an incentive for the executive to continue working for a specific period of time. The options available differ depending on whether the organization is governmental or private. Below is a brief outline of the issues faced in this area.

Private Nonprofits

These organizations are generally subject to ERISA and thus the plans are required to meet certain funding standards. This provides no tax issues for IRC Section 401(a) or 403(b) plans. But in other areas of deferred compensation, in order to avoid taxation on the deferred compensation the plan needs to be unfunded. An exemption from ERISA funding rules is available if the arrangement is offered only to select group of highly compensated management employees. If an arrangement is offered only to the Chief Executive Officer at the organization, this does not create an issue. If the group is larger, analysis is required to insure that the group meets the required standard under ERISA. This plan requires a filing with the Department of Labor at the time the plan is initially implemented in order to claim exemption from annual 5500 filings.

IRC Section 457(b) allows the employer to put away a sum of money equal to the amount of the IRC Section 402(g) limit for the year. This limit is $16,500 for 2010 and is indexed for inflation in future years. Any assets allocated to this plan remain in the general account of the employer. It is often funded by an annuity contract or custodial account but a trust can also be used and funded with a greater variety of assets. The employer can use the allocated assets for measure earnings of the funds contributed to the plan. However the funds remain subject to the claims of the general creditors of the employer until the amounts are paid out in accordance with the terms of the deferred compensation agreement. 457 b allows for payments on death, disability, separation from service or unforeseeable emergency. The employee can select the timing and form of payout.

For deferral of amounts in excess of the IRC Section 457(b) limits, an arrangement can be established under IRC Section 457(f). The advantage of this arrangement is there is no annual dollar limit on the deferrals. However all amounts deferred under this arrangement become taxable as soon as a substantial risk of forfeiture no longer applies to the funds. So this is ideal for a situation where the employer wishes to set up an incentive for an individual to remain employed for a certain period of years. However, if the arrangement provides that the amounts vest after 5 years, for example, all amounts and earnings to date are taxable at that time even if the plan provides for a later payout. In addition since these plans are also subject to IRC Section 409A, once a plan is set up with a deferred payout, the payments cannot be accelerated. So there is definitely a tax trap for the unwary if these plans are not set up properly.

Governmental Schools, Colleges and Universities

For individuals who exceed the IRC Section 401(a)(17) limits in a qualified plan, a mirror plan can be provided which is set up to comply with IRC Section 403(b). Since the nondiscrimination rules do not apply to governments, the IRC Section 403(b) plan can provide an identical benefit on compensation that exceeds the IRC Section 401(a)(17) limit in the basic qualified plan. These two plans have separate IRC Section 415 limits. If there is a situation where an individual also exceeds the IRC Section 415 limit, an IRC Section 415(m) plan can be set up for the excess. This is an arrangement where the assets are held subject the claims of the employer’s general creditors similar to the deferred compensation arrangements discussed above.

IRC Section 457(f) plans are also available to government entities subject to the same restrictions described above for private plans.

Health benefits for Executives

Prior to the passage of the Health Reform Act, nondiscrimination rules did not apply to insured medical plans. It was not uncommon to see arrangements where additional benefits were provided to certain highly compensated employees. In addition to benefits during employment, it was possible to set aside funds in a grantor trust that could be used to pay the insurance premiums after retirement. Unless the arrangement meets the grandfather arrangement rules as of 3/23/10, these arrangements will not be permitted in the future. Any plan which was in existence should not make any changes that might jeopardize the grandfather plan status since the tax impact will be significant for the highly compensated individual.