Evaluating Executive Benefit Options in the New Non-Profit Tax Environment

TRISCEND NP

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 challenging. 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.

Financial Statement Impact of Executive Benefit Decisions

In our first article, we covered issues related to the efficiency of the various executive benefit plan designs and assets that are available to tax-exempt organizations. Once these areas are fully explored, an organization should shift its attention to the impact of the various alternatives on its financial statements. Each plan type has its pros and cons, and a complete understanding of the financial effect of this choice is an important component in the decision process.

To review, the plan types available to non-profit organizations are deferred compensation plans [§457(f)], executive bonus plans (§162) and split dollar arrangements. The financial impact of the plan-types is evaluated in the following areas:

- Income/Expenses (Income Statement)
- Assets/Liabilities (Balance Sheet)
- Cash Inflows/Outflows (Statement of Cash Flows)

Income Statement

All plan types will affect the organization's income statement. The key is to determine how and to what extent the effect will be.

- **Deferred Compensation**

  Deferred compensation plans are a contractual promise to pay an amount in the future, typically subject to certain performance or retention conditions. This promise generates a liability on the organization's balance sheet that periodically increases until the payment is made. This accrual to the liability is reflected on the income statement as a benefit expense that increases annually until the benefit is vested and paid.

- **Executive Bonus Plans**

  These plans involve a regular payment (in the form of life insurance policy premium) that is taxable compensation to the executive when made. These payments are typically made on an annual basis and treated as a compensation expense on the income statement.

- **Split Dollar Arrangements**

  Depending upon the design and structure, a split-dollar arrangement can trigger either expenses or income on the income statement. This treatment depends on the facts and circumstances of the arrangement and whether or not it meets certain conditions. These conditions were initially set out in EITF 06-10 and later codified in ASC 715-60.

  At a high level, the arrangement can generate interest income if the amount funded by the organization to the life insurance policy(ies) is subject to an interest rate. This interest (subject to adjustments) is usually recorded as "other" interest income. If the interest is forgiven or the interest rate is zero, the arrangement will not generate income. Any interest the organization could have received is treated as a compensation expense and included in the executive's taxable income.

Balance Sheet

As with the income statement, any executive benefit plan implemented by a tax-exempt organization will affect its balance sheet.

- **Deferred Compensation**

  As mentioned above, the organization will recognize benefit expenses regularly until the payment is made to the executive. These benefit expenses accrue to a benefit liability on the balance sheet. Once paid, the liability is extinguished. As part of the payment, cash is also permanently reduced.

- **Executive Bonus Plans**

  The only effect this plan type has on the balance sheet is a reduction in cash as payments (premiums) made to the associated life insurance policy.

- **Split Dollar Arrangements**

  Since the majority of split-dollar arrangements we see are loan-regime (also known as collateral assignment) structures, we will limit our comments to these designs. These plans are recorded as an asset (receivable) on the organization's balance sheet that, in many cases, will accrue interest. The value of this receivable is limited to the cash value of the assets (life insurance policies) collateralizing the arrangement. That is, the value of the receivable carried on the organization's balance sheet is the lesser of the premiums paid by the organization plus the accrued interest or the cash value of the collateralized assets.

Statement of Cash Flows

Eventually, all executive benefit arrangements will result in an outflow of cash from the organization. Understanding the timing, magnitude and the potential alternatives providing cash inflows is crucial.

- **Deferred Compensation**

  These plans are associated with permanent outflows of cash although typically not immediate. Since deferred compensation plans serve dual purposes of retention and retirement cash flow, they typically vest and pay when the executive is at or nearing retirement. As a result, the cash flows associated with deferred compensation plans are usually years in the future. For organizations with limited cash on the balance sheet, these structures can be appealing.

- **Executive Bonus Plans**

  Executive bonus plans result in immediate outflows of cash in all years in which premiums are paid. These cash outflows are permanent.

- **Split Dollar Arrangements**

  Split dollar arrangements provide for both cash outflows and cash inflows. The outflows occur during the years the life insurance policies are being funded. Funding is accomplished most efficiently if completed at implementation, but we also see organizations elect to fund over time (but typically not more than ten years). However, organizations that do not have strong cash positions will want to consider other alternatives or funding over time.

Split dollar arrangements must, at a minimum, return the premiums funded by the organization to remain compliant and avoid income inclusion for the executive. If sufficient interest on these premiums is accrued and not forgiven, the accumulated interest will be returned as well. In most split-dollar arrangements, these cash inflows occur at the executive's mortality. But, in limited cases, payments (full or partial) can occur earlier.

Given the significant capital required to implement executive benefit arrangements, the decision of plan type may be a strategic one. Not only are significant cash flows associated with each option but the 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. Understanding how these arrangements affect the financial statements is one such step. In our upcoming article, we will close this series with a look at non-financial statement costs/gains and other factors that organizations should consider as part of its decision-making process.

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