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 pace. With the addition of §4960 to the Internal Revenue Code and the associated excise tax for excess executive compensation, an already difficult situation is becoming more challenging. There is heightened pressure to get these decisions right and making the wrong move could fail to achieve strategic objectives, upset stakeholders, and cost the non-profit organization precious capital.

Other Costs and Factors Resulting from Executive Benefit Decisions

In our previous articles, we covered issues related to the efficiency of plan types and assets and the impact of executive benefit decisions on the financial statements of tax-exempt organizations. From here, we move our attention to a discussion of non-financial statement costs and potential gains as well as other qualitative considerations that are part of a decision process. As it is with other decision factors, each alternative has its pros and cons, and a complete understanding of all effects of this choice is an important component.

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 non-financial statement impact of the plan-types is evaluated in the following areas:

- Opportunity Costs
- Public Reporting/Disclosure
- Resilience

Opportunity Costs

An opportunity cost is a gain forgone by choosing a particular course of action over another possible alternative. While opportunity costs are not reported on the organization's financial statements, they are an important consideration when evaluating executive benefit plans. No organization has unlimited capital, so understanding the result of these decisions versus the alternatives is crucial.

We tend to look at opportunity costs in the following contexts:

- **Versus Alternative Investments**
  For the most part, organizations deem executive benefits for senior leadership as an integral part of a reasonable compensation package. As a result, it is rare for a decision of this type to come down to whether the arrangement provides returns comparable to alternative investments. That said, we believe it is prudent to understand how these alternatives stack up, but it should not drive, in our opinion, the decision to implement a plan.

  When an organization makes a comparison of this or any type, it is important to ensure the executive benefit alternative is compared to another likely and available option. We have seen organizations attempt to make this comparison against hypothetical investments representing reasonably available options.

- **Versus Other Executive Benefit Alternatives**
  More common, and we believe, more correct is a comparison of returns among the available executive benefit options. As we covered in the other articles in this series, each alternative has a unique combination of cash inflows/outflows, expenses/income, and liabilities/assets and each of these will be important factors in the analysis.

  Assumptions also play a key role in making this comparison accurate, and we recommend testing these assumptions against reality before moving forward.

Public Reporting/Disclosure[1]

Most tax-exempt organizations will report executive benefit arrangements for its highly compensated executives on Form 990. It will either be primarily disclosed on Schedule J (Compensation Information) or Schedule L (Transactions with Interested Persons) depending upon the nature of the plan.

- **Compensatory Plans**
  Deferred compensation plans and executive bonus plans are compensatory arrangements and disclosed on Schedule J of Form 990. While reporting varies, we typically see these values reflected in Columns B(ii) or C of Part II of Schedule J in addition to a narrative description of the Plan in Part III. Strangely, deferred compensation plans are reported as values are accrued, and again when paid.

- **Split Dollar Arrangements**
  While these plans provide for retirement benefits like deferred compensation and executive bonus plans, they are not considered compensatory and reported in a different location on Form 990. Recall, split dollar arrangements are treated as loans for tax purposes. Given this treatment, it follows that these arrangements are reported on Schedule L, Part II, where other loans are disclosed. Similar to the above, there is also a section of Schedule L (Part V) where a detailed description of the plan should be provided.

Some tax-exempt organizations, like federal credit unions, are not currently required to file a Form 990. Instead, these entities file financial reports to the National Credit Union Association (NCUA) on Form 5300. While compensation and most executive benefit arrangements are not specifically reported on Form 5300, the values associated with split-dollar arrangements, and other benefit-related assets, are disclosed on Schedule B.

With the advent of the excise tax on excess executive compensation for tax-exempt organizations, some organizations will be required to report such excess compensation on IRS Form 4720. Our understanding is this form only needs to be filed if an executive has more than $1,000,000 in remuneration, which will include vested deferred compensation arrangements. As of this writing, split dollar arrangements are not included in the definition of remuneration for excise tax purposes.

Regardless of the reporting requirements for the available alternatives, organizations should ponder how its stakeholders will view the benefit arrangement within the context of its stated purpose. That is, no organization has limitless capital, so is it important to ensure the amount funded by the organization is returned? Or, is the environment such that plans increasing reportable compensation are not viewed favorably. Either way, organizations should take the time to understand their stakeholder's perspective.

---

[1] Triscend[NP] does not provide tax, accounting or legal advice. Organizations should seek independent guidance on these matters.

Cost of Volatility

When comparing options, it is common for organizations to judge alternatives based on the rate of return the organization expects to receive on its existing assets, as well as new assets which may be purchased in connection with a plan. We find that while organizations know with relative certainty their portfolio rates and specific asset returns, they tend to pay less attention to the risk of returns when comparing various assets.

If return risk and volatility are not taken into account, it could result in a poor decision. We recommend organizations attempt to normalize these returns by using either the Sharpe Ratio or the Sortino Ratio, which measures only the volatility associated with negative returns.

Finally, as an executive begins to draw down on his/her retirement assets, the order in which investment returns are received can have a dramatic effect on the amount of retirement cash flow realized. The uncertainty associated with this ordering is referred to as sequence risk. As a result, in addition to adjusting expected rates of return for volatility, both executives and organizations should consider the impact of return sequence (especially post-retirement) on the effectiveness of the plan alternative in delivering the desired result.

Given the significant capital required to implement executive benefit arrangements, the decision of plan type is strategic. 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 the data into actionable information, and making an informed decision which is executed by the organization.

We will be discussing these topics in more detail on the ASAE-sponsored webinar on May 30, 2019 and look forward to your participation.

H. David Wright, MHA, MBA
Chief Strategy Officer
Triscend^{NP}, LLC
(972) 410-3740
dwright@triscendnp.com