Optimizing Retirement Plan Benefits for Executives in Not-for-Profit Organizations

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Today’s Agenda

• Why NFP organizations may elect to customize retirement benefits for executives
• Three types of plans in which contributions for NFP executives can be customized
  - 403(b), 401(k), or 401(a) plans with non-matching employer contributions
  - 457(b) plans for additional employee deferrals and/or employer contributions
  - 457(f) plans for additional employer contributions with a golden handcuff feature
• Differences between these plan types
• Selecting plans to customize benefits for a NFP executive
Reasons for Customizing Retirement Benefits for NFP Executives
Polling question #1

What type of retirement Plan does your organization sponsor?

• 403(b) Plan
• 401(k) Plan
• Profit Sharing/Money Purchase Pension Plan
• Defined Benefit Plan
• Other/None
Why customize executive retirement benefits

- Retirement plans covering staff may not meet key executives’ needs

- Customizing retirement plans for executives be needed to address:
  - Compensation cap used to calculate retirement benefits
  - Limits on salary deferrals and/or matching contributions due to nondiscrimination tests (ADP/ACP tests)
  - Executive wanting salary deferrals higher than the normal 401(k) or 403(b) dollar limit
Why customize executive retirement benefits

- Minimize risk of costly turnover in leadership positions when overall plan contributions must be reduced
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- Negotiate competitive compensation & benefits package when recruiting for key executive position
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- Provide additional retirement benefits for a key executive due to special individual circumstances
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- Negotiate competitive compensation & benefits package when recruiting for key executive position

- Provide additional retirement benefits for a key executive due to special individual circumstances

- Use as “golden handcuffs” to supplemental executive retirement benefits
Typical Retirement Plan(s) in NFP Organization

- 403(b) Plans
  - Employee Deferrals
  - Employer Matching and Non-matching

- 401(k) Plans
  - Employee Deferrals
  - Employer Matching and Non-matching

- 401(a) Plans (e.g. Profit Sharing, Money Purchase Pension Plans)
  - Employer Contributions—no Employee Deferrals
Option 1

Customizing non-matching contributions under 403(b), 401(k), or 401(a) plans
Customizing non-matching employer contributions

- Non-matching employer contributions can be flexible
  - All participants do not have to receive same %
- Contribution rates can differ based on criteria such as:
  - Positions within the organization
  - Length of service with the organization
  - Departments or divisions within the organization
  - Job categories
- Plan can even treat each participant as a separate group for determining contribution amounts
Customizing non-matching employer contributions

- Example Contribution Allocation

  5% of pay contribution for staff
  8% of pay for all directors
  10% of pay for all vice presidents
  15% of pay for president/executive director
Customizing non-matching employer contributions

- Non-uniform contribution rates subject to annual non-discrimination testing
  - Testing method similar defined benefit pension plans
  - Testing based on value of projected benefits at retirement age, not current year contribution rate
  - Demographics of employee group can affect minimum contribution rate for staff
Customizing non-matching employer contributions

- Maximum annual contribution limit in a single 403(b) or 401(k) plan
  - $51,000 from employee deferrals and employer contributions combined
  - $56,500 if employee is age 50+ and makes catch-up salary deferrals
Customizing non-matching employer contributions—

Higher contributions with 403(b) plan & separate 401(a) plan

<table>
<thead>
<tr>
<th>Plan</th>
<th>Contributions</th>
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</thead>
<tbody>
<tr>
<td>403(b) Plan</td>
<td>$17,500</td>
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<tr>
<td>401(a) Plan</td>
<td>$52,500</td>
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<tr>
<td>Combined</td>
<td>$87,500</td>
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</tbody>
</table>

- Catch Up (2013 limit: $5,500)
- Employer Contribution
- Deferral (2013 limit: $17,500)
457(b) and 457(f) Plans
Non-Qualified Deferred Compensation Arrangements for Executives in NFP Organizations
Additional retirement benefits using 457 plans (for select executives only)

- All deferred compensation arrangements for NFP executives must comply with IRC 457
- 457(b) and 457(f) plans are non-qualified plans
- Participation in 457 plans must be limited to a select group of highly compensated employees,
  - Cannot be made available to all employees
- Different rules apply to “eligible” 457(b) and to “ineligible” 457(f) plans
“Eligible” 457(b) plans - Contribution Rules

- Contributions can be employee salary deferrals, employer contributions, or both

- 457(b) annual contribution limit
  - $17,500 in 2013
    - No age 50+ catch-up contributions
    - Contribution limit applies to employee deferrals and employer contributions combined

- 457(b) employer funded accounts should be 100% vested
“Eligible” 457(b) plans - Contribution Rules

- Contributions not subject to current income tax
- Contributions are subject to current FICA taxes
- Contributions do not reduce salary deferrals allowed under a 403(b) or 401(k) plan
- Contributions do not reduce maximum annual amount allowed under 401(a), 401(k) plan, or 403(b) plan
“Eligible” 457(b) plans - Maximum annual contribution when combined with a tax-qualified plan

- 403(b)
- 401(a)
- Comb 403(b) & 401(a)
- Plus 457(b) Plan

- Catch Up (2013 limit $5,500)
- Employer Contribution
- Deferral (2013 limit $17,500)
“Eligible” 457(b) plans - Distribution Rules

- Benefits payable only after covered executive terminates employment
- Distributions are subject to ordinary income tax when paid or made available for payment
  - If distributed in installments, income tax applies only to installments as received
  - Distributions not subject to FICA tax when paid if reported as FICA wages when contributed
- Distributions are not eligible for tax-deferred rollover to an IRA or to another employer’s qualified retirement plan
“Ineligible” 457(f) Plans - Contribution Rules

- Any NFP deferred comp arrangement that does not comply with 457(b), falls under 457(f)

- No dollar limit on annual contributions
  - “Reasonable compensation” principles apply

- 457(f) account must be subject to substantial risk of forfeiture specified in plan document
  - to avoid immediate income taxation to the executive

- Executive is 0% vested in his/her accumulated 457(f) amount until vesting event or date specified in plan is reached
  - Executive who voluntarily terminates employment prior to vesting date forfeits entire 457(f) benefit
“Ineligible” 457(f) Plans - Distribution Rules

- Entire benefit is taxed when *vesting* occurs
  - Benefit is taxed even if no distribution is made to the participant
  - Installment payments cannot postpone taxation of payments made in future years
- Due to the vesting requirement and risk of forfeiture, 457(f) plans are funded only with employer contributions
Polling question #2

What type of document can constitute a 457(f) plan?

- Prototype document
- Individually designed plan document
- Employment agreement
- Email
Major Differences Between Plans Customized for Key Executives
Difference #1: Non-discrimination testing

- Non-uniform employer contributions to 403(b), 401(k), and 401(a) plan are subject to annual discrimination testing.

- Contributions to a 457(b) or 457(f) plan by or for a covered executive are not subject to discrimination testing.
Difference #2: Location of plan assets

- 403(b), 401(k), and 401(a) plans
  - Held in trust fund or custodial accounts for exclusive benefit of employee and protected from attachment by creditors of the employer

- 457(b) and 457(f) plans
  - Held as part of general assets of employer and subject to attachment by creditors of the employer in event of insolvency
  - Covered executive is an unsecured creditor of the organization with respect to these benefit plans
Difference #3: Taxation of benefits

- **403(b), 401(k), and 401(a) plans**
  - Benefits subject to ordinary income tax when paid
  - Taxation can be deferred by rolling over distribution to an IRA or another employer’s retirement plan

- **457(b) and 457(f) plans**
  - 457(b) benefits subject to income tax at the **earlier of**:
    a) when paid or b) when eligible for payment
  - 457(f) benefits subject to income tax when risk of forfeiture expires, regardless of whether benefit is actually paid at that time
  - Not eligible for tax-deferred rollover to an IRA or to another employer’s qualified retirement plan.
Optimizing Retirement Benefits for a Key Executive
Optimizing benefits for key executive—Case Study 1

- A NFP Organization with 150 employees sponsors a 401(k) plan.
- The plan allows for pre-tax employee deferrals and an employer non-matching contribution, with all participants receiving the same % of compensation for the employer contribution.
- Due to budgetary constraints, the employer contribution has been reduced from 12% to 5% over the past several years.
- The favored candidate for the new CEO position is currently with an employer that pays 10% contributions to his 401(k) retirement plan. He is unwilling to take the 5% contribution. He has agreed to the $200,000 salary.
- In order to hire the new CEO, the NFP wants to make up the 5% contribution. What are the next steps?
Optimizing benefits for key executive—Case Study 1

1. Determine whether the NFP can make the additional 5% to the 401(k) plan without increasing the contribution for other participants.
   - They will need to perform the non-discrimination testing.

2. If the 401(k) plan will not pass the non-discrimination testing, establish a 457(b) plan for the new CEO. Increase his wages by the $10,000 and allow him to defer the funds into the 457(b) plan.
Optimizing benefits for key executive—Case Study 2

- A NFP Organization with 200 employees sponsors a 403(b) plan.
- The plan allows for pre-tax employee deferrals and an employer matching contribution of 100% of deferrals up to 4% of pay.
- The CFO intends to retire at the end of the year.
- The NFP is in the final stages of an acquisition that will be effective next year and feels the CFO will be instrumental to a successful transition.
- In order to entice the CFO to stay another year, the NFP wants to offer her a $25,000 lump sum payment at the end of next year for staying.
- What are the next steps?
Optimizing benefits for key executive—Case Study 2

1. Draft a 457(f) arrangement that specifies the CFO will be paid $25,000 at the end of next year if she remains employed through December 31.

2. If the CFO leaves prior to the December 31 date, she will receive nothing. However, if she remains employed through the specified date, she will receive the $25,000 and be subject to taxes on this amount.
Intermediate Sanctions Overview
Intermediate Sanctions: IRS Goal and Objective

- Ensure greater alignment of compensation with strategic objectives of an organization.
- Encourage boards of directors/compensation committees to engage in appropriate analyses and decision-making processes that protect tax-exempt organizations.

**Statute and Its Purpose**

- **Statute** – Intermediate Sanctions refers to the penalty excise taxes imposed by the IRS when individuals associated with a tax-exempt organization receive excess benefits
- **Purpose** – To provide the IRS with alternate methods of discouraging excessive compensation of senior executives of tax-exempt organizations
Intermediate Sanctions: Excess Benefit Transactions

- **1st Tier Penalty**
  - Initial tax of 25% of excess benefit paid by disqualified person
  - Initial tax of 10% ($20,000 max) of excess benefit paid by any manager who willingly participates

- **2nd Tier Penalty**
  - If not corrected, a second tax of 200% of excess benefit may be imposed

*Potential Excess Benefit Transactions relate to cash compensation, benefits, and perquisites of substantial market value.*
Intermediate Sanctions: Compliance Steps

Tax-exempt status (Internal Revenue Code sec. 501(c)(3) and sec 501(c)(4))

Covered individuals (Disqualified Individuals and/or Organization Managers)

Compensation definition (Salary/Incentive(s), Basic and Supplement Benefits)

Statement of Rebuttable Presumption:

Reasonable compensation is presumed when:
1. Transaction approved by authorized body of the organization (with no conflicts of interest)
2. Appropriate data is used to determine comparability prior to making a decision
3. Contemporaneous documentation
Corrections for Late 403(b) Plan Documents
Revenue Procedure 2013-12

Released December 31, 2012 - Employee Plans Resolution Correction System (EPCRS) – revised correction program provides relief for 403(b) plans.

- EPCRS and its correction methodologies are available to 403(b) plans on substantially same terms as tax-qualified plans.
- 403(b) sponsors that did not adopt a written plan document timely (by 12/31/2009) may correct the error under EPCRS with compliance fee reduced by 50% if submitted to the IRS by December 31, 2013.
- A 403(b) plan is treated as having a favorable determination letter if the written plan document was adopted timely, or if failure to adopt is corrected through VCP.
Questions?

Contact us:
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Next Web Seminar
Wednesday, July 17, 2013 – 11:00am PT
Benefits Trends Survey with Focus on Not-for-Profits
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