Non-Profit Organizations Have Few Options for Deferred Compensation

By William L. MacDonald and Bruce Knox

William MacDonald and Bruce Knox explain how the new Regulations under Code Sec. 409A impose restrictions on non-profit organizations in compensating their executive level employees.

Tax-exempt organizations are subject to more stringent IRS rules than their for-profit counterparts in terms of how they can provide nonqualified deferred compensation plans for highly paid employees.

Non-profit organizations should analyze their deferred compensation arrangements to ensure that such arrangements comply with the restrictive tax requirements of Code Sec. 457. Code Sec. 457(f) generally provides that in order to defer an employee's compensation to a future calendar year, the payment of that compensation must be contingent on the employee performing substantial services for the employer through a date in that future calendar year. If such a contingency is not present, the compensation will be taxed in the first calendar year in which that contingency is no longer present. For example, if an organization establishes a deferred compensation arrangement that provides an employee with $50,000 a year for the following two calendar years, the employee generally will be taxed on the $100,000 in the calendar year that the arrangement is established if the payment of that $100,000 is not contingent on the employee performing substantial services for the organization in the two future calendar years. Certain arrangements are exempt from the substantial services requirement in Code Sec. 457(f), including eligible deferred compensation plans under Code Sec. 457(b), tax-sheltered annuity plans under Code Sec. 403(b), and qualified retirement plans under Code Sec. 401(a). However, there are limits on the amounts that can be deferred under these plans.

Deferred Compensation Alternatives

Fortunately, alternatives are available for tax-exempt organizations that seek to set up such plans for their highly compensated employees and contractors. By subjecting employer-paid, tax-deferred compensation to risk of forfeiture or by paying the required taxes, tax-exempt organizations can develop workable alternatives for funding nonqualified deferred compensation plans.

Nonqualified deferred compensation plans in tax-exempt organizations, unlike those in for-profit organizations, are subject to Code Sec. 457. Two types of deferred compensation plans exist under Code Sec. 457: eligible and ineligible. Under Code Sec. 457, contributions to an eligible plan are limited to the lesser of $15,500 or 100 percent of an employee's annual compensation. In general, it is financially advantageous to highly compensated employees to maximize contributions to 403(b) and 401(k) plans. However, maximizing these contributions can be accomplished only at the expense of the Code Sec. 457 plan.

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Therefore, employees who choose to maximize contributions to Code Sec. 403(b), 457(b), and 401(k) plans can participate only in an ineligible Code Sec. 457 plan. Many organizations are taking advantage of the ability to maximize their contributions in both the 401(k) or 403(b) and a 457 plan. This coordination allows a person whose employer has a 401(k) or 403(b) plan and a 457 plan to defer the maximum contribution into two plans instead of being subject to a single limit amount. Thus, a participant can contribute the maximum $15,500 for 2007 into their 401(k) and also the maximum $15,500 into their 457(b). If that person is over age 50, they can also contribute the additional catch-up amount into each plan—meaning an additional $5,000 into the 401(k) and another $5,000 into their 457(b). With an ineligible plan, deferred compensation contributions have no limits. However, they are taxed in the current year unless the plan is subject to a substantial risk of forfeiture.

It is important to understand why tax-exempt organizations are subject to Code Sec. 457 for both non-elective (employer-paid) and voluntary (employee-paid) deferred compensation plans. For-profit organizations pay taxes on the deferred compensation until it is paid to employees; tax-exempt organizations, by definition, are not subject to this taxation. In addition, the growth of assets held by tax-exempt organizations to fund nonqualified plans is non-taxable because the organization itself is exempt from taxes. By subjecting nonqualified deferred compensation plans to strict forfeiture requirements, the IRS intends to discourage the provision of tax-sheltered deferred compensation to highly paid employees at the expense of all other employees in the tax-exempt organization.

Code Sec. 457 Guidelines

Deferred compensation plans that are subject to Code Sec. 457(f) include defined contribution plans and benefits provided under individual and group agreements. Early retirement incentives can also be subject to Code Sec. 457(f).

Substantial Risk of Forfeiture

As mentioned earlier, ineligible Code Sec. 457(f) plans allow for tax-deferred compensation only when the deferred compensation is subject to substantial risk of forfeiture. Voluntary deferred compensation plans typically are not subject to forfeiture. Furthermore, tax-exempt organizations traditionally have provided portable retirement benefits to highly compensated employees. Hence, the dilemma in developing nonqualified deferred compensation plans for such employees in tax-exempt organizations is how to achieve tax deferral for vested nonqualified benefits.

There is no official guidance on what constitutes "substantial risk of forfeiture" beyond making the payment of deferred compensation conditional on the "future performance of substantial services." Because of a lack of official guidance, the interpretation of substantial risk of forfeiture varies, and many look to Code Sec. 83, which also refers to substantial risk of forfeiture.

Generally, deferred compensation that is based either on continued employment for a specified period or on the occurrence of a specific event, such as retirement, is considered subject to risk of forfeiture. Thus, after deferred compensation is vested, it is no longer considered subject to substantial risk of forfeiture. If deferred compensation is vested upon the occurrence of a specific event, such as eligibility for retirement, then eligibility for retirement triggers vesting and taxation of the benefit at that time, even if the employee does not retire.

Is There an Alternative to Code Sec. 457(f)?

Yes, one alternative is an Insured Security Option Plan (ISOP®). ISOP® is a wealth accumulation benefit program designed for the highly compensated at non-profit organizations. The purpose of the ISOP® is to provide a tax-advantaged savings and investment vehicle without the annual contribution limits imposed on qualified plans, such as the Code Sec. 401(k) and 403(b) limits, or the restrictions of Code Sec. 457.

The 3 Phases of Your Money

To see the advantages of the ISOP®, it is important to think of your money as having three distinct phases (see Chart I). In planning for retirement income, one should focus on the three phases of retirement income planning: the contribution phase, the accumulation phase, and the distribution phase. Understanding these phases will provide a better appreciation of the ISOP®'s design.

During the contribution phase, a portion of income is set aside for use in future years. We have always been told that "pre-tax" deferral is better than "after-tax," but is that really true? By deferring pre-tax, we accept that all distributions at retirement will be taxed as ordinary income.

The next phase is the "accumulation" or "investment" phase. This is when our money grows. We have always been told not to put all of our eggs in one basket during this phase. Truly, investment diversification is important. However, of greater importance is the non-taxable, deferred growth of the money.

The final phase is the "distribution" phase. In this phase, the money is taxed at the time of distribution. This phase is of paramount importance.

income during retirement and is safe from creditors of the sponsoring organization. The important thing to remember is, "It's not how much you make, but how much you keep." The distribution phase could be the most important phase of your retirement planning. No one knows what income tax rates will be when you retire (Chart III). Going from a 35 percent tax bracket to a 50 percent tax bracket reduces your retirement income by approximately 25 percent. The ISOP® distributes income at retirement without taxation, thus taking the future tax risk out of the equation. Based on the history of U.S. top income tax rates (Chart III), how likely is it they will continue to decrease?

The ISOP® provides the power of pre-tax savings without the contribution limits or age restrictions of qualified plans. To get the maximum value from retirement accumulation, participants should first maximize their pre-tax contributions into their 403(b), 457(b), and 401(k) plans.

Chart I

Contribution Phase	Accumulation Phase	Distribution Phase
• Pre-tax, after-tax, or both? • Qualified Plans have limits. • We are told that pre-tax is better, but this is not always the case. Real estate investing, for example, is done with after-tax dollars and accumulates tax-deferred. • The ISOP® is designed for participant control and creditor protection.	• ROI (Return on Investment) directly impacts retirement lifestyle. • Modern Portfolio Theory states that diversification is key. • Mutual fund investing is a common form of diversifying. • Objective is tax-deferred accumulation.	• Typically three buckets are available during distribution. – Taxable as regular income – Taxable as capital gains – Non-taxable • Just as you diversify during accumulation, you should diversify during distribution. • The ISOP® is designed to payout in a tax-advantaged manner.

What is the ISOP®?

What sets the ISOP® apart from traditional deferred compensation plans as well as qualified plans is the way participants are taxed (see Chart II). The participant makes contributions with after-tax dollars, but accumulates all earnings on the pre-tax amount. When money is withdrawn from the ISOP®, it comes out non-taxable.

Why the ISOP®?

The ISOP® was designed according to the premise that some percentage of your retirement savings should be in a vehicle that can generate non-taxable

How the ISOP® Works

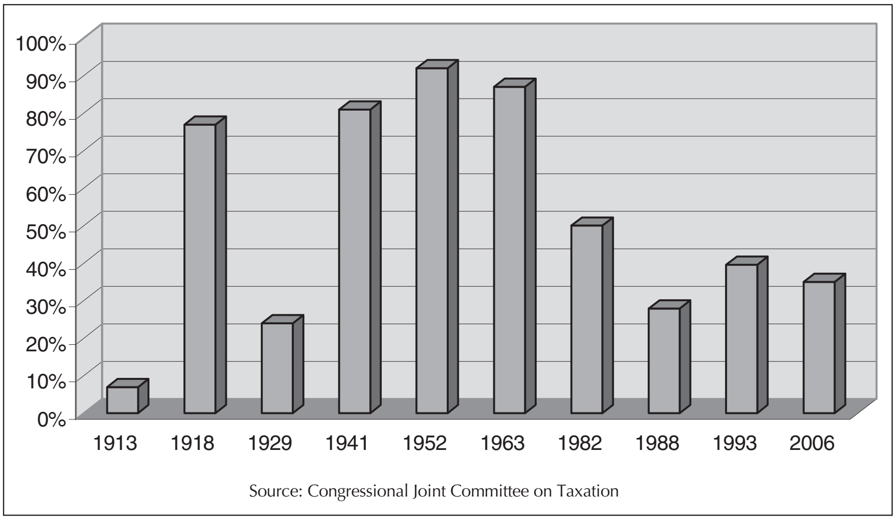
The ISOP® achieves its tax-advantaged status as a result of being powered by an institutionally priced variable universal life (VUL) insurance policy not available to individuals. "Institutionally priced" means that the policy's charges are significantly lower than would be the case in comparable retail VUL products. For example, the policy has 100 percent cash value (they are invested in mutual fund investments called sub-accounts) in year one and has no surrender charges. What also makes the ISOP® unique as a wealth accumulation plan is the policy's loan feature, which allows a participant to

Chart II

	ISOP®	Traditional Deferred Compensation
Contributions	• Made after-tax • No current tax benefit	• Made pre-tax; no tax paid on contribution amount
Accumulation	• Tax-deferred earnings on *full pre-tax* deferral	• Tax-deferred earnings on pre-tax deferral
Withdrawals	• Received without income tax*	• Taxed as ordinary income

* As its funding vehicle, the ISOP® uses an institutionally designed variable universal life insurance policy that has favorable tax treatment if withdrawals are made up to basis and through policy loan.

Chart III History of US Top Income Tax Rates



take a non-recourse, "tax replacement" policy loan to make up for the taxes paid on the amount of any after-tax deposit.

Here is an example of the mechanics of the ISOP®. Let us say you were to receive a $100,000 bonus as income. You owe approximately $40,000 in taxes, which leaves about $60,000 left to invest. You could elect to invest the money in mutual funds, and assuming you were to earn 8 percent annual return, you would have to pay taxes on some portion of the gain depending on how the money was invested. Therefore, you would pay taxes each year on your gains.

With the ISOP®, you would deposit the $60,000 in your account, and the policy loan feature would increase your balance to $100,000—the pre-tax amount of your bonus. Assuming you were to earn the same 8 percent return, your ISOP® account would accrue the gains on the entire $100,000 with no current taxation. Also, any asset reallocation between sub-accounts is not subject to taxation. Later, you could make non-taxable withdrawals of both principal and interest. In addition, the ISOP® provides the participant with a non-taxable life insurance benefit.

The policy loan to restore the taxes would be deducted from the policy's death benefit, along with the capitalized interest. This would reduce the death benefit somewhat, but the approach still compares favorably with the mutual fund investment example, which does not provide a death benefit.

Conclusion

This article has addressed the applicability of Code Sec.457(f) plans and many of the implications of Code Sec. 409A. The new world of nonqualified plans, including 457(f) plans, is very complex. Tax-exempt entities should move swiftly to ensure that all plans subject to Code Sec. 409A have been identified and that the plans are currently designed to help the organization attract and retain the people that make a difference. Attracting, retaining, and rewarding personnel to non-profit organizations has become more difficult and must be addressed if non-profits are to compete with for-profit businesses. The ISOP® can help level the playing field when it comes to attracting and retaining key talent.

Chart IV