Tax-Exempt Organizations – Executive Retention Programs
How to Prepare for and Mitigate the Loss of a Key Employee

The Issue

Few things are more disruptive for an organization than the loss of a key executive. The definition of a “key” executive depends on who you ask. A regional manager of a retail chain might say their store managers. A CEO of a health care corporation might say their chief marketing officer. The term is subjective and varies by industry, but each company recognizes the contributions that key people make to the organization. They’re easy to identify, because they’re leaders that drive results.

Split dollar is one of the most powerful benefit and retention tools a TEO can utilize. Its value is driven by shifting the special tax treatment of the life insurance asset to the executive while building in an automatic cost recovery feature.
Enterprise risk management dictates the need to insure property and equipment to protect against the possibility of fire, theft, cyber-attacks and natural disasters. Proper risk management should also include insuring against the loss of key personnel. Life insurance is a strong solution to combat this issue. It delivers what was promised precisely when it’s needed the most, during that very difficult time following the loss of a key employee.

Another risk management issue often overlooked, or not fully understood, is losing a key employee to a competitor that’s offering a better compensation package. Sadly, most organizations also delay or never address key gaps in their compensation and benefits package. Unlike death, the risk of losing a key employee to a competitor can be mitigated – and sometimes avoided – through thoughtfully designed and coordinated retention plans.

**The Cost**

Most tax-exempt organizations (TEOs), especially ones that rely on donations or government funding, are under social pressure to control compensation expenses. Compensation information isn’t typically available for private companies; however, TEOs are required to disclose compensation information for key employees on the Form 990 regardless of the organization’s size. Understanding that, deciding to delay or not to implement a plan based on cost and disclosure without comparing it to the cost of losing that executive may be a mistake.

In today’s employment environment, the direct cost to replace a key employee is estimated to be 200% of the annual salary associated with that position. If indirect expenses are also considered, the total cost can easily approach 400%.

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**A New Problem – 2017 Tax Cuts and Jobs Act**

**ORGANIZATIONAL IMPACT**

The 2017 Tax Cuts and Jobs Act (TCJA) created a new 21% excise tax on TEOs for compensation paid to “covered employees” in excess of $1,000,000 or for excess parachute payments. Compensation paid in excess of these limits is no longer exempt from taxation and the organization owes the applicable tax.

Said another way, the TCJA imposes a tax expense of $21,000 for every $100,000 in excess compensation. The new tax rules can create unbudgeted and unanticipated additional cash outlays in three ways.

1. **Annual Excess Compensation**: Applies to compensation in excess of $1,000,000
2. **457(f) Retention and Retirement Plan Vesting & Payment Events**: Applies to compensation in excess of $1,000,000
3. **Severance and Separation Payments**: Applies to payments in excess of 3x the previous 5 years’ average annual compensation

**PARTICIPANT IMPACT**

Due to the tax treatment associated with vested benefits in 457(f) programs, plans are typically structured with lump sum vesting and payments to cover the immediate tax obligations.

In addition to applicable state, local and Medicare taxes, participants in these plans will potentially pay up to 37% in federal tax on the benefit. A significant lump sum benefit payment can potentially push a recipient into the highest tax bracket. Depending on the state of the taxpayer’s residence, taxes due could be in excess of 50%.

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**Direct Costs**
- Screening
- Interviewing
- Acquisition Cost
- On-boarding
- Training

**Direct Costs + Indirect Costs**
- Lost Productivity
- Short-staffing
- Coverage Costs
- Institutional Capital
- Reduced Morale
THE SOLUTION

Properly designed executive programs play an important role in retaining key employees. At the same time, these plans can also mitigate taxes for both the TEO and the employees. Executive programs may also enable your key people to accumulate additional funds for retirement and other important milestones. These plans will increase the value of an organization's overall benefits package.

Make an Investment in Your Key People

Investing in your top talent may appear daunting in the short term. However, by utilizing appropriate financing early, the TEO not only ensures the stability of the program but also instills confidence in the participants that the organization is committed to its key employees. With proper due diligence, detailed analysis and careful modeling, there’s a clear way to define and recover the costs associated with an executive retention plan that’s sure to not only retain, but also attract, the talent you need to make your organization thrive.

Below are a variety of creative executive benefits solutions that provide advantages for both the TEO and the executive.

<table>
<thead>
<tr>
<th>Tax status of contribution</th>
<th>Contribution limits</th>
<th>Vesting</th>
<th>General creditor risk</th>
<th>Additional survivor benefits</th>
<th>Administrative requirements</th>
<th>Fees</th>
<th>Asset growth</th>
<th>Investments</th>
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<tbody>
<tr>
<td>457(b)</td>
<td>457(f)</td>
<td>After-tax Bonus Plan</td>
<td>Loan Regime Split-Dollar</td>
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<td>Pre-tax</td>
<td>After-tax</td>
<td>Loans</td>
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<td>Tax-deferred, then taxable at ordinary income tax rates</td>
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Spotlight on Split Dollar

The excise tax problem has brought increased attention to an old, proven strategy.

Split-dollar plans can be a powerful solution for executive benefits planning for many TEO executives based on a few key factors:

- Historically low long-term interest rates
- Better pricing in insurance contracts
- The power of deferred taxation

The goal: deliver an enhanced, portable life insurance benefit that's cost and tax efficient for both the TEO and the executive.

How it works: The organization provides a loan to the executive, which is used to purchase a cash value life insurance policy the executive owns. The loan must include interest and will be repaid to the TEO through a “split” sharing of the death benefit.

For the organization, a few key features for accounting and reporting are important to consider. For accounting, if properly structured, the loan is a receivable (asset) rather than a benefit liability (expense). For reporting, the compensation/benefit liability on the compensation disclosure schedule of the 990 is repositioned and disclosed on the “Transactions with Interested Parties,” Schedule L, of the 990, which makes for more attractive disclosure optics.

For the employee, taxation is based on loan rules and is not considered income. As the policy owner, the employee can withdraw or borrow from the policy’s cash value on a tax-favored basis for retirement or other needs. The residual death benefit, not used for loan repayment, is paid to the executive's beneficiary income tax free.

SPLIT DOLLAR PLAN MECHANICS

<table>
<thead>
<tr>
<th>Company</th>
<th>Participant</th>
<th>Policy</th>
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<tbody>
<tr>
<td>(Tax-exempt entity)</td>
<td></td>
<td>Policy designed to provide value and repay loan plus interest upon death</td>
</tr>
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</table>

- Company loans premium for an insurance policy
- Employee purchases policy and agrees to repay loan
- Loan repayment via death benefit proceeds satisfies loan

Death Benefit
- Loan Repayment
- Estate Preservation
- Unexpected Expenses

Cash Value
- Retirement Income
In Summary

LOSS — THE PROBLEM AND THE IMPERFECT SOLUTION

Loss of key talent is a problem that all organizations face. TEOs can mitigate the impact of these losses by implementing programs to retain, recruit and reward employees who are critically important to an organization’s future.

The problems for key employees of TEOs and their sponsoring organization are:

1. Compensation paid in excess of $1 million results in a 21% excise tax paid by TEO.
2. TEOs are at a competitive disadvantage in recruiting talent versus for-profit companies that offer equity.
3. Compensation disclosure optics for TEOs limit options and create stress for the organizations and their key employees.
4. Lump-sum payments expose key employees to federal income taxes equal to or exceeding 37% (combined to be greater than 50% in some states).

The probability of losing a key employee to a competitor can be mitigated or even prevented with comprehensive executive benefits planning. Let us help you strategically design a benefits package that will enhance your enterprise risk management objectives.

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