Executive Nonqualified Deferred Compensation Plans for Nonprofit Organizations

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Nonprofit organizations continue to face challenges in attracting and retaining top executives to lead their institutions. As these entities respond to the dynamic economic, legislative and regulatory environment, they have often had to adjust their business models to become more cost efficient in the delivery of services. Organizations have also had to strategize on how best to find and retain the talented individuals who can lead them through these challenging times.

One of the mechanisms nonprofit organizations use to try to attract and retain top executives is by offering executive deferred compensation plans (sometimes referred to as Top Hat plans). These are nonqualified plans intended to supplement the retirement benefits offered through the broad-based retirement programs sponsored by the nonprofit organization. Depending on the ultimate goal of the plan, there are different styles of nonqualified deferred compensation plans to use. There are also a variety of considerations related to plan design that are impacted by laws and regulations to which the organization must pay attention to avoid potentially costly problems in the future.

LIMITATIONS OF QUALIFIED PLANS

Broad-based retirement plans, such as 403(b) and 401(k) plans, are subject to strict rules under the Internal Revenue Code (IRC) and the Employee Retirement Income Security Act (ERISA). These tax rules impose a variety of plan design limitations that restrict the level of benefit that can be provided to higher-paid employees. For example, the level of annual compensation eligible to be taken into account in determining annual contributions or benefits is $265,000 in 2016.

Additionally, unless the organization has the resources and chooses to fund a so-called “safe harbor plan”, the nondiscrimination requirements also limit the level of defined contribution plan benefits that can be provided to highly compensated employees relative to non-highly compensated employees with respect to both basic and matching contributions. Since the nonprofit organization is unable to provide contributions on the entire compensation of the executive, and may have to limit the contribution on that lesser compensation, the executive can end up with a significant shortfall in terms of replacement income for retirement.

NONQUALIFIED PLANS

There are three main types of nonqualified plans: a restoration plan, a supplemental executive retirement plan (SERP), and a voluntary nonqualified deferred compensation plan. A restoration plan focuses on replacing the benefits that get “lost” for executives due to IRC limitations. A SERP may seek to accomplish this, as well as other objectives, such as achieving a higher level of replacement income and/or replacing income from other types of compensation not recognized in a qualified plan. These plans may also be used to try to tie the executive to the organization for an extended period of time. In addition, the executive may elect to defer compensation into a voluntary nonqualified deferred compensation plan to save even more for retirement and defer taxation on compensation.

CONCERNS WITH EXECUTIVE NONQUALIFIED DEFERRED COMPENSATION PLANS

While nonqualified plans can be helpful for achieving retirement objectives for executives, there are some issues that can arise that may prevent the executive from receiving some or all of the benefits. These events include: failure to comply with applicable law, bankruptcy or insolvency of the institution, and/or a change in control of the organization.

FAILED COMPLIANCE

One of the important benefits of an executive deferred compensation plan is that the executive...
can delay the taxation to be paid on this additional income, both on the contributions that the institution makes, as well as income that the executive voluntarily defers into the plan. Thus, the investment earnings on the executive’s account under the plan is tax-deferred until distribution. With the expectation that the executive will be in a lower tax bracket after retiring, delaying the taxation on this compensation should enable the executive to pay a lower taxation rate on the benefits once they are received.

Prior to the American Jobs Creation Act of 2004 (AJCA), executive compensation benefits were generally held in vehicles that were beyond the reach of creditors. IRC Section 409A was added as part of the AJCA to impose requirements on nonqualified deferred compensation plans that had not existed in the past. Basically, Section 409A imposes rules on initial deferral elections, limits distribution events and constrains an executive’s ability to accelerate or further defer payment. In addition, there are tax rules applicable to tax-exempt organizations that make it more difficult to provide deferred compensation to executives.

IRC Section 457 provides rules on two types of deferred compensation plans. “Eligible” deferred compensation plans that meet the requirements under IRC Section 457(b), (similar to the rules under 403(b) and 401(k)), allow for annual contributions up to a certain dollar limit ($18,000 in 2016). Importantly, an executive’s account balance under a 457(b) plan can be vested and is not subject to the onerous 409A rules. Deferred compensation plans that are not eligible under 457(b) are considered “ineligible” plans and are governed by IRC section 457(f). 457(f) requires that the deferred compensation be subject to a “substantial risk of forfeiture” in order to receive the tax-favored status. This means that the plan benefits cannot be vested, but should be conditioned upon the future performance of substantial services by the executive. If there is no risk of forfeiture, benefits under the plan will become subject to taxation immediately.

Furthermore, to qualify as a Top Hat plan and be exempt from most of ERISA’s requirements, (including the vesting requirement), the benefit must be an “unfunded” promise to pay the executive, and the plan may only cover a select group of management or highly compensated employees. If assets are set aside in a trust to pay these deferred benefits, the assets must be subject to the claims of creditors of the organization (i.e. in the event of bankruptcy) to be considered “unfunded.” If the plan is subject to 409A and does not meet these requirements, in addition, a 20% tax penalty will apply to the executive.

**BANKRUPTCY**

An issue related to the substantial risk of forfeiture requirement under 457(f) occurs with the possibility that the nonprofit entity fails on difficult financial times. If the nonprofit organization were to become insolvent or file for bankruptcy, any assets held in trust to pay the deferred compensation to the executives would need to be subject to the claims of creditors of the organization, and thus, potentially forfeited. Naturally, this would be a cause for concern for the executive because it would apply to both the contributions made by the nonprofit organization, as well as the compensation that the executive deferred into an eligible 457(b) plan.

One way to mitigate this risk is to hold the assets for the deferred compensation plan in a rabbi trust. As long as the trust imposes substantial limitations on the ability to access the assets, (the IRS has a model rabbi trust document that provides a safe harbor), the trust will be considered “unfunded” and will not be subject to ERISA’s requirements.

**CHANGE IN CONTROL**

A change in control of the organization could also jeopardize the executive’s ability to collect these deferred benefits. Management of the acquiring entity could decide not to honor the arrangements put in place by the previous administration. Nonprofit organizations should consider including successor liability provisions in the plan design to protect the executives from the potential problems with a change in control.

**OTHER CHALLENGES**

Even if the plan sponsor and the executives prepare for all of the above possible contingencies, there is always a chance that someone will sue the organization over the plan. Current or former employees may try to challenge the plan believing that they should be (or should have been) eligible, or question whether the eligible individuals form a Top Hat group (a challenge often presented by the attorney of a former employee seeking to receive additional compensation).

The problem for the executive deferred compensation plan under either of these lawsuit scenarios is that there is no formal guidance from
the Department of Labor as to what constitutes a Top Hat group. The general premise is that the employees eligible for nonqualified executive deferred compensation plans must include only a select group of upper management or highly compensated employees, or both. But there may be additional factors used to determine whether it is to be considered a Top Hat group. These may include:

- Percentage of all employees included
- Relative compensation of included personnel
- How the group membership was determined, i.e., by employee title, by Board appointment
- Level of management responsibility of group members

Evaluating these factors should provide the plan sponsor with a good sense of which employee can be eligible to participate in the plan. However, if there are any employees included in the group that should not have been eligible, the Top Hat group fails the test, and thus jeopardizes the status of the executive deferred compensation plan as exempt from much of ERISA’s requirements.

CONCLUSION
Nonqualified executive compensation plans can be instrumental in helping nonprofit organizations attract and retain top leadership talent, enabling their executives to have a better chance of reaching their retirement replacement income goals. Given the potential pitfalls and the uncertainty surrounding the Top Hat status, nonprofit institutions should document how they determine which employees would be eligible for these plans and be able to demonstrate the steps they undertook to properly restrict eligibility to the appropriate group of employees. Plan sponsors may also wish to use an outside entity to help make this assessment in order to ensure the analysis was independent and impartial should it ever be questioned in the future.