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## Deferred Compensation for Tax-Exempt and Governmental Executives

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One of the most significant challenges in attracting talented executives in the tax-exempt and governmental entity (TE/GE) sectors is designing a compensation structure that accomplishes three goals: rewards acknowledged "superstars" in the field; incentivizes performance commensurate with the long-term goals of the entity; and sufficiently protects the entity against employees' being lured away by other employers.

TE/GEs are continuously looking to creative compensation mechanisms that duplicate the benefits of equity compensation available from corporate employers. (Look no further than the recently revised IRS Form 990 Schedule J reporting requirements for tax-exempt entities, which identify 69 separate categories of compensation.) While there are numerous compensatory benefits available to TE/GE executives, the form that most closely approximates the tangible and intangible benefits of equity compensation is "deferred compensation." However, deferred compensation for TE/GE executives must comply, in both operation and documentation, with a complex and interrelated scheme of federal tax requirements.

Typically, the discussion of deferred compensation for executives revolves around Section 409A of the Internal Revenue Code. In sum, Section 409A addresses the deferral, distribution and taxation of deferred compensation. Section 409A is explained by more than 400 pages of IRS regulations, two correction programs and numerous IRS directives.

In addition to Section 409A, TE/GEs must also comply with IRC Section 457(f), which specifically applies to deferred compensation of tax exempt and governmental entities. When designing an incentive-based, tax-efficient compensation package, the TE/GE must coordinate the interaction of these two sections, the rules of traditional qualified retirement plans (such as IRC Section 401(k), 403(b) and 457(b) plans) and, with respect to tax-exempt employers, the Employee Retirement Income Security Act of 1974 (ERISA).

Consider the following example: Weathers University, a private institution, wants to hire a new executive vice president (EVP) for its teaching hospital. A significant portion of the EVP's duties will be attracting research dollars. WU's president has promised to find a "superstar" to fill the position. The new EVP is also expected to be integral to the creation of a stand-alone cancer center funded by the donation of a major WU alum. Given the stakes, the EVP position will be a seven-figure hire. It is crucial, in light of increased budgetary constraints and the public nature of the position, that the EVP's compensation package be tied to the achievement of tangible goals.

Thus, in designing the compensation scheme, WU has three basic objectives:

- Assembling a total package that will attract a leader in the field.
- Imposing a set of matrices that adequately reward the executive for attainment of reasonable near-term fundraising goals (within 18 months of hire).
- Setting a target compensation package for successful work toward the long-term objective of constructing the new cancer facility.

WU's potential EVP has his own considerations. First is a desire to bring along other highly skilled colleagues as a group. Second, the candidate seeks a bonus reward system that provides a significant upside in the form of a single-sum payment upon satisfaction of certain fundraising targets. Lastly, he will require a compensation package to be structured such that it satisfies certain income replacement objectives upon retirement in a tax efficient manner.

### Qualified Plans

Given the interests of both WU and the potential EVP, WU should first take advantage of the various "qualified" retirement and deferred compensation vehicles available to tax-exempt entities. On the qualified plan side, an executive may participate in a 401(k) plan and a 457(b) plan concurrently. The executive and his team could possibly make elective deferral contributions to both plans at the maximum limit for each (currently $16,500) for a total of $33,000 in elective deferral contributions. There are also "catch-up" opportunities available under the 401(k) plan or the 457(b) plan for employees age 50 and older.

A 401(k) plan is a broad-based plan that typically covers the entire full-time workforce and is subject to ERISA. Therefore, it must satisfy various non-discrimination rules that could limit the total deferred contributions that may be made by an executive and the total matching contribution that may be made by the employer.

In contrast, a 457(b) plan of a tax-exempt entity, by definition, must be restricted to "a select group of management or highly compensated employees." Such a plan is commonly referred to as a "top hat" plan and is exempt from the eligibility, vesting and the non-discrimination rules of ERISA and the IRC. However, any assets held to satisfy benefit obligations of the 457(b) must be made available to creditors of the entity in the event of its bankruptcy or insolvency.

Typically, the amounts contributed to the 457(b) plan, if made by the executive, are immediately vested. WU could, however, elect to make the 457(b) contributions on behalf of the EVP and his team. The advantage is that WU could impose a vesting schedule that would aid in retention of the executive and could be tied into the midterm or long-term objectives of the entity. (Note, however, that every dollar contributed by WU will count toward the 457(b) dollar limitation in the year in which it vests, not the year of contribution.)

The 457(b) and 401(k) vehicles discussed are very useful for upper management, but may not satisfy the compensation objectives of the "C-suite" executive or the superstar in a chosen field. For this individual, the deferred compensation targets will require compliance with IRC Sections 409A and 457(f).

### Nonqualified Deferred Compensation

Despite its complexity, Section 409A is designed to address three fairly straightforward objectives:

- The appropriate deferral of compensation.

- The vesting of such compensation (which converts it to deferred compensation).
- The distribution of deferred compensation.

If all of the conditions of Section 409A are satisfied, the deferred compensation is taxed only upon distribution. Thus, if the entire deferred compensation account meets Section 409A and is distributed in a single sum, it is taxed in the year of distribution. Alternatively, if it is distributed in 10 annual installments, each installment is taxed at the time of distribution.

As is the case with Section 409A, there are no dollar limitations on the amounts that may be allocated under a Section 457(f) program. Section 457(f) also is exempt from most compliance requirements of ERISA. The key distinction between Sections 409A and 457(f) is that Section 457(f) taxes compensation in the year in which it is no longer subject to a "substantial risk of forfeiture" — i.e., the date it vests — even if the compensation is to be distributed in a later year. Therefore, the challenge in structuring a deferred compensation package for the TE/GE executive is to match the vesting and receipt of such compensation with the entity's short-term and long-term objectives.

It is crucial that the TE/GE communicate to the executive that the promised compensation will be subject to certain real risks of forfeiture that are tied to the entity's objectives. In the example, the EVP's annual bonus payment could be "earned" upon satisfaction of annual objectives and allocated to an account. (The allocation may held in a "rabbi trust" to assure that it is not used for purposes other than payments to the executive.)

The allocations and credited earnings would not vest to the EVP, however, until the third anniversary of employment. At that time, it would become taxable to the EVP and available for distribution. By using an annual accrual but delayed vesting, WU establishes an appropriate incentive for the EVP's performance, while adding some degree of retention protection. The executive should be advised that amounts under a 457(f) program are subject to the claims of creditors of the TE/GE and, upon vesting, will be reportable on the Form 990 (if the entity is required to file). Nonetheless, if these objectives of the TE/GE are satisfied, and the total compensation is within the range of "reasonable compensation" (with respect to tax-exempt employers) then the deferred compensation mechanism has achieved its goal.

The deferred compensation analysis is almost identical with respect to public sector employers (also subject to IRC Sections 409A and 457(f)). In fact, the most significant differences relate to qualified plans in that most governmental entities cannot sponsor 401(k) plans; and governmental 457(b) plans must be funded via a trust mechanism. Accordingly, the same type of coordination of entity objectives and compensation targets would apply to the deferred compensation package of a public utility CEO, school district superintendent or the head football coach of State U.

TE/GEs evaluating or currently maintaining deferred compensation programs should be mindful of the increased scrutiny on overall executive compensation. In May 2010, the IRS released the results of its higher education survey in which it compiled executive compensation data on 344 colleges and universities. This survey, following a similar survey of more than 500 nonprofit hospitals completed in 2009, is a clear sign of the IRS's intent to focus on executive compensation in the tax-exempt sector.

That focus, given the wealth of data now reportable on the revised Form 990s, will be intensified. Deferred compensation offers a proven method of attracting and retaining top tier executives. However, it is critical that the TE/GE and the executive evaluate the intersection of IRC Sections 409A and 457(f) in the negotiation and documentation of the employment relationship.

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