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Non-Profits Can Be Profitable, Too

Non-profit organizations can use non-qualified benefit (NQ) plans to attract, retain, and reward key executives just like for-profit businesses. While Internal Revenue Code (IRC) Section 457 may pose an added hurdle to utilizing these plans in a non-profit organization, it can be overcome successfully.

Case Study

Charlene is the new executive director of Northeast Estuary Sanctity Trust (NEST), a private not-for-profit foundation devoted to wildlife protection and land conservation in the northeast United States. Charlene is 48 years old with an extensive background in the area of environmental protection and strong fundraising skills. The board of directors believes that Charlene is the ideal person to lead the foundation into the future and hopes she will remain in the position for at least ten years, if not longer. In addition to her salary and other regular benefits, the board would like to implement a non-qualified retirement benefit plan for Charlene to provide her incentive to remain with the foundation and reward her for a job well done.

If NEST were a for-profit company (NEST FP), then implementing a NQ plan for Charlene would be simple and straightforward. NEST FP could promise to pay her income for a specified number of years upon her retirement, accrue the benefit during her pre-retirement years (whether deferring earned income or simply accruing additional benefits), and deduct the benefit payments for tax purposes when the benefit was paid. NEST FP could "informally" finance the future benefit by setting aside money during Charlene's working years that remains a corporate asset subject to the risk of the general creditors. Life insurance would be a particularly attractive financing vehicle to NEST FP because the policy cash surrender value grows tax-deferred, and the corporation receives the death proceeds income-tax-free. Charlene would be taxed on the benefit in the year it is paid.

However, as an organization exempt from tax under Section 501 of the IRC, NEST must consider IRC Section 457 when establishing a non-qualified benefit plan for Charlene. Section 457 applies to virtually all non-qualified plans maintained by state or local governments or tax-exempt entities.

Why are there different rules for non-profit organizations and for-profit businesses?

(With some exceptions, a church or qualified church-controlled organization is not subject to Section 457, nor are bona fide vacation leave, sick leave, compensatory time, severance pay, disability pay, or death benefit plans.)

The history of the Revenue Act of 1978 provides the answer. A for-profit business incurs a cost for allowing employees to defer income outside of a qualified plan. The cost is the deferral of the corresponding tax deduction that the for-profit business could have taken if it had paid the income to the employee. This direct cost to the employer is sufficient incentive for the employer to limit the amount of income deferred by its employees outside of qualified plans to reasonable levels. On the other hand, non-profits face no corresponding cost since, being tax-exempt, they have no need for deductions. The limitations upon Section 457(b) eligible plans and the risk of forfeiture of Section 457(f) ineligible plans were created to impose the same sort of reasonable boundaries faced by for-profits.

NEST can comply with Section 457 in one of two ways: design the plan as 457(b) eligible or as 457(f) ineligible. There are benefits and limitations to each approach as summarized in Chart 1.

Chart 1
Section 457 Benefits and Limitations for Non-Profit Organizations

457(b) Eligible Plans	457(f) Ineligible Plans
Applicable annual dollar amounts for true income deferrals or benefit accruals limited to the following: $11,000 in 2002 $12,000 in 2003 $13,000 in 2004 $14,000 in 2005 $15,000 in 2006 *After 2006 amounts are indexed for COLA*	No limitation on dollar amounts for contributions.
Participants taxed when benefits are paid or made available. No substantial risk of forfeiture required	Participants taxed when benefits are paid, made available, or no longer subject to substantial risk of forfeiture
Distributions not permitted before the earlier of (a) calendar year participant reached age 70.5, (b) separation from service, or (c) unforeseeable emergency	Not subject to distribution limitations

As is pparent from Chart 1, a 457(b) eligible plan faces many of the limitations of a qualified plan. The annual amount NEST could accrue for Charlene's benefit would be limited by the dollar values shown. The annual dollar limits are the same as for qualified plans. After 2006 the annual dollar amount limits will be indexed for cost of living adjustments (COLA). The annual dollar limits severely restrict the amount of benefit that can be provided to Charlene during retirement through a 457(b) eligible plan.

For example, let's compare NEST's annual liability accrual, using one of the IRS approved accounting methods, to provide Charlene a retirement benefit at age 65 from each of the two approaches. For purposes of this discussion, assume that the NEST plan (1) is either exempt from or meets the Top Hat plan criteria to avoid falling under ERISA and (2) is unfunded or informally funded, meaning that the plan assets are subject to the founda-tion's general creditors. (A Top Hat plan is an excess benefit plan for a select group of management or highly compensated *executives.*)

Under a 457(b) eligible plan NEST would be able to provide Char-lene an annual retirement benefit for 15 years of only $40,000. This is because NEST's annual liability accrual amount would bump up against the dollar limits imposed by 457(b). If Charlene's current salary of $150,000 increases three percent annually, then her average final three year salary would be $233,763. Thus, $40,000 represents only 17 percent of Charlene's average final three year salary.

Under a 457(f) ineligible plan, NEST would be able to promise Charlene an annual retirement benefit for 15 years of any reasonable amount. For illustration purposes, suppose that NEST wants to provide Charlene an annual benefit equal to 60 percent of her average final three years' salary, a benefit equal to $140,258, more than 3.5 times the benefit under the 457(b) eligible plan. *Which of the two benefits would Charlene find more attractive?*

NEST's annual accrual liabilities for the two benefits are shown in Chart 2, disregarding the issue of indexing the 457(b) eligible plan accruals for years 2007 and after.

Using 457(b) Eligible Versus 457(f) Ineligible. Which plan design should NEST choose for Charlene's non-qualified benefit plan: 457(b) eligible or 457(f) ineligible? The 457(b) eligible approach provides a much lower benefit, but the 457(f) ineligible approach contains a substantial risk of forfeiture provision. For the vast majority of plans, a 457(f) ineligible would be the preferred approach so long as the contractual arrangement includes the appropriate language to deal effectively with the substantial risk of forfeiture issue.

It is critical in this analysis to understand the issue of "substantial risk of forfeiture." It represents the most substantive difference between a 457(b) eligible plan and a 457(f) ineligible plan. This concept means that Charlene's receipt of any benefit under the 457(f) ineligible plan is conditional, based on her performance of substantial future services to the foundation, including during her retirement. In any year that Charlene is no longer expected to perform substantial services to the foundation, either pre-retirement or post-retirement, and the benefits are not forfeited, then the full amount of the remaining benefit is included in her taxable income. If Charlene leaves NEST before her benefits vest, she forfeits any unpaid benefits.

In order to continue deferring taxation on the retirement benefit until it is actually paid to Charlene, the period of substantial risk of forfeiture must also be extended. To accomplish this, NEST and Charlene can include a provision that requires her to be available for consulting services to NEST through the benefit payment period. If Charlene fails to fulfill her obligations under this provision, she will forfeit any unpaid benefits. Some agreements also include a non-compete provision, buttressing the risk of forfeiture.

The substantial risk of forfeiture issue is a heavy burden to Charlene. She will not want to defer any of her own income in a 457(f) ineligible plan because of the real risk of losing it if she leaves NEST. It is for this reason that true income deferral plans are unattractive when the 457(f) ineligible plan approach is used. The use of a SERP (supplemental executive retirement plan) is much more attractive because the risk to Charlene is the loss of money the foundation promised, not income she would have received but elected to defer. The risk of forfeiture is a very strong incentive (golden handcuffs) for Charlene to remain at NEST, which is very attractive to NEST. It also means that Charlene is expected to be available to perform substantial services to the foundation during her retirement years, at least until all retirement benefits are paid.

Life insurance remains a suitable vehicle to informally fund a non-qualified benefit plan for a non-profit organization. The tax advantages that life insurance offers, such as income-tax free buildup of cash value and income tax-free death proceeds, are not as significant to a non-profit organization. Even so, life insurance is valuable because in the event of Charlene's death, it provides instant cash to the non-profit to pay all plan benefits and recover plan costs.

Chart 2
Annual Accrual Liabilities

Age	Year	457(b) Eligible Plan Annual Liability Accrual	457(b) Eligible Plan Annual Dollar Limit	457(f) Ineligible Plan Annual Liability Accrual
48	2002	10,956	11,000	38,417
49	2003	11,833	12,000	41,490
50	2004	12,779	13,000	44,809
51	2005	13,801	14,000	58,394
52	2006	14,906	15,000	52,266
53	2007	16,098		56,447
54	2008	17,386		60,963
55	2009	18,777		65,840
56	2010	20,279		71,107
57	2011	21,901		76,795
58	2012	23,653		82,939
59	2013	25,546		89,574
60	2014	27,589		96,740
61	2015	29,796		104,479
62	2016	32,180		112,838
63	2017	34,754		121,865
64	2018	37,535		131,614

Summary

Non-profit organizations can offer non-qualified benefit plans for key executives just like for-profit businesses. The difficulty introduced by Internal Revenue Code Section 457 can be addressed successfully, and unless non-profit clients want to completely avoid the risk of forfeiture issue or provide a comparatively small retirement benefit to the executive, then a 457(f) ineligible plan is recommended. When using a 457(f) ineligible plan, a SERP approach is more attractive than a true salary deferral plan because of the real risk of forfeiture. The use of a consulting provision permits the executive to defer taxation on unpaid benefits during retirement, so long as the expectation of providing services to the organization is real and significant.

Life insurance remains a suitable vehicle for informally funding a non-qualified benefit plan. Don't overlook the sales opportunities that non-profit organizations can provide. ❑